RESPIRONICS INC
Form 10-K
September 13, 2006
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# UNITED STATES

# SECURITIES AND EXCHANGE COMMISSION

**WASHINGTON, D. C. 20549**

# FORM 10-K

**(Mark One)**

**x Annual Report pursuant to section 13 or 15(d) of the Securities Exchange Act of 1934**
**For the fiscal year ended June 30, 2006**

**or**

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

**Commission File No. 000-16723**

# RESPIRONICS, INC.

**(Exact name of registrant as specified in its charter)**

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

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

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

| Title of each class | Name of each exchange on which registered |
|---|---|
| **Common Stock, par value $.01 per share** | **The NASDAQ Stock Market** |

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

**(Title of Class)**

**None**

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

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

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

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

As of December 31, 2005, the aggregate market value of the registrant s voting and non-voting common equity held by non-affiliates computed by reference to the price at which the common equity was last sold, or the average bid and asked price of such common equity, as of the last business day of the registrant s most recently completed second fiscal quarter was approximately $2,628,298,000. (All directors, executive officers, and 10% shareholders of the registrant are considered affiliates).

As of August 31, 2006, there were 79,869,297 shares of Common Stock of the registrant outstanding, of which 6,990,315 were held in treasury.

Documents incorporated by reference: Portions of the Proxy Statement for the registrant s Annual Meeting of Shareholders to be held on November 14, 2006 are incorporated by reference into Part III of this Annual Report on Form 10-K.

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PART I

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

The statements contained in this Annual Report on Form 10-K, including those contained in Item 1 Business and Item 7 Management s Discussion and Analysis of Results of Operations and Financial Condition, and statements incorporated by reference in this Form 10-K from the 2006 Annual Report to Shareholders, along with statements in other reports filed with the Securities and Exchange Commission, external documents and oral presentations which are not historical are forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21B of the Securities Exchange Act of 1934, as amended. These forward-looking statements represent the Company s present expectations or beliefs concerning future events. The Company cautions that such statements are qualified by important factors that could cause actual results to differ materially from the expected results included in the forward-looking statements. Those factors include, but are not limited to, the following: developments in the healthcare industry; the success of the Company s marketing, sales, and promotion programs; future sales, acceptance and quality of the Company s products and programs; the timing and success of new product introductions; new product development; anticipated cost savings; U.S. Food and Drug Administration (FDA) and other regulatory requirements; enforcement actions, product recalls or related field actions; future results from acquisitions and strategic investments; growth rates in foreign markets; regulations and other factors affecting operations and sales outside the United States; foreign currency fluctuations; the effects of a major earthquake, cyber-attack or other catastrophic event that results in the destruction or disruption of any critical business or information technology systems; customer consolidation and concentration; increasing price competition and other competitive factors in the manufacture, distribution, and sale of products; interest rate fluctuations; expiration of intellectual property rights; intellectual property and related litigation; other litigation; future levels of earnings and revenues; the number of equity awards granted to employees and changes in the Company s stock price; and third party reimbursement; all of which are subject to change.

**Item 1. Business**

Respironics, Inc. was incorporated in Delaware in 1984. Its executive offices are located at 1010 Murry Ridge Lane, Murrysville, PA 15668-8525. Unless the context indicates otherwise, reference in this Annual Report to the Company or Respironics refers to Respironics, Inc. and its domestic and foreign subsidiaries. Unless the context indicates otherwise, reference in this Annual Report to fiscal year refers to the twelve-month period ending on June 30 of the year indicated.

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

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

**General**

Respironics is a leading provider of innovative solutions for the global sleep and respiratory markets. Respironics designs, develops, manufactures and markets medical devices used primarily for the treatment of patients suffering from sleep and respiratory disorders. The Company s products are designed to reduce costs while improving the effectiveness of patient care and are used primarily in homes, hospitals, alternative care facilities and emergency medical settings. The Company s primary product lines are:

(i) Sleep and Home Respiratory products:

a. Sleep Disordered Breathing The sleep market is one of the cornerstones of Respironics business strategy. Recognized as a global leader and innovator in the sleep-disordered breathing marketplace, Respironics goal is to leverage its core expertise in treating Obstructive Sleep Apnea (OSA) to develop innovative solutions for the diagnosis, treatment and monitoring of other sleep disorders. OSA is a serious disorder characterized by the repeated cessation of breathing during sleep. The Company s sleep therapy products are designed to encourage patients acceptance of OSA therapy through increased comfort. The end result is improved sleep and, ultimately, improved quality of life. Sleep therapy products include continuous positive airway

pressure (CPAP) devices and bi-level positive airway pressure electro-mechanical devices (and related patient interfaces and accessories) used in the home for the treatment of OSA. The Company also offers a wide range of technologically advanced clinical products for use in sleep laboratories that are used to diagnose sleep disorders.

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b. Home Respiratory Care Respironics Home Respiratory Care business is expanding the Company s solutions for patients who suffer from chronic respiratory diseases. With a broad range of oxygen, ventilation, and monitoring products, Home Respiratory Care offers an array of solutions to help clinicians manage respiratory diseases in a transitional care or home environment. Home Respiratory Care is dedicated to improving today s respiratory technologies, while leading research and development of emerging therapies to assist homecare providers and healthcare professionals in addressing patients needs. Home Respiratory Care products include (a) noninvasive ventilation products that provide positive airway pressure by mask to supplement the patient s own breathing; (b) portable life support ventilators used in the home on patients requiring continuous support; (c) and home oxygen delivery products and; (d) oximetry products

c. Sleep Well Ventures Sleep Well Ventures moves Respironics beyond its core OSA business into the broader sleep market, which encompasses the millions of people who suffer from undiagnosed and untreated sleep and sleep-related movement disorders such as insomnia, circadian rhythm disorders, or restless legs syndrome. Sleep Well Ventures also works to identify and provide solutions for millions of problem sleepers who may not have a specific sleep disorder like chronic snorers or people who have difficulty falling asleep only occasionally. Through products like Actiwatch, a device designed to monitor sleep/wake patterns over time and help assess multiple sleep disorders, Sleep Well Ventures seeks to offer sleep professionals, clinicians and their patients solutions that help to improve quality of life through improving the patients quality sleep.

(ii) Hospital Products:

a. Critical Care Respironics Critical Care business offers a unique platform for managing respiratory patients in a variety of medical environments. Through its Total Ventilation Solutions program, Critical Care gives healthcare providers a diverse and innovative portfolio of invasive and noninvasive ventilators; patient masks; accessories and patient monitoring technologies to help treat, monitor and manage respiratory-impaired patients throughout their diseases. Total Ventilation Solutions comprehensive offerings are designed to provide patients with the best care available while focusing on economical and efficient treatment solutions for healthcare providers. From prehospital admission to long-term acute treatment, Respironics leverages its core expertise and leadership in noninvasive ventilation to assist caregivers in avoiding intubation whenever possible, seeking to reduce the patient s risk of infection and to shorten the length of hospitalization. Critical Care offers therapeutic devices that assist or control a patient s ventilation. These include bi-level noninvasive ventilation products and critical care ventilation products that can deliver both noninvasive and invasive ventilation and cardiorespiratory monitoring products that provide information about a patient s condition, including the effectiveness of ventilation. All of these products are used in hospital or institutional settings.

b. Respiratory Drug Delivery Reflecting its commitment to emerging market needs and providing valued solutions for patients, clinicians and healthcare providers, Respironics is expanding its presence in the respiratory market space through its Respiratory Drug Delivery business. The Company is exploring enhanced methods of delivering drugs via the respiratory pathway to help treat chronic obstructive pulmonary disease, asthma, pulmonary arterial hypertension, cystic fibrosis and conditions beyond respiratory ailments that would benefit from direct, aerosol delivery methods. Respironics unique proprietary technology Adaptive Aerosol Delivery is being integrated into products released in both the European and U.S. markets and offers potential for effective and reliable patient treatment.

c. Children s Medical Ventures Children s Medical Ventures focuses on improving developmental care outcomes for some of the smallest and most fragile patients. Children s Medical Ventures is a leading provider of developmentally supportive products for premature babies and ill infants in the hospital or home. Children s Medical Ventures also offers apnea monitors and recorders, state-of-the-art diagnostic and treatment tools for jaundice, and a line of specialty products designed to enhance infant growth and development. The business promotes education and hands-on programs for neonatal nurses, and works with parents and caregivers to understand the unique requirements of premature and ill infants. Products and programs are developed to meet the needs of this dynamic market. The business helps extend the Company s reach in hospital Neonatal Intensive Care Units (NICUs).

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

With an appreciation for the diversity of the global markets it serves, Respironics is committed to a deep understanding of each country s distinctive business environment. International growth and expansion are key components of Respironics strategic plan. Targeted international acquisitions, investments in the Company s international sales and marketing infrastructure, and strong distribution channels have increased Respironics presence in the global sleep and respiratory markets. As of June 30, 2006, Respironics maintains a country specific infrastructure in Germany, France, the United Kingdom (UK), Italy, Switzerland, Japan and China with expansion initiatives in place to increase this direct presence even further.

**Recent Acquisitions**

Fiscal Year Ended June 30, 2006

**OxyTec** On April 21, 2006, the Company purchased 100% of the outstanding stock of OxyTec Medical Corporation (OxyTec) for a cash purchase price of $10,400,000 (including transaction costs), with provisions for up to $30,000,000 of additional payments to be made based on the acquired company s operating performance in future years. OxyTec, located in Anaheim Hills, California, developed an innovative portable oxygen concentrator that has the potential to provide ambulatory oxygen patients greater freedom to be mobile while reducing homecare providers costs associated with the delivery of oxygen to these patients.

**Omni Therm** On May 15, 2006, the Company purchased certain assets and liabilities of Omni Therm, Inc. (Omni Therm) for a cash purchase price of $2,510,000 (including transaction costs). Omni Therm, located in St. Louis, Missouri, is an original equipment manufacturer, supplier, and wholesaler of infant heel warmers, infant warming mattresses, and hospital thermometer products. Prior to the acquisition, Omni Therm was the Company s supplier of these products through Children s Medical Ventures.

**Other** On October 6, 2005, Respironics acquired an oxygen generation technology company. The acquired technology has the potential to be used as a basis for a cost effective oxygen generation device. The total cash purchase price approximated $8,400,000 (including transaction costs), with provisions for uncapped additional payments to be made based on the acquired company s operating performance in future years through 2010.

The results of operations of these acquired companies are included in the Company s Consolidated Statement of Operations beginning on their respective acquisition dates.

The acquisitions did not have a material impact to the Company s financial condition or results of operations, individually or in the aggregate, during the year ended June 30, 2006.

Fiscal Year Ended June 30, 2005

**Mini-Mitter** On April 1, 2005, the Company acquired 100% of the outstanding shares of Mini-Mitter Company, Inc. (Mini-Mitter). The base cash purchase price (including $500,000 scheduled to be paid after a three-year retention period) approximated $10,500,000, with provisions for up to $7,500,000 of additional payments to be made based on Mini-Mitter s operating performance through March 31, 2007. Mini-Mitter, located in Bend, Oregon, develops and sells sleep and physiological monitoring products to commercial sleep laboratories and other medical, pharmaceutical and health research institutions involved in clinical trials. The acquisition of Mini-Mitter broadens the Company s presence in the sleep market beyond its core OSA business through innovative technologies that will enable the Company to expand its current position and access new markets that have been identified as key in the broader sleep market. The results of operations of Mini-Mitter are included in the Company s Consolidated Statement of Operations beginning on the acquisition date, April 1, 2005.

**Profile** On July 1, 2004, the Company s offer to acquire 100% of the outstanding shares of Profile Therapeutics plc (Profile) was declared unconditional, and the Company paid 50.9 British Pence for each share of Profile, representing a total purchase price of 26,309,000 British Pounds (or approximately $43,524,000 net of $4,675,000 of cash acquired in the

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transaction). Profile, which is based in the UK, distributes, develops and commercializes specialty products to improve the treatment of sleep and respiratory patients. The acquisition of Profile expands the Company s presence in the global sleep and respiratory markets, and enhances the breadth of its products and services with Profile s new innovative technologies for respiratory drug delivery. Prior to the acquisition, Profile was a distributor of the Company s sleep and ventilation products in the UK; the acquisition therefore expands the Company s distribution channel in the UK. Profile s core respiratory drug delivery system is an innovative platform that utilizes intelligent inhalation technology called Adaptive Aerosol Delivery (AAD). This delivery system is designed to automatically respond to individual patients breathing patterns to deliver a precise dose synchronized with a patient s inhalation cycle. The technology has the potential to benefit patients by ensuring a uniform drug dose and reproducible therapy, and in addition, allows for smaller fill volumes of drug to be used compared to conventional nebulizers. The results of operations of Profile are included in the Company s Consolidated Statement of Operations beginning on the acquisition date, July 1, 2004.

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

Fiscal Year Ended June 30, 2004

**Caradyne** On February 27, 2004, the Company acquired 100% of the outstanding capital stock of Western Biomedical Technologies (WBT), an Ireland-based company, which owns 100% of the outstanding capital stock of Caradyne Limited, now known as Respironics (Ireland) Limited , for a base purchase price of $5,970,000 (including transaction costs), of which $4,470,000 was paid at closing and $1,500,000 was paid on March 2, 2006 upon the conclusion of a two-year retention period. The Company was also required to make up to $2,500,000 of additional future payments based on the achievement of various performance milestones following the acquisition through March 31, 2006 (as amended). The Company paid $2,000,000 as of December 31, 2005, and $500,000 on May 1, 2006, as a result of the successful achievement of performance milestones. The total purchase price, including the additional payments was $8,470,000.

WBT and Caradyne Limited are collectively referred to herein as Caradyne. Caradyne is involved in the development, manufacturing, and marketing of unique technologies that are complementary with the Company s ventilation product portfolio, primarily used in hospital settings and pre-hospital applications.

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

**Products**

The following are registered trademarks of the Company as used in this document: Respironics, REMstar, Encore, Encore SmartCard, Smart Monitor, ePOD, Wallaby, Inspiration, Esprit, BiPAP, BiPAP Vision, PLV, Synchrony, Alice, Stardust, BiliChek, AAD, Flow-TRAK, NICO, WhisperFlow, Actiwatch and I-neb. The following are trademarks of the Company as used in this document: Respironics Millennium, Profile Lite, Comfort Series, ComfortSelect, ComfortClassic, ComfortLite, ComfortGel, ComfortFull, BiPAP Focus, Cadence, LoFlo, Auto-TRAC, Promixin and NeoPAP.

The trademark C-Flex is used under license.

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

Sleep and Home Respiratory Products

The Company s sleep and home respiratory products can be separated into the following major subcategories: Sleep Disordered Breathing products; Home Respiratory Care products; and Sleep Well Ventures products.

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Sleep Disordered Breathing

*Sleep Apnea Products*. Respironics is a worldwide leader in OSA therapy devices. The Company s primary OSA products include the new M Series REMstar and legacy REMstar family of CPAP devices and the BiPAP Series of bi-level devices, as well as related accessories such as humidifiers, masks, tubing, filters and headgear.

The Company s CPAP devices consist of a small, portable air pressurization device, an air pressure control and a mask worn by the patient at home during sleep.

During the 2006 fiscal year, the Company initiated the transition from its prior REMstar family of CPAP devices to the new M Series. With three settings, patients have the ability to select the level of pressure relief that is right for them, without altering the benefits of prescribed therapy. The M Series small size, three primary control buttons and more lifestyle-oriented design are aimed at improving the patient s acceptance of therapy. Other comfort features, such as ramp and integrated humidification, are also incorporated into the design. The REMstar M Series has also been designed with an improved monitoring system to make data management more efficient. Some models are also equipped with an Encore Pro SmartCard accessory module to record information for the homecare provider, and the self-management feature allows the proactive user to monitor and verify the effectiveness of therapy. As of June 30, 2006, the M Series was available in limited quantities on all versions of CPAP, including the REMstar, REMstar Auto, Pro, and Plus. The Company plans to complete the M Series launch in the first half of fiscal year 2007 by releasing the new platform in all major international markets, releasing the M Series BiPAP platform, and increasing production capacity to meet global demand on the new platform.

C-Flex technology provides OSA sufferers with a more comfortable treatment for sleep apnea when compared to traditional CPAP treatment by tracking the patient s breathing to ensure the optimal amount of pressure is delivered at exhalation. C-Flex tracks and reacts to every breath throughout the night. This gives the device the ability to make breath-by-breath adjustments to ensure a more reduced level of pressure relief during exhalation.

The REMstar Series CPAP systems (REMstar Plus, REMstar Pro and REMstar Auto) are cost effective, innovative OSA therapy devices that meet the Company s strategy of offering units that provide high-quality treatment options at an economical price.

The REMstar Auto CPAP system utilizes innovative technology to monitor the patient s airway and adjust output automatically in order to deliver the appropriate pressure. The REMstar Pro and REMstar Auto also feature built-in memory to record patient usage and quality of life data. The Company s Encore SmartCard is a device used to retrieve this patient data, update air pressure settings, and change modes of operations for certain of the Company s CPAP and bi-level devices by utilizing specially developed data management software that is programmed onto the credit card sized Encore SmartCard.

BiPAP Pro2, BiPAP Plus and BiPAP Auto are the Company s primary bi-level OSA units. These units sense the patient s breathing cycle and adjust the pressure accordingly. BiPAP Pro also contains advanced leak-sensing technology, which improves the unit s pressure adjustment capability. Bi-level units are used to treat severe OSA and are useful in improving acceptance of therapy by patients as an alternative to CPAP.

The Company also offers both integrated and stand-alone humidifiers as accessories to support its strategy of enhancing patient adherence to prescribed therapy. Humidified air provides more comfortable therapy for certain patients.

The Company also provides masks used with CPAP and bi-level devices, primarily from its Comfort Series including the Respironics ComfortFull 2 and ComfortLite 2, Profile Lite, ComfortSelect, ComfortClassic, and ComfortGel. The Company s nasal mask products are designed to enhance patient comfort by utilizing a variety of shapes and designs and a variety of cushion materials to create a comfortable mask seal around the contours of the face while delivering effective CPAP and bi-level therapy. The ComfortLite 2, released in fiscal year 2006, is a uniquely designed mask for patients. It offers three interchangeable cushion options and a unique headgear system that leaves no pressure points on the face. Full face masks address the needs of specific patient groups for whom CPAP and bi-level therapy is delivered most effectively and comfortably through masks that cover the mouth and nose.

Respironics also manufactures and distributes a wide range of technologically advanced computer-based products for use in the diagnosis of sleep related disorders. The Company provides advanced, technically proficient clinical products for use in sleep labs. The Company also provides products for patient testing in the home that allow clinicians to expand the number of patients who can be served by a traditional sleep lab.

The Company s primary sleep diagnostic product is the Alice Polysomnography System (Alice). Alice is a computer-based system for use in sleep labs and other clinical settings. Alice 5, released during the 2005 fiscal year, is capable of recording up to 25 channels of physiological

data, which are stored on either a desktop or portable computer prior to permanent storage

on optical cartridges. In addition to acquiring and storing the patient s physiological data, the Alice System utilizes physician input and internal algorithms to provide a comprehensive range of reports for clinical analysis. Alice can be used on infants or adults, and separate software programs were developed specifically for each type of patient.

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

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

The Company estimates that in the U.S. there are currently more than 3,500 sleep labs located at hospitals, other medical centers and freestanding sites. Pulmonologists, technicians and other medical professionals diagnose sleep disorders and then prescribe the appropriate treatment. Sleep labs provide the most frequent source of patient introductions to the Company s sleep disordered breathing products.

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

Home Respiratory Care

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

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

The BiPAP S/T System is a compact and lightweight home noninvasive ventilator that is simple to operate offering a straight forward user interface and an integrated heated humidifier for easier set-up and patient comfort. The unit also is the first noninvasive device to combine Respironics proven BiPAP technology with SmartCard for use with Encore Pro and includes features such as Digital Auto-Trak Sensitivity, adjustable RiseTime, and integrated alarms.

The Company believes that its noninvasive ventilation products have the potential for increasing patient comfort by adapting to the patient s breathing cycles as opposed to requiring the patient to adapt his or her breathing to the ventilator cycles. Noninvasive ventilation delivers therapy effectively with a patient mask rather than requiring a tracheotomy for support. Noninvasive ventilation products are generally less expensive than invasive ventilators.

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

The Company s principal invasive portable volume ventilator is the PLV-100, a microprocessor-controlled, electrically powered unit specifically designed for long-term use in the home. It is suitable for transport, short-term and institutional use. The PLV-100 can be used to ventilate a wide range of patients. The small, lightweight unit delivers volume ventilation through the operation of a piston inside the unit. This ventilator can be powered by normal AC or DC battery power and can be operated in three different ventilation modes depending on the patient s needs. The unit features a variety of alarms and displays that alert clinicians and caregivers to changes in the patient s pulmonary status or to possible unit malfunction. The Company manufactures and distributes different versions of the PLV-100 for international markets based on language

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differences, and it also manufactures and distributes a variety of accessories for use with the PLV-100. The PLV-100 unit and related accessories reach end-user patients primarily through the Company s network of medical product dealers who purchase or rent the unit from the Company and resell or rent it to end-users. In certain limited cases, the Company rents these units directly to end-users. The Company s next generation invasive portable volume ventilator, the PLV-Continuum (PLV-C), was released on a limited basis in August 2005. The PLV-C offers adult and pediatric patients, their physicians, and healthcare providers options in treating respiratory diseases. This advanced, new portable ventilator is designed with the capability to program a primary and alternate set of parameters that provide patients with a distinct ventilation prescription for daytime and nighttime breathing comfort. With an easy-to-read, easy-to-navigate graphic user interface, users should find the PLV-C easy to set up, monitor and use. In May 2006, the Company announced that it voluntary recalled 269 PLV-C ventilators representing all models and serial numbers of the PLV-C. Respironics identified a problem after an analysis of returned units revealed the potential for failure of an internal flow valve, which could result in the ventilator suddenly stopping to provide mechanical ventilation. The Company has received no reports of adverse events or injuries resulting from this problem. Respironics notified the FDA of its decision to voluntarily recall the product in April 2006. The Company plans to re-release the PLV-C in fiscal year 2007.

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

The Company s primary oxygen concentrator product is the Respironics Millennium. This unit is suitable for chronic patients in the advanced stages of illness as well as for the less severe respiratory patient. The Company offers the Respironics Millennium 5 LPM (liters per minute) and 10 LPM concentrator. The Respironics Millennium 5 LPM is a lightweight mobile concentrator. The Millennium 10 LPM (M10) concentrator delivers up to 10 LPM of oxygen reducing the delivery costs associated with 5 LPM-and-above oxygen patients. The M10 is engineered to reduce the cost of providing oxygen at higher liter flow.

The Company s recent acquisitions of OxyTec and other oxygen delivery technology support the Company s strategy of providing treatment solutions to the growing number of ambulatory patients reliant on long-term oxygen therapy, such as those people with Chronic Obstructive Pulmonary Disease (COPD). OxyTec s recently developed portable oxygen concentrator is a highly efficient portable oxygen concentrator that lasts up to eight hours before the patient must recharge the unit s internal batteries or connect to a conventional power source. Additionally, the 900 milliliter per minute oxygen output is exceptional among portable oxygen concentrators weighing less than ten pounds and is intended to serve as an alternate to traditional portable oxygen tanks and liquid reservoirs. Respironics will introduce the OxyTec product to the U.S. market in fiscal year 2007, with international release to follow.

The Company also offers an electronic pulse oxygen conserving device (ePOD), which combines the durability and ease-of-use of pneumatic conservers and the pulse dose capability of electronic conservers.

The Company also manufactures and markets oximeter products for use in the home. The units, which allow the caregiver to take readings of the patient s blood oxygen levels and pulse rate, feature the capability to store up to 18 hours of data. This data can be later downloaded via the Company s software, which prints reports for oximetry analysis. Additionally, VirtuOx is the latest generation of overnight oximetry testing service that is designed to meet the Centers for Medicare and Medicaid Services (CMS) guidelines for testing and oxygen qualification. It was designed to be an easy to use software application available to homecare providers. VirtuOx is compatible with various versions of the Company s oximeters, and it does not require additional hardware or software. It is the only web-based platform that is hosted on a secure server. Physicians will be able to view home oximetry test results instantly, and auto-faxing software sends the physician a copy of the report within minutes.

Sleep Well Ventures

*Sleep Well Ventures*. Sleep Well Ventures was established to become the worldwide leader at providing innovative and highly valued sleep and wake solutions beyond OSA. Sleep Well Ventures gained several active product lines and development initiatives with the acquisition of Mini-Mitter on April 1, 2005.

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Current products support the field of actigraphy, and include devices used to determine energy expenditure, sleep/wake patterns, and sleep quality and also to evaluate circadian rhythms. Additionally, biotelemetry products are used to monitor body temperature, heart rate and variability and stress responses.

Hospital Products

The Company s hospital products can be separated into the following major subcategories: Critical Care, Respiratory Drug Delivery, and Children s Medical Ventures.

Critical Care

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

The Company also manufactures and markets the Esprit, a ventilator designed for use in the hospital and other institutional settings. Esprit is designed to deliver both invasive and noninvasive ventilation effectively, eliminating the need to use two separate ventilators for one patient and allowing it to be used throughout the continuum of patient care. With invasive ventilation, the ventilator delivers a mixture of room air and oxygen into a patient s lungs via a tube inserted into the patient s airway. These patients are typically dependent on the ventilator for life support. Esprit features a graphic user interface with an infrared touch screen; alarm and status indicators designed to allow rapid assessment of alarm conditions and patient status; volume and pressure control; and is designed to be easily upgraded. The Company developed and released several software and other product enhancements to the Esprit ventilator, including a neonatal option, Flow-TRAK and Trending, all aimed at increasing its capabilities and ease of use. The neonatal option allows the ventilator to be used for all patient ranges. Flow-TRAK provides a new breathing mode for the Esprit, whereby the volume of gas delivery can be increased or decreased based on the patient s requirements. Trending provides the clinician with the ability to review patient data, alarm occurrences and ventilator settings from the previous seventy-two hour period. The Esprit has a graphics option available, designed to provide clinicians with immediate, real time feedback in order to optimize ventilator settings. A color screen option is also available and is designed to enhance the clinicians ability to identify displays and facilitate the Esprit s easy-to-use graphic user interface.

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

The Company also manufactures, distributes and rents several other hospital ventilation products, including a version of the PLV-100 designed more specifically for institutional use, and a variety of masks, tubing and headgear similar to those used in the sleep and home respiratory market described above along with certain other accessories specifically designed for hospital and institutional use. Additionally, the Company offers the BiPAP Focus Noninvasive Ventilator, which is a basic bi-level delivery system designed specifically for the institutional setting. Ventilatory assistance is provided to stable, lower acuity patients with respiratory insufficiency or failure. Compact and lightweight, the BiPAP Focus System provides features that make delivery of noninvasive ventilation easy and effective. The Company s Cadence Self-Breathing Technology offers a minimally invasive approach to self-breathing trials. It is designed for prolonged mechanical ventilator patients who have undergone a tracheotomy and who are candidates for self-breathing trials. In contrast to other self-breathing methods, the Cadence Self-Breathing System provides oxygen-enriched, heated and humidified gas directly to the patient s lungs through the proprietary Cadence Transtracheal Catheter.

*Cardiorespiratory Monitoring Products*. The Company manufactures and markets cardiorespiratory monitors, sensors and related disposable accessories. These electronic devices provide the measurements and continuous display of a patient s cardiac output, carbon dioxide, oxygen saturation and respiratory mechanics parameters. The sensors for the Company s devices are designed so that this patient data can be gathered noninvasively. Noninvasive monitoring offers advantages over invasive monitoring, including a reduced likelihood of infection and other associated complications that can result from invasive monitoring. The NICO Cardiopulmonary Management System measures cardiac output based on changes in respiratory carbon dioxide concentration caused by a brief period of rebreathing. The measurement of cardiac output is accomplished by interpreting data collected by sensors that measure flow, airway pressure, and carbon dioxide concentration, and then combining these signals to calculate carbon dioxide elimination. Using these variables, a technique known as Fick

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partial rebreathing is applied to calculate cardiac output. The NICO monitor can be used with mechanically ventilated patients in the operating room, intensive care, or emergency departments. The Company s cardiorespiratory monitoring devices are used in hospital operating rooms, intensive care units, emergency departments, and while transporting patients to or within hospitals. The technology behind Respironics Cardio-Monitoring product line is also packaged for and sold as an OEM module to the major monitoring companies.

Respiratory Drug Delivery

*Adaptive Aerosol Delivery (AAD).* Through its July 1, 2004 acquisition of Profile, the Company added Profile s core respiratory delivery technology, an intelligent inhalation platform, AAD. Respironics AAD technology is an intelligent inhalation technology that continually monitors and automatically adapts to an individual patient s breathing pattern to deliver a precise medication dose during the patient s inhalation phase. This delivery system is designed to automatically respond to individual patients breathing patterns to deliver a precise dose synchronized with the patient s inhalation cycle. The technology has the potential to benefit patients by ensuring a uniform drug dose and reproducible therapy, and in addition, allows for smaller fill volumes of drug to be used and faster treatment times compared to conventional nebulizers.

The I-neb AAD System is Respironics third generation AAD System and is smaller, quieter and more portable than earlier product generations. It also provides audible and visual feedback to the patient informing them that the treatment is complete. The device is cleared for use by the patient in the homecare, nursing home, sub-acute institution, or hospital environments. During the 2005 fiscal year, the Company reached agreement with a customer to supply the AAD system for delivery of the pulmonary arterial hypertension drug, Ventavis (iloprost) Inhalation Solution, which had previously received FDA approval for marketing in the U.S. The Company also provides, via a third party contract manufacturer, its own branded antibiotic, Promixin, which treats chronic infections associated with cystic fibrosis. Promixin, launched by Profile in 2003 in the UK and marketed in the European Community primarily in combination with the Company s AAD device, is a branded generic antibiotic designed to be delivered directly to the site of infection in the lungs.

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

Children s Medical Ventures

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

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

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Children s Medical Ventures also manufactures and markets the Wallaby 3 Phototherapy System, a cost-effective, home-based alternative to conventional overhead phototherapy lights for treating newborn jaundice, a condition which is caused by elevated levels of bilirubin in the blood and which, in severe cases, can result in brain damage.

The Company also manufactures and markets the BiliChek Noninvasive Bilirubin Analyzer, a noninvasive device that measures the level of bilirubin in the blood of infants. The historical method of measuring bilirubin levels to diagnose jaundice in infants, the heel stick, involves drawing blood from the infant and is a painful, costly and time consuming procedure. BiliChek replaces the heel stick by analyzing reflected light shined on an infant s forehead to generate immediate and painless test results at a low cost.

Children s Medical Ventures also markets developmental care products designed to meet the unique needs of premature infants. Developmental care products are used in the home and in neonatal and pediatric intensive care units of hospitals. These products include appropriately sized infant care products, safety equipment and specialty feeding and skin care products. The Company also offers educational products and programs to teach caregivers how to address the specific needs of premature and ill infants.

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Sales of Sleep and Home Respiratory products and all related accessories and replacement parts accounted for 73% (domestic 51%; international 22%), 73% (51%; 22%) and 74% (56%; 18%), of the Company s net sales for its fiscal years 2006, 2005, and 2004, respectively. Sales of hospital products and accessories accounted for 27% (domestic 18%; international 9%), 27% (18%; 9%), and 26% (19%, 7%) of the Company s net sales for fiscal years 2006, 2005, and 2004, respectively.

**Manufacturing and Properties**

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

| | Square Feet | Owned/Leased |
|---|---|---|
| United States: | | |
| Murrysville, Pennsylvania (offices) | 55,000 | Owned |
| Murrysville, Pennsylvania (offices) | 23,000 | Leased |
| Murrysville, Pennsylvania (offices and manufacturing) | 127,000 | Owned |
| Monroeville, Pennsylvania (offices) | 138,000 | Owned |
| Plum Borough, Pennsylvania (offices and warehouse) | 26,000 | Leased |
| Kennesaw, Georgia (offices and manufacturing) | 129,000 | Leased |
| Carlsbad, California (offices and manufacturing) | 85,000 | Leased |
| Wallingford, Connecticut (offices and manufacturing) | 53,000 | Leased |
| Cedar Grove, New Jersey (offices) | 10,000 | Leased |
| Youngwood, Pennsylvania (warehouse) | 104,000 | Leased |
| Edison, New Jersey (warehouse) | 6,800 | Leased |
| Houston, Texas (warehouse) | 6,000 | Leased |
| Concord, California (warehouse) | 6,400 | Leased |
| La Mirada, California (warehouse) | 6,400 | Leased |
| Bend, Oregon (offices and manufacturing) | 13,000 | Leased |
| Thornton, Colorado (offices and warehouse) | 9,000 | Leased |
| International: | | |
| Hong Kong (offices) | 10,000 | Leased |
| Shenzhen, China (manufacturing) | 100,000 | Leased |
| Subic Bay, Philippines (manufacturing) | 6,800 | Leased |
| Laguna, Philippines (offices and manufacturing) | 19,600 | Leased |
| Tokyo, Japan (offices) | 5,400 | Leased |
| Saitama City, Japan (warehouse) | 26,300 | Leased |
| Herrsching, Germany (offices and warehouse) | 19,000 | Leased |
| Nantes, France (offices and warehouse) | 7,800 | Leased |
| Paris, France (offices) | 3,400 | Leased |

| | | |
|---|---|---|
| Galway, Ireland (offices and manufacturing) | 14,000 | Leased |
| West Sussex, United Kingdom (offices and manufacturing) | 36,000 | Leased |
| Zofingen, Switzerland (offices) | 600 | Leased |
| Desio, Italy (offices) | 1,200 | Leased |

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The Company also has approximately 85 sales and service centers throughout Japan, each of which is approximately 950 square feet in size and is leased.

On May 11, 2006 the Company announced it would be closing the Galway, Ireland manufacturing facility. The Company expects this facility to close by October 31, 2006. The manufacturing activities previously conducted at the Galway facility will be transferred to three manufacturing sites within the U.S.

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

The Company believes that its present facilities are suitable and adequate for its current and presently anticipated future needs. While several facilities are extensively utilized, additional productive capacity is available through a variety of means including, rental space near each current location that the Company believes is readily available and reasonably priced and production capacity at other existing locations that are less extensively utilized. The Company also owns undeveloped land near its existing Murrysville, Pennsylvania facilities that can be used for future expansion, if needed. The Company s current and prior year acquisitions did not create any material excess or unused capacity.

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

**Sales, Distribution and Marketing**

The Company sells and, in some cases, rents its products primarily to homecare providers and distributors. These parties in turn resell and rent the Company s products to end-users. The Company also sells certain of its products directly to hospitals. The Company initiated a change in the third quarter of fiscal year 2005 related to the distribution of its BiPAP Vision Noninvasive Ventilation System for hospital applications. Effective July 1, 2005 the Company began selling the Vision ventilator directly to its domestic hospital customers, replacing the previous distributor-based sales model.

The Company s products reach its customers in the United States through the direct sales force, comprised of national account and regional sales managers that direct the activities of sales representatives and sales support specialists, as well as independent manufacturers representatives. The Company s sales management team includes leadership positions across all major product groups and geographical regions, including the U.S., Canada, South and Central America, Europe and Middle East, and Far East and Asia Pacific. The Company s international sales organization sells products from both the Sleep and Home Respiratory and Hospital product groups. International sales accounted for approximately 31%, 31%, and 25% of the Company s net sales for fiscal years 2006, 2005, and 2004, respectively.

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

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

The Company has relationships with a variety of key customers. Some of these relationships are based on written supply agreements, while others are not. The Company extended its supply agreements with several key customers during the 2006 fiscal year. These agreements generally represent the right to sell to customers, often at stated prices and terms. However, often this access is shared and the Company (and its competitors) must compete for new business. Most of these relationships are terminable at will or upon short notice periods. Maintaining positive relationships with these customers is a key element of the Company s sales and marketing strategy. Failure to maintain customer relationships could adversely affect the Company s future results of operations.

The Company s U.S. homecare provider customer base (which ranges in size from large, publicly held companies with several hundred branch locations to small, owner-operated companies with one location) continues to undergo consolidation, particularly among companies specializing in homecare products. The impact on the Company of this customer consolidation is likely to continue to be reduced selling prices for the

Company s products as a result of greater purchasing power and market dominance enjoyed by larger customers.

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During the fiscal years ended June 30, 2006, 2005, and 2004, no individual customer accounted for 10% or more of the Company s net sales. However, in the aggregate sleep and home respiratory dealer customers constitute an important market for the Company s products.

The Company offers leasing programs to certain of its customers through arrangements with independent leasing companies. In some cases, these arrangements make the Company contingently liable, in the event of a customer default, to the leasing companies for certain unpaid installment receivables initiated by or transferred to the leasing companies. The Company s total exposure for unpaid installment receivables under these leasing programs was approximately $15,718,000 and $16,835,000 at June 30, 2006 and 2005, respectively. Approximately 9% of the Company s net sales were made under these financing arrangements during the year ended June 30, 2006 and 8% of the Company s net sales for the years ended June 30, 2005 and 2004. A portion of these sales were made with recourse. The Company is not dependent on these off-balance sheet arrangements. See Note L to the Consolidated Financial Statements for additional information.

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

**Competition**

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

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

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

**Research and Development**

The Company believes that its ability to identify product opportunities, to respond to the needs of physicians, healthcare providers, and their patients in the treatment of sleep and respiratory and other disorders and to incorporate the latest technological innovations into its products has been and will continue to be important to its success. The Company s research and development efforts are focused on understanding the problems faced by physicians and healthcare providers and their patients needs and on maintaining the Company s technological leadership in its core product areas. The Company maintains both formal and informal relationships with physician practitioners and researchers to supplement its research and development efforts. The Company s research and development efforts enable it to capitalize on opportunities in the sleep and respiratory medical product market by upgrading its current products as well as developing new products. In addition to the ongoing research and development work in the Company s existing product areas and existing sleep and respiratory markets, the Company continues to invest in research and development to identify opportunities, and potential solutions to other patient needs, in the sleep and respiratory markets. In April 2006, the Company announced that effective May 1, 2006 David P. White, M.D. joined the Company as Chief Medical Officer. Dr. White is a physician and leading researcher in sleep disorders and will lead the Company s clinical research strategies and programs in the sleep and respiratory markets.

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The Company conducts the vast majority of its research and development for existing and potential new products in the U.S. Through the acquisition of Profile, the Company also conducts certain research and development activities in the UK. The research and development staff performs overall conceptual design work for all products and the design work related to the manufacturing, engineering and tooling for products manufactured by the Company. The Company spent approximately $58,966,000 (6% of net sales) in fiscal 2006, $45,625,000 (5% of net sales) in fiscal year 2005, and $29,478,000 (4% of net sales) in fiscal year 2004 to support product enhancement and new product development.

The Company introduced new products in many of its core product areas during fiscal years 2006, 2005, and 2004. New product introductions in 2006 included:

Sleep and Home Respiratory Group

*Sleep Disordered Breathing*: The Company s most significant new product introduction during 2006 is the new platform of CPAP devices, the REMstar M Series sleep therapy device system, which was available on the REMstar, REMstar Auto, Pro, and Plus by the end of the year. The new M Series was available with the Company s C-flex technology, heated humidification, and Encore SmartCard technology. Also during the year the BiPAP Auto was introduced. This product represents the Company s first auto titrating bilevel device. The Company also introduced two new patient interface products, the ComfortFull 2 and ComfortLite 2. Additionally, the Stardust II portable sleep diagnostic device and software enhancements for the Alice lab-based sleep diagnostic device were released during the year.

*Home Respiratory Care*: The Company released the Synchrony II noninvasive ventilator internationally and the Virtuox overnight oximetry testing software in 2006.

Hospital Group

*Critical Care:* The Company continued to add various enhancements and software options to the Esprit invasive ventilation system, including the Respri-link and neonatal options. Additionally, the Company released the Esprit NICO interface in the international markets, as well as an Esprit unit designed for the Chinese market. The Company launched the Cadence Self-Breathing System and began shipping the LoFlo C5 Engine to OEM customers in 2006.

*Respiratory Drug Delivery:* The I-neb next generation Adaptive Aerosol Delivery (AAD) System for the aerosolization of liquid medication was launched in 2006.

Significant product development efforts are ongoing and new product launches in certain of the Company s major product lines are scheduled for the next six to eighteen months. Additional development work and clinical trials are being conducted in certain product areas and markets outside the Company s current core products and patient groups.

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

**Patents, Trademarks and Licenses**

The Company seeks protection for certain of its products through the acquisition of patents and exclusive licensing arrangements. In addition, the Company aggressively defends its patents and other rights when infringed by other companies. The Company currently has approximately 624 U.S. and foreign patents (compared to 471 as of June 30, 2005) and has additional U.S. and foreign patent applications pending. Some of these patents and patent applications relate to significant aspects and features of the Company s products. 106 of these patents expire in the next five years as follows: 15 expire in fiscal year 2007, 10 expire in fiscal year 2008, 12 expire in fiscal year 2009, 23 expire in fiscal year 2010, and 46 expire in fiscal year 2011. The Company has an increasingly diverse portfolio of products that should help to mitigate the impact that expiring patents could have on its business. However, the expiration of the Company s intellectual property rights may have a future adverse impact on the Company.

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The Company also has approximately 263 registered U.S. and foreign trademarks (compared to 279 as of June 30, 2005) and has additional U.S. and foreign trademark applications pending.

**Regulatory Matters**

The Company s products are subject to regulation by, among other governmental entities, the FDA and corresponding foreign agencies. The FDA regulates the introduction, manufacture, advertising, labeling, packaging, marketing and distribution of and recordkeeping for such products in the U.S. The Company must comply with statutory requirements and FDA regulations and is subject to various FDA recordkeeping and reporting requirements and to inspections by the FDA. The testing for and preparation of required applications can be expensive, and subsequent FDA review can be lengthy and the results uncertain. The FDA also regulates the clinical testing of medical devices. Moreover, FDA clearance or approval, if granted, can include significant limitations on the indicated uses for which a product may be marketed. Failure to comply with applicable FDA requirements can result in fines, civil penalties, suspensions or revocation of clearances or approvals, recalls or product seizures, operating restrictions or criminal penalties. Delays in receipt of, or failure to receive, FDA clearances or approvals for the Company s products for which such clearances or approvals have not yet been obtained would adversely affect the marketing of such products in the U.S. and could adversely affect the results of future operations.

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

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

Foreign regulatory approvals vary widely depending on the country. The Company s business in Japan is subject to government regulation generally similar to that in the U.S. The Japanese Ministry of Health requires registration and review of new products prior to granting approval to distribute such products in Japan and also requires product recalls and corrective actions when circumstances warrant. The Company has received ISO 13485:2003 certification for its Wallingford, Connecticut, Galway, Ireland, Bognor Regis, UK, and Subic Bay, Philippines facilities and ISO 9001:2000 certification for its Nantes, France facility. The Company has received both ISO 9001:2000 and ISO 13485:2003 certifications for its Murrysville, Pennsylvania, Kennesaw, Georgia, Bend, Oregon, Carlsbad, California, Cedar Grove, New Jersey, Herrsching, Germany, and Shenzhen, Peoples Republic of China, facilities. ISO Certification is based on criterion developed by the International Organization for Standardization, a quality standards organization with headquarters in Geneva, Switzerland. The Company has also received authorization for the same facilities, under the European Union s Medical Devices Directive, to affix the CE Mark to the Company s products marketed throughout the world. The primary component of the certification process was an audit of the facilities quality systems conducted by an independent agency authorized to perform conformity assessments under ISO guidelines and the Medical Devices Directive. Since receiving their original ISO certification, these facilities have undergone periodic update audits by such independent agencies.

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

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**Third Party Reimbursement**

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

Reimbursement systems vary in countries outside of the United States. Some countries do not provide reimbursement for certain of the products manufactured by the Company. Other countries that allow reimbursement may be subject to various restrictions. The ability of providers to purchase the Company s products in these countries is impacted by the amount of reimbursement available from third-party payors.

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

The amount of reimbursement that a hospital can obtain under the Medicare Diagnosis Related Group (DRG) payment system for utilizing the Company s products in treating patients is a primary determinant of the revenue that can be realized by the Company as well as medical product distributors and dealers who resell or rent the Company s hospital products. Many private insurance programs also utilize the Medicare DRG system. The various uses of the Company s hospital products to treat patients are provided within the DRG system. The levels of reimbursement under the DRG system are also subject to review and change. In August 2006 CMS published a final rule to modify the Medicare Inpatient Prospective Payment System. The rule adds or modifies some DRG codes which CMS hopes will more closely align payments based on severity of the illness.

The Medicare Prescription Drug, Improvement and Modernization Act of 2003 (the 2003 Act) was signed into law on December 8, 2003. The 2003 Act reduced medical reimbursement for respiratory drugs and home oxygen to homecare providers and placed a freeze on current reimbursement levels for Durable Medical Equipment (DME) through 2008, including certain of the Company s products. As required by the 2003 Act, Medicare plans to implement competitive bidding of durable medical equipment in 10 of the largest Metropolitan Statistical Areas (MSA) by the end of 2007, and in 80 of the largest MSAs by the end of 2009. Although specific DME products and services that will be included in competitive bidding have not yet been determined, it is likely that some of the Company s product offerings will be included.

In February 2006 the US Congress passed the Deficit Reduction Act of 2005 (2005 Act) which contained Medicare payment reductions for home oxygen equipment, and certain durable medical equipment classified by Medicare as capped rental equipment. In August 2006 CMS published a proposed regulation to implement the 2005 Act which could reduce Medicare reimbursement in 2007 for oxygen equipment and capped rental equipment. Additional reimbursement reductions for home oxygen were proposed in President Bush s Fiscal Year 2007 budget proposal, and could also be enacted into law. Both the federal government and state legislatures are considering options for containing growth in the Medicaid program.

Reimbursement reductions, coverage restrictions, and alternative payment systems implemented by state Medicaid policies add to an uncertain reimbursement environment. These changes in medical reimbursement may have a future adverse impact on the Company s results of operations, although the Company believes that its product breadth and diversification and manufacturing efficiencies will help to mitigate the potential financial impact of the medical reimbursement reductions.

**Employees**

The Company currently has approximately 4,700 employees, including approximately 1,233 hourly employees in the U.S. and 1,050 hourly employees in the Far East. None of the Company s employees are covered by collective bargaining agreements. The Company considers its labor relations to be good and has never suffered a work stoppage as a result of a labor conflict.

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**Financial Information About Foreign and Domestic Operations and Export Sales**

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

**Item 1A. Risk Factors**

The following factors, among other items, could cause the Company s future results to differ from those contained in forward-looking statements made in this report and presented elsewhere by management from time-to-time. Such factors, among others, may have a material adverse effect on the Company s business, financial condition and results of operations. The risks identified in this section are not all inclusive. The Company operates in a dynamic and competitive environment. New risk factors affecting the Company emerge from time-to-time and it is not possible for management to predict all such risk factors. Further, it is not possible to assess the impact of all risk factors on the Company or the extent to which any individual factor or combination of factors may cause actual results to differ materially from those contained in any forward-looking statements. Due to these inherent risks and uncertainties, investors should not place undue reliance on forward-looking statements as a prediction of actual results. Additionally, the Company undertakes no obligation to publicly update or revise any forward-looking statements, whether as a result of new information, future events or otherwise. The following discussion of the Company s risk factors speaks only as of the date on which they were made and should be read in conjunction with the consolidated financial statements and related notes included herein. Because of these and other factors, past financial performance should not be considered an indication of future performance.

**INDUSTRY RISKS**

**The Company participates in a highly competitive environment.**

The markets the Company participates in are highly competitive and are characterized by frequent product improvements and evolving technology. The Company s ability to compete successfully depends, in part, on its ability to develop, manufacture and market innovative new products. The development of innovative new products by competitors or the discovery of alternative treatments or potential cures for the conditions that the Company s products treat could make Respironics products noncompetitive or obsolete.

Additionally, some competitors may have greater financial, research and development, manufacturing and marketing resources than Respironics. The consolidation by the Company s competitors could result in greater competition. Increased competition could lead to greater increases in pricing pressure. If innovative new products cannot be developed, the Company may not be able to maintain competitive pricing and market share.

**The decline in the availability of, or the increase in cost of raw materials could increase the Company s costs of producing its products or limit the Company s ability to meet sales demand.**

The Company generally performs all major assembly work on all of its products. It manufactures many of the plastic components for its face mask products and uses subcontractors to supply certain other components, including printed circuit boards, motor / blower assemblies, and plastics. The Company purchases the component parts for its major products from a number of different suppliers. Where appropriate, the Company employs contracts with its suppliers, both domestically and internationally. The Company believes that its relationships with its suppliers are satisfactory and that alternative sources of supply are available. The raw materials used in the Company s components have historically been readily available. However, loss of a key supplier or access to certain raw materials could have a material adverse impact on the Company.

From time-to-time, the prices and availability of these raw materials may fluctuate due to global market demands, which could impair the Company s ability to procure necessary materials, or could increase the cost of such materials. Inflationary and other increases in costs of these raw materials may occur from time-to-time. In addition, freight costs associated with shipping and receiving product are impacted by fluctuations in the cost of oil and gas. A reduction in the supply or an increase in the cost of those raw materials could impact the Company s ability to manufacture its products and could increase the cost of production.

**The Company is subject to substantial domestic and international government regulation, including regulatory quality standards applicable to its manufacturing and quality processes. Failure by the Company to comply with these standards could have an adverse effect on the Company s business, financial condition, or results of operations.**

The FDA regulates the approval, manufacturing, and sales and marketing of many of the Company s products in the U.S. Significant government regulation also exists in Canada, Japan, Europe, and other countries in which the Company conducts business. As a device manufacturer, the

Company is required to register with the FDA and is subject to periodic inspection by the FDA for

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compliance with the FDA s Quality System Regulation ( QSR ) requirements, which require manufacturers of medical devices to adhere to certain regulations, including testing, quality control and documentation procedures. In addition, the federal Medical Device Reporting regulations require the Company to provide information to the FDA whenever there is evidence that reasonably suggests that a device may have caused or contributed to a death or serious injury or, if a malfunction were to occur, could cause or contribute to a death or serious injury. Compliance with applicable regulatory requirements is subject to continual review and is rigorously monitored through periodic inspections by the FDA. In the European Community, the Company is required to maintain certain ISO certifications in order to sell its products and must undergo periodic inspections by notified bodies to obtain and maintain these certifications. Failure to comply with current governmental regulations and quality assurance guidelines could lead to temporary manufacturing shutdowns, product recalls or related field actions, product shortages or delays in product manufacturing. Efficacy or safety concerns, an increase in trends of adverse events in the marketplace, and/or manufacturing quality issues with respect to the Company s products could lead to product recalls or related field actions, withdrawals, and/or declining sales.

From time-to-time the Company is required to conduct product recalls and/or field actions associated with certain of its products. The Company is currently conducting certain recalls and is investigating certain customer product complaints. The Company has accrued for the anticipated costs associated with these product matters in its consolidated balance sheets as of June 30, 2006 and 2005. There can be no assurance these accruals are adequate to cover the actual costs incurred related to these items.

The pricing, sales and marketing programs and arrangements, and related business practices of the industry are under increasing scrutiny from federal and state regulatory, investigative, prosecutorial and administrative entities. These entities include the Department of Justice and its U.S. Attorney s Offices, the Office of Inspector General of the Department of Health and Human Services, the FDA, the Federal Trade Commission and various state Attorneys General offices. Many of the healthcare laws under which certain of these governmental entities operate, including the federal and state anti-kickback statutes and statutory and common law false claims laws, have been construed broadly by the courts and permit the government entities to exercise significant discretion. In the event that any of those governmental entities believes that wrongdoing has occurred, one or more of them could institute civil or criminal proceedings, which, if instituted and resolved unfavorably, could subject the Company to substantial fines, penalties and injunctive or administrative remedies, including exclusion from government reimbursement programs. The Company also cannot predict whether any investigations will affect its marketing practices or sales. Any such result could have a material adverse impact on the Company s results of operations, cash flows, financial condition, or its business.

**Sales may decline if the Company s customers do not receive adequate levels of reimbursement from third-party payors for the Company s products and if certain types of healthcare programs are adopted in the Company s key markets.**

In the United States, healthcare providers that purchase the Company s products generally rely on payments from third-party payors (principally federal Medicare and private health insurance plans) to cover all or a portion of the cost of the Company s products. In the event that third-party payors deny coverage or reduce their current levels of reimbursement, the Company may experience increased selling price pressure and/or weakened demand for its products. Further, third-party payors are continuing to carefully review their coverage policies with respect to existing and new therapies and can, without notice, deny coverage for treatments that may include the use of the Company s products.

Outside the U.S., reimbursement systems vary significantly from country-to-country. In the majority of the international markets in which the Company s products are sold, government-managed healthcare systems mandate the reimbursement rates and methods for medical devices and procedures. If adequate levels of reimbursement from third-party payors outside of the U.S. are not obtained, international sales of the Company s products may decline. Many foreign markets, including Canada, and some European and Asian countries, have tightened reimbursement rates. The ability of the Company to continue to sell certain of its products profitably in these markets may diminish if the government-managed healthcare systems continue to reduce reimbursement rates.

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**A natural or man-made disaster could have a material adverse effect on the Company s business.**

The Company has approximately ten manufacturing operations located throughout the world. However, a significant portion of the Company s products are produced at its facility in Murrysville, Pennsylvania. In the event that this facility or any other significant facility were severely damaged or destroyed as a result of a natural or man-made disaster, the Company would be forced to shift production to its other facilities and/or rely on third-party manufacturers. Such an event could have a material adverse effect on the Company s business, results of operations and financial condition.

The Company also operates a substantial amount of its business transactions on an integrated enterprise resource planning system. Failure by the Company to protect its systems from a cyber attack or other security breach could have a material adverse impact on the Company.

**COMPANY RISKS**

**The Company s future profitability depends on the success of the Company s principal product lines.**

Sales of the Company s sleep apnea products accounted for approximately 54% of the Company s net sales for the year ended June 30, 2006. The Company expects sales of sleep apnea products to continue to account for a significant portion of the Company s aggregate sales. Any event adversely affecting the sale of sleep apnea products may, as a result, adversely affect the Company s business, results of operations and financial condition.

**The success of the Company depends on its ability to effectively market to home healthcare providers and sleep laboratories.**

The Company markets certain products primarily to homecare providers and to sleep clinics that diagnose OSA and other sleep disorders. The role of homecare providers and sleep laboratories is significant in the determination of the brand of product a patient will use. The Company s success depends on its ability to effectively market its products to homecare providers and sleep laboratories.

The Company markets to approximately 3,500 U.S. sleep laboratories and approximately 6,500 homecare providers, most of which use, sell or recommend multiple brands of products. Declining governmental and third-party reimbursement amounts have caused pricing pressure on homecare providers. Due to this, homecare providers may require price discounts and longer periods of time to pay for products purchased. The Company cannot assure that sleep physicians will continue to prescribe Respironics products, or that homecare providers or patients will not substitute competing products when a prescription specifying the Company s products has been written.

Marketing activities targeted toward the population with a predisposition to sleep-disordered breathing, as well as primary care physicians and various medical specialists are ongoing. The Company cannot assure that these marketing efforts will be successful in increasing awareness of OSA or sales of Company products.

**The inability to support continued growth could negatively impact the Company.**

The Company has experienced substantial growth. The effective management of growth depends upon, among other things, the ability to monitor and improve manufacturing systems, information technology, quality and regulatory compliance systems, and financial and management reporting systems. The failure to attract and retain qualified employees, the failure to manage costs, or the inability to support current and future growth could negatively impact the Company.

**The Company s revenues are subject to risks arising from currency exchange rate fluctuations, which could adversely affect the Company s results of operations or financial position.**

During fiscal year 2006, sales of the Company s products in foreign markets approximated $178,814,000 or 17% of the Company s total revenues. Accordingly, the U.S. dollar value of the Company s foreign-generated revenues varies with currency exchange rate fluctuations. Currency exchange rates are subject to fluctuation due to, among other things, changes in local, regional, or global economic conditions, the imposition of currency exchange restrictions, and unexpected changes in regulatory or taxation environments. The local country currency of the Company s subsidiaries outside the U.S. is the predominant currency used by the subsidiaries to transact business. Through its international operations, the company is exposed to foreign currency fluctuations, and changes in exchange rates can have a significant impact on the Company s results of operations.

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**The Company is subject to certain risks inherent in managing a global and decentralized organization.**

The Company has significant international operations and operates under a decentralized operational structure. Certain risks are inherent in operating and selling products in a global and decentralized organization, including:

- Difficulties in enforcing agreements and collecting receivables through certain foreign legal systems;
- Foreign customers who may have longer payment cycles than customers in the U.S.;
- Tax rates in certain foreign countries that may exceed those in the U.S., and foreign earnings that may be subject to withholding requirements;
- The imposition of tariffs, exchange controls or other trade restrictions including transfer pricing restrictions when products produced in one country are sold to an affiliated entity in another country;
- General economic and political conditions in countries where the Company operates or where end users of the Company s products reside;
- Difficulties in enforcing intellectual property rights and weaker intellectual property rights protection in some countries;
- Required compliance with a variety of foreign laws and regulations; and;
- Other difficulties associated with managing a decentralized organization.

**The inability to effectively market the Company s products outside the U.S. could adversely impact profitability.**

Approximately 30% of the Company s revenues are generated outside the U.S., in approximately 131 different countries. Many of these countries have unique regulatory, medical, and business environments. The inability to effectively market the Company s products outside the U.S. could have an adverse impact on the Company s business, results of operations and financial condition.

**The Company s acquisition and strategic investment activity may not be successful.**

As a part of the Company s growth strategy, the Company seeks to make strategic investments and acquisitions of companies, products, and technologies to expand its presence in the sleep and respiratory markets. The Company may not be able to successfully manage and integrate future acquisitions and strategic investments. There are no assurances that any acquisition or investment opportunities will arise or if they do, that they will be consummated, or that any needed additional financing will be available on satisfactory terms when required. In addition, acquisitions and strategic investments involve risks that the businesses, products or technology acquired will not perform in accordance with expectations, that business judgments concerning the value, strengths and weaknesses of businesses or technology acquired will prove incorrect, that the acquired businesses or technology may not be integrated successfully, and that the acquisitions may strain management resources.

The integration of operations of acquired companies, including the consolidation of systems, procedures, personnel and facilities, the relocation of staff, and the achievement of anticipated cost savings, economies of scale and other business efficiencies, presents significant challenges, particularly if several acquisitions occur within a short period of time. The Company may not be able to successfully integrate any business, products, technologies or personnel that may be acquired in the future, and the failure to do so could adversely affect the Company.

**The Company may be adversely affected by the outcome of legal proceedings.**

The Company may be party to various legal proceedings which could result in substantial costs and could harm the Company s on-going operations. The results of legal proceedings are difficult to predict. The Company cannot provide assurance that an action or proceeding will not be commenced against it, or that the Company will prevail in any such action or proceeding. An unfavorable resolution of any legal action or proceeding could materially and adversely affect the Company s business, results of operations, liquidity or financial condition. The Company does accrue for the anticipated costs associated with legal matters in its consolidated balance sheets as of June 30, 2006 and 2005. There can be no assurance these accruals are adequate to cover the actual costs incurred related to these matters.

**The Company s intellectual property rights may expire, or they may not sufficiently protect its products, or the Company s products may infringe on the intellectual property rights of third parties.**

The Company relies on a combination of patents, trade secrets and non-disclosure agreements to protect its intellectual property. The Company s success depends, in part, on its ability to obtain and maintain U.S. and foreign patent protection for its products. The Company currently has a number of pending patent applications. It is not possible to determine whether the Company will obtain any patents from these applications. Additionally, the claims in previously issued patents or pending applications may not provide the Company with significant protection against competitive products or otherwise be commercially valuable. Additionally, third party patents, patent applications, and other intellectual property, which are not known to the Company, may block or compete with the Company s existing product lines.

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Litigation may be necessary to enforce the Company s patents, to protect existing proprietary rights, or to defend third party infringement claims. The defense and prosecution of patent claims, including these pending claims, as well as participation in other inter-party proceedings, can be expensive and time consuming, even in those instances in which the outcome is favorable. If the outcome of any litigation or proceeding were adverse, the Company could be subject to significant liabilities to third parties, could be required to obtain licenses from third parties, may be forced to redesign or rename its products, or could be required to cease sales of the affected products. Additionally, the laws regarding the enforceability of patents vary by country; therefore, any patent issues faced by the Company may not be uniformly resolved.

**The Company is exposed to certain credit risks, resulting primarily from customer sales.**

Substantially all of the Company s receivables are due from homecare providers, distributors, hospitals, and independent leasing companies. The Company s customers are located throughout the U.S. and around the world. A significant portion of products sold to providers, distributors and hospitals, both foreign and domestic, is ultimately funded through government reimbursement programs or through private insurance programs. As a consequence, changes in these programs can have an adverse impact on the liquidity and profitability of the Company s customer base. In addition, because a concentration of market share exists in the sleep and home respiratory product industry in the U.S. among national and large regional homecare providers, the Company experiences a comparable concentration of credit risk with these customers.

The Company records an estimated allowance for uncollectible amounts based primarily on the Company s evaluation of the payment pattern, financial condition, cash flows, and credit history of its customers as well as current industry and economic conditions. Respironics s inability to collect on its trade accounts receivable from major customers could substantially reduce the Company s income and have a material adverse effect on its financial condition and results of operations.

**Item 1B. Unresolved Staff Comments**

None.

**Item 2. Properties**

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

**Item 3. Legal Proceedings**

**Invacare Litigation**

On March 5, 2004, the Company filed a lawsuit against Invacare Corporation (Invacare) in the U.S. District Court for the Western District of Pennsylvania alleging that Invacare s manufacture, sale and marketing of a new CPAP device infringes one or more of eleven U.S. patents of the Company. In its complaint, the Company has sought preliminary and permanent injunctive relief, damages and an award of three times actual damages. In its answer to the complaint, Invacare has denied the infringement allegations of the complaint and has asserted that the company s patents are invalid. Discovery has concluded, and the Court delivered an opinion on issues regarding the interpretation of patent claims on August 30, 2006. The Court postponed the May 2006 trial but has not yet set a new trial date.

On August 6, 2004, Invacare filed a lawsuit against the Company in the U.S. District Court in the Northern District of Ohio alleging that the Company has engaged in monopolization, restraint of trade and unfair competition in the sale and distribution of sleep apnea products. The lawsuit s claims include allegations that the Company s actions and alleged market power have foreclosed competitors from alleged markets and have created markets where there has not been competitive pricing or availability of competitive product offerings. In the lawsuit, Invacare seeks damages in an unspecified amount and to treble such damages pursuant to the antitrust laws, as well as attorney s fees and punitive damages. Invacare also seeks injunctive relief as to certain marketing practices. The Company is vigorously defending itself in this suit.

**Other**

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

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

During the fourth quarter of the fiscal year 2006, no matters were submitted to a vote of security holders.

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PART II

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

As of June 30, 2006, 79,730,591 shares of the Company s common stock were issued, of which 6,990,315 were held in treasury. The common stock is traded on the NASDAQ Stock Market under the symbol RESP. As of September 1, 2006, there were approximately 2,600 holders of record of the Company s common stock.

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

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

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

Fiscal year ended June 30, 2006:

| | First | Second | Third | Fourth |
|---|---|---|---|---|
| High | $ 42.18 | $ 42.62 | $ 38.91 | $ 37.96 |
| Low | $ 36.06 | $ 35.73 | $ 34.14 | $ 33.39 |

Fiscal year ended June 30, 2005:

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

The Company did not repurchase any shares of its common stock during the years ended June 30, 2006, 2005, or 2004. On a cumulative basis since inception of a previously disclosed stock repurchase plan that was initially approved by the Company s Board of Directors in August 1998, through June 30, 2006 the Company repurchased 7,600,000 shares at an average price per share of approximately $5.75. A maximum of 8,000,000 shares may be repurchased under this program (from which 400,000 shares remain available for repurchase as of June 30, 2006), for which there is no expiration date. The Company may continue to repurchase shares of its common stock for cash in the open market, or in negotiated block transactions, from time-to-time as market and business conditions warrant.

**Item 6. Selected Financial Data**

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

The results of operations of acquired entities, including the oxygen generation technology acquired in October 2005; OxyTec acquired in April 2006; and Omni Therm, acquired in May 2006; Mini-Mitter, acquired in April 2005; Profile acquired in July 2004; Caradyne, acquired in February 2004; BiliChek, acquired in March 2003; Fuji, acquired in May 2002; and Novametrix, acquired in April 2002, have been included in the Company s Consolidated Statements of Operations beginning on their respective acquisition dates.

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Income Statement Data:

| | Year Ended June 30 | | | | |
|---|---|---|---|---|---|
| | 2006 (1)(3)(5) | 2005 (1) | 2004 (1) | 2003 (1) | 2002 (2)(4) |
| | (Amounts in thousands except per share data) | | | | |
| Net sales | $ 1,046,141 | $ 911,497 | $ 759,550 | $ 629,817 | $ 494,919 |
| Cost of goods sold | 473,263 | 413,215 | 356,625 | 310,385 | 260,795 |
| | 572,878 | 498,282 | 402,925 | 319,432 | 234,124 |
| General and administrative expenses, excluding acquisition earn-out expenses | 149,485 | 123,040 | 100,232 | 83,731 | 60,719 |
| Acquisition earn-out expenses | 2,935 | 3,493 | 8,533 | 2,036 | |
| Sales, marketing and commission expenses | 206,433 | 182,796 | 147,740 | 116,300 | 86,189 |
| Research and development expenses | 58,966 | 45,625 | 29,478 | 24,047 | 17,317 |
| Contribution to Foundation | 1,500 | 3,000 | 2,844 | | |
| Restructuring and acquisition-related expenses | 3,953 | 6,415 | 10,942 | 17,789 | 2,288 |
| Impairment charge | | | | | 2,006 |
| Other (income) expense, net | (9,616) | (1,806) | (2,078) | 639 | 1,569 |
| Income before income taxes | 159,222 | 135,719 | 105,234 | 74,890 | 64,036 |
| Income taxes | 59,329 | 51,363 | 40,214 | 28,309 | 25,619 |
| Net income | $ 99,893 | $ 84,356 | $ 65,020 | $ 46,581 | $ 38,417 |
| Diluted earnings per share | $ 1.36 | $ 1.17 | $ 0.92 | $ 0.68 | $ 0.60 |
| Diluted shares outstanding | 73,570 | 72,255 | 70,619 | 68,688 | 64,016 |

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

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

(3) Includes a gain of $4,398,000 as result of the sale of Company s investment in AirLogix. See Note S to the Consolidated Financial Statements for additional information.

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

(5) Includes stock compensation expense totaling $11,955,000, pursuant to the Company s adoption of FASB No. 123(R), Share-Based Payment (FASB No. 123(R)) on July 1, 2005.

All amounts reflected in the above footnotes are reported on a pre-tax basis.

Balance Sheet Data:

| | June 30 | | | | |
|---|---|---|---|---|---|
| | 2006 | 2005 | 2004 | 2003 | 2002 |
| | (Amounts in thousands) | | | | |
| Working capital | $ 431,050 | $ 338,102 | $ 301,032 | $ 212,787 | $ 198,966 |
| Total assets | 1,017,378 | 878,446 | 711,139 | 582,196 | 550,911 |
| Total long-term obligations | 26,756 | 29,241 | 26,897 | 16,513 | 59,502 |
| Shareholders equity | 764,448 | 627,646 | 519,053 | 426,869 | 367,720 |

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

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

**EXECUTIVE SUMMARY**

The Company reported record financial results in fiscal year 2006, exceeding $1 billion in revenues. The year was marked by the Company s continued growth in the global OSA marketplace, the successful release of the new M Series

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family of CPAP products, the further acceptance and adoption of the Company s ventilation therapies in various geographic markets, and successful international expansion. The Company s strategy is to continue to grow these core drivers, while also broadening the scope of its products in the sleep and home respiratory markets. In connection with this strategy, during 2006, the Company continued to invest and gain critical mass in Respiratory Drug Delivery, Children s Medical Ventures, and Sleep Well Ventures. Listed below are some of the individual measures of the Company s performance in 2006 and other significant highlights:

The Company achieved 15% revenue growth in fiscal year 2006 compared to fiscal year 2005, led by global OSA growth of $89,880,000, or 18% (domestic - 17%; international - 19%). The Company s growth in OSA therapy products was achieved through the success of recent product introductions, including the M Series family of CPAP devices and new masks, and the Company s overall product breadth in OSA therapy, continued acceptance and recognition of C-Flex technology among patients and providers, strong sales channels with sleep labs, thought leaders, and homecare providers, strength of the sales force and the success of customer programs, and growth of the domestic sleep apnea therapy market (estimated to be approximately 15% - 20%). Overall global hospital ventilation growth was $16,915,000, or 15% compared to fiscal year 2005, as the Company s Esprit and Vision critical care ventilators continued to gain market acceptance. The Company s global Respiratory Drug Delivery revenue exceeded the $53,000,000 level during the 2006 fiscal year, representing 34% growth compared to the prior year. The primary geographic locations experiencing organic revenue increases were the U.S., Europe and the Far East/Asia Pacific, where the Company has made significant investments in sales force and marketing programs.

The Company completed several business acquisitions during fiscal year 2006, enabling the Company to expand its presence in the oxygen market and Children s Medical Ventures by enhancing the breadth of products and services in these areas. Overall, $5,580,000 of incremental sales were contributed by acquired companies in fiscal year 2006, primarily from acquisitions made in the prior year represents less than 1% of the Company s sales.

The Company achieved earnings of $1.36 per diluted share in fiscal year 2006, compared to $1.17 per diluted share in fiscal year 2005. The improved earnings were primarily driven by the 15% revenue growth described above. Fiscal year 2006 earnings also included stock compensation expense totaling $8,524,000 or $0.12 per diluted share after tax, pursuant to the Company s adoption of FASB No. 123(R).

The Company spent approximately $58,966,000 on research and development activities in fiscal year 2006, which represents 6% of net sales. The Company introduced a number of new products across all major product groups, including the REMstar M Series sleep therapy device system; two new patient interface products, the ComfortFull 2 and ComfortLite 2; Software enhancements for the Alice sleep diagnostic device; the international launch of the Synchrony II noninvasive ventilator and the Virtuox overnight oximetry testing software. New hospital products include the Cadence, Breathing System; the LoFlo C5 Engine. Software and functional enhancements were made to the Espirit ventilation system; international release of the Esprit NICO interface and the I-neb Adaptive Aerosol Delivery (AAD) System.

During the 2006 fiscal year the Company contributed $1,500,000 to the Respironics Sleep and Respiratory Research Foundation (Foundation), which was formed for scientific, educational, and charitable purposes and is used to promote awareness of and research into the medical consequences of sleep and respiratory problems.

On July 21, 2005, Centene Corporation (Centene) acquired AirLogix, Inc. (AirLogix) for approximately $35,000,000 in cash plus additional consideration of up to $5,000,000 based on the achievement of certain performance milestones. At the time of the sale, the Company held approximately 17% ownership in AirLogix. As a result of the sale, the Company received $5,488,000 of proceeds and recorded a pre-tax gain of $4,398,000.

During the 2006 fiscal year, the Company incurred $3,953,000 of restructuring and acquisition-related expenses. This included costs associated with the integration of recently acquired companies. Additionally, in the fourth quarter of 2006, the Company announced

the closure of its Galway, Ireland manufacturing facility. As a result of this closure the Company incurred $1,640,000 of restructuring and acquisition-related expenses. Products previously manufactured in Galway (including the NeoPAP and WhisperFlow) will be transferred to the Wallingford, Connecticut, Carlsbad, California, and Murrysville, Pennsylvania manufacturing facilities. The Company expects the transition to complete by December 31, 2006.

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The Company adopted FASB No. 123(R) on July 1, 2005, as such, which resulted in the recognition of stock compensation expenses in the consolidated statement of operations during the fiscal year ended June 30, 2006. The Company adopted FASB No. 123(R) using the modified prospective method, prior period financial statements have not been restated. Stock-based compensation expenses for the year ended June 30, 2006 totaled $11,955,000 on a pre-tax basis ($8,524,000 after tax, or $0.12 per basic and diluted share).

The Company generated $92,965,000 in cash from operations during the 2006 fiscal year. After spending $29,227,000 on the acquisition of businesses, intangible assets, and strategic investments, during the 2006 fiscal year, the Company added $30,719,000 to its cash, cash equivalents and short-term investments balance during the year. As of June 30, 2006, the Company has $265,351,000 of cash, cash equivalents, and short term investments and $148,735,000 in borrowing capacity under its Revolving Credit Agreement available for future expansion.

**RESULTS OF OPERATIONS**

Fiscal Year Ended June 30, 2006, Compared to Fiscal Year Ended June 30, 2005:

| Year ended June 30 | 2006 | 2005 | Percent Increase (Decrease) |
|---|---|---|---|
| Net sales | $ 1,046,140,962 | $ 911,496,811 | 15% |
| Cost of goods sold | 473,263,286 | 413,214,533 | 15% |
| | 572,877,676 | 498,282,278 | 15% |
| General and administrative expenses (excluding acquisition earn-out expenses) | 149,484,784 | 123,040,210 | 21% |
| Acquisition earn-out expenses | 2,934,571 | 3,492,699 | (16%) |
| Sales, marketing and commission expenses | 206,433,281 | 182,796,568 | 13% |
| Research and development expenses | 58,966,164 | 45,625,059 | 29% |
| Contribution to foundation | 1,500,000 | 3,000,000 | (50%) |
| Restructuring and acquisition-related expenses | 3,953,312 | 6,415,363 | (38%) |
| Other income | (9,616,528) | (1,806,475) | |
| | 413,655,584 | 362,563,424 | 14% |
| INCOME BEFORE INCOME TAXES | 159,222,092 | 135,718,854 | 17% |
| Income taxes | 59,328,706 | 51,362,800 | 16% |
| NET INCOME | $ 99,893,386 | $ 84,356,054 | 18% |
| Diluted earnings per share | $ 1.36 | $ 1.17 | 16% |
| Diluted shares outstanding | 73,570,239 | 72,254,509 | |

**Net sales** Net sales for the year ended June 30, 2006 were $1,046,141,000, representing a 15% increase over sales of $911,497,000 recorded for the year ended June 30, 2005. The Company s sales growth occurred across all product groups, summarized as follows.

| | Year Ended June 30 | | | | Dollar | Percent |
|---|---|---|---|---|---|---|
| | 2006 | | 2005 | | Increase | Increase |
| Domestic Sleep and Home Respiratory Products | $ 535,654,000 | 51% | $ 463,073,000 | 51% | 72,581,000 | 16% |

| | | | | | | |
|---|---|---|---|---|---|---|
| Domestic Hospital Products | 189,128,000 | 18% | 162,138,000 | 18% | 26,990,000 | 17% |
| International Products | 321,359,000 | 31% | 286,286,000 | 31% | 35,073,000 | 12% |
| | $ 1,046,141,000 | 100% | $ 911,497,000 | 100% | 134,644,000 | 15% |

The Company s core growth drivers devices for the diagnosis and treatment of OSA, total ventilation solutions aimed at the range of ventilator-assisted patients and international expansion as well as other emerging product lines, including Respiratory Drug Delivery and Children s Medical Ventures led the Company s year-over-year growth during the year ended June 30, 2006. Changes in foreign currency exchange rates reduced revenues by $7,941,000 (1%) during the year ended June 30, 2006 compared to the prior year. Revenues from acquired businesses contributed $5,580,000 (less than 1%) of revenues during the fiscal year ended June 30, 2006. On July 1, 2005, the Company changed the reporting classification of certain product revenues

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within the Sleep and Home Respiratory, Hospital, and International product categories. These changes are reflected in the table above and the following discussion for all periods presented. The reporting classification is consistent with the way the product groups are described in Item 1.

The Company s domestic Sleep and Home Respiratory revenue gains during the year ended June 30, 2006 were led by year-over-year increases of $66,520,000 (17%) in OSA (consisting of sleep therapy and sleep diagnostics products). The Company s growth in OSA was achieved through the Company s overall product breadth in OSA therapy, strong sales channels with thought leaders and homecare providers, and growth of the domestic OSA therapy market (estimated to be approximately 15% 20%). The increase in sleep therapy revenues was achieved as the Company continued its transition to the new M Series platform of CPAP devices. The new CPAP series incorporates the Company s C-flex technology, as well as auto titrating capability in certain devices. The Company s Alice 5 Sleep Diagnostics System also continued to gain acceptance in sleep labs, posting a domestic year-over-year increase of $7,381,000 (63%) in the year ended June 30, 2006.

Sales of domestic Hospital products during the year ended June 30, 2006 increased by $26,990,000 (17%). Sales of domestic Critical Care products (consisting of ventilation therapy and cardiorespiratory monitoring products) increased by $14,241,000 (17%) during the year ended June 30, 2006. These gains were led by increased Vision and Esprit ventilator sales. Revenues from domestic Respiratory Drug Delivery products (consisting of traditional asthma and nebulizer products as well as advanced respiratory drug delivery systems) increased by $10,097,000 (40%) during the fiscal year ended June 30, 2006. These increases were largely driven by the success of the Company s I-neb Adaptive Aerosol Delivery System. Domestic Children s Medical Venture product revenues (consisting of infant monitors, bilirubin devices, and developmental care products) increased by $2,652,000 (5%) during the year ended June 30, 2006.

The Company s international growth during the year ended June 30, 2006 included increased sales of both Sleep and Home Respiratory and Hospital products. The most significant increases were driven by OSA, which increased by $23,359,000 (19%) during the fiscal year ended June 30, 2006. International Hospital product sales increased by $10,948,000 (14%) for the year ended June 30, 2006. The increase was driven primarily by higher ventilation therapy and respiratory drug delivery product sales. The Company s international revenue growth occurred across many key markets, with Europe, Canada, the Far East / Asia Pacific, and South and Latin Americas all experiencing revenue increases.

**Gross Profit** The Company s gross profit was 55% of net sales for the years ended June 30, 2006 and 2005. Gross profit percentage remained flat as the Company transitioned to the new M Series platform of CPAP devices in the last two quarters of fiscal year 2006. The margin pressure from the CPAP platform transition were partially offset by higher revenue, product sales mix and material cost reductions achieved through the Company s successful negotiations with suppliers and product design changes, resulting in the Company maintaining its gross profit at 55% of sales. During this transition the Company continued to aggressively sell its legacy CPAP platform, sometimes at discounted prices and has not yet reached peak manufacturing efficiency on the new M Series.

**General and Administrative Expenses (excluding acquisition earn-out expenses)** General and administrative expenses were $149,485,000 (14% of net sales) for the year ended June 30, 2006, compared to $123,040,000 (13% of net sales) for the year ended June 30, 2005. The dollar increases for the year ended June 30, 2006 were due primarily to stock-based compensation expenses as a result of the adoption of FASB 123(R); higher employee compensation consistent with the growth of the Company s business and the financial performance achieved during the fiscal year; and other expenses incurred consistent with the Company s growth, including warranty and business development expenses.

**Acquisition Earn-out Expenses** During the years ended June 30, 2006 and 2005, the Company incurred acquisition earn-out expenses related to the Company s May 2002 acquisition of Fuji equal to $2,935,000 and $3,493,000 (less than 1% of net sales in both periods), respectively. See Note R to the consolidated financial statements for additional information regarding the Fuji acquisition.

**Sales, Marketing and Commission Expenses** Sales, marketing and commission expenses were $206,433,000 (20% of net sales) for the year ended June 30, 2006, compared to $182,797,000 (20% of net sales) for the year ended June 30, 2005. The dollar increases were driven by stock-based compensation expenses as a result of the adoption of FASB 123(R); higher variable sales force compensation, consistent with the increase in sales levels from the prior year; and the Company s continued investments in sales and marketing programs and sales force, especially in the international markets as well as related to the market release of M Series.

**Research and Development Expenses** Research and development expenses were $58,966,000 (6% of net sales) compared to $45,625,000 (5% of net sales) for the prior year. The increase was due to the Company s continuing commitment to research, development and new product introductions. Significant product development efforts are ongoing and new product launches in certain of the Company s major product lines were made during the year and are scheduled over the next eighteen months. Additional development work and clinical trials are being conducted in certain product areas within the sleep and respiratory markets outside the Company s current core products and patient groups.

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**Contribution to Foundation** During the years ended June 30, 2006 and 2005, respectively, the Company made contributions totaling $1,500,000 (less than 1% of net sales) and $3,000,000 (less than 1% of net sales) to the Foundation. The Foundation was formed for scientific, educational and charitable purposes and is used to promote awareness of and research into the medical consequences of sleep and respiratory problems.

**Restructuring and Acquisition-Related Expenses** During the year ended June 30, 2006, the Company incurred restructuring and acquisition-related expenses of $3,953,000, related primarily to closure of its Galway, Ireland manufacturing facility ($1,640,000), the integration of acquired companies (Profile and Mini-Mitter $2,211,000), and other costs ($102,000). Current year expense related to the closure of the Galway, Ireland manufacturing facility is primarily comprised of employee termination benefits, lease termination costs, and grant money which must be refunded to local governmental agencies. It is anticipated that the closure of the Galway, Ireland manufacturing facility will result in future cost reductions and operational efficiencies. Products previously manufactured in Galway (including the NeoPAP and Whisperflow) will be transitioned to the Wallingford, Connecticut, Carlsbad, California, and Murrysville, Pennsylvania manufacturing facilities. While the facility is expected to close by October 31, 2006, the Company expects the transition to be complete by December 31, 2006.

During the year ended June 30, 2005, the Company incurred restructuring and acquisition-related expenses of $6,415,000, related primarily to the restructuring of operations at the Wallingford, Connecticut manufacturing facility ($4,701,000) and the integration of recently acquired companies ($2,611,000), offset by a reduction to the reserve for idle facility lease obligation at the Kennesaw, Georgia manufacturing facility based on increased utilization ($897,000 credit).

See Note Q to the Consolidated Financial Statements for additional information regarding restructuring and acquisition-related expenses.

**Other Income** Other income was $(9,617,000) for the year ended June 30, 2006 as compared to $(1,806,000) for the year ended June 30, 2005. Other income in the year ended June 30, 2006 includes a one-time gain of $(4,398,000) from the sale of a minority equity investment in AirLogix that is more fully described in Note S to the consolidated financial statements. Other income in all periods presented is also comprised of net interest income and realized and unrealized foreign currency exchange (gains) losses, partially offset by recognized losses (gains) on designated cash flow hedges that are more fully described in Note J to the consolidated financial statements.

**Income Taxes** The Company s effective income tax rate was approximately 37% for the year ended June 30, 2006 compared to 38% for the year ended June 30, 2005, despite the current year adoption of FASB No. 123(R) that added 1% to the tax rate. The decrease in the Company s effective tax rate from the prior year was driven by income tax benefits associated with various on-going tax planning activities, primarily in the state and international tax areas. Additionally, in the prior year, the Company incurred additional income tax expense from the repatriation of foreign earnings that is more fully described in Note M to the Consolidated Financial Statements.

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

**Net Income** As a result of the factors described above, the Company s net income was $99,893,000 (10% of net sales) or $1.36 per diluted share for the year ended June 30, 2006 as compared to net income of $84,356,000 (9% of net sales) or $1.17 per diluted share for the year ended June 30, 2005. Stock-based compensation expenses from the Company s implementation of FASB 123(R) were $11,955,000 on a pre-tax basis, or $0.12 per basic and diluted share after tax for the year ended June 30, 2006. Additionally, restructuring and acquisition-related expenses totaled $3,953,000 on a pre-tax basis in fiscal year 2006, or approximately $0.03 per diluted share after tax, compared to $6,415,000 on a pre-tax basis, or approximately $0.05 per diluted share after tax in fiscal year 2005.

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

| Year ended June 30 | 2005 | 2004 | Percent Increase (Decrease) |
|---|---|---|---|
| Net sales | $ 911,496,811 | $ 759,549,845 | 20% |
| Cost of goods sold | 413,214,533 | 356,625,125 | 16% |

| | | | |
|---|---|---|---|
| | 498,282,278 | 402,924,720 | 24% |
| General and administrative expenses (excluding acquisition earn-out expenses) | 123,040,210 | 100,231,728 | 23% |
| Acquisition earn-out expenses | 3,492,699 | 8,533,000 | (59)% |
| Sales, marketing and commission expenses | 182,796,568 | 147,739,729 | 24% |
| Research and development expenses | 45,625,059 | 29,477,699 | 55% |
| Contribution to foundation | 3,000,000 | 2,844,475 | 5% |
| Restructuring and acquisition-related expenses | 6,415,363 | 10,942,352 | (41)% |
| Other (income), net | (1,806,475) | (2,078,417) | |
| | 362,563,424 | 297,690,566 | 22% |
| INCOME BEFORE INCOME TAXES | 135,718,854 | 105,234,154 | 29% |
| Income taxes | 51,362,800 | 40,214,309 | 28% |
| NET INCOME | $ 84,356,054 | $ 65,019,845 | 30% |
| Diluted earnings per share | $ 1.17 | $ 0.92 | 27% |
| Diluted shares outstanding | 72,254,509 | 70,618,700 | |

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

| | Year Ended June 30 | | | | Dollar | Percent |
|---|---|---|---|---|---|---|
| | 2005 | | 2004 | | Increase | Increase |
| Domestic Sleep and Home Respiratory Products | $ 463,073,000 | 51% | $ 402,595,000 | 56% | 60,478,000 | 15% |
| Domestic Hospital Products | 162,138,000 | 18% | 144,630,000 | 19% | 17,508,000 | 12% |
| International Products | 286,286,000 | 31% | 212,325,000 | 25% | 73,961,000 | 35% |
| Total | $ 911,497,000 | 100% | $ 759,550,000 | 100% | 151,947,000 | 20% |

Domestic sleep and home respiratory product sales for the year ended June 30, 2005 were driven primarily by year-over-year increase totaling $64,620,000 (20%) in OSA. The Company s growth in OSA therapy products was achieved through the success of recent product introductions and the Company s overall product breadth in OSA therapy, continued acceptance and recognition of C-Flex technology among patients and providers, strong sales channels with sleep labs, thought leaders, and homecare providers, strength of the sales force and the success of customer programs, and growth of the domestic OSA therapy market (estimated to be approximately 15% 20%).

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

The Company s international growth during the year ended June 30, 2005 included increased sales of both sleep and home respiratory and hospital products; the most significant increases coming from OSA ($28,187,000 increase over the prior year, representing 29% growth), home ventilation systems and accessories ($19,131,000 over the prior year, representing 32% growth), and international hospital ventilation products ($10,454,000 increase over the prior year, representing 27% growth). The Company s 2005 acquisitions, including Profile and Caradyne, contributed $27,238,000 of international sales during the year ended June 30, 2005. The primary geographic locations experiencing organic revenue increases were Europe and the Far East/Asia Pacific, where the Company has made significant investments in sales force and marketing programs. Changes in foreign currency exchange rates contributed $4,500,000 of revenues during the year ended June 30, 2005 (less than 1% of net sales) compared to the prior year.

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

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**General and Administrative Expenses (excluding acquisition earn-out expenses)** General and administrative expenses were $123,040,000 (13% of net sales) for the year ended June 30, 2005 as compared to $100,232,000 (13% of net sales) for the year ended June 30, 2004. The increase for the year ended June 30, 2005 was due primarily to higher employee compensation, consistent with the growth of the Company s business and the financial performance achieved during the year, increases in information technology, legal and product warranty costs, and general and administrative expenses at recently acquired companies (which constituted $9,133,000 of the increase).

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

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

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

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

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

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

**Income Taxes** The Company s effective income tax rate was approximately 38% for the years ended June 30, 2005 and 2004. The income tax benefits associated with various on-going tax planning, primarily in the state and international tax areas, were offset by additional income tax expense from the repatriation of foreign earnings during the year ended June 30, 2005 (partially offset by foreign tax credits and other items) that is more fully described in Note M to the Consolidated Financial Statements, and higher non-deductible acquisition earn-out expenses during the year ended June 30, 2004.

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

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

**FINANCIAL CONDITION, LIQUIDITY, AND CAPITAL RESOURCES**

The Company had working capital of $431,050,000 at June 30, 2006 and $338,102,000 at June 30, 2005. Net cash provided by operating activities for the year ended June 30, 2006 was $92,965,000, compared to $135,078,000 for the year ended at June 30, 2005 and $140,937,000 for the year ended June 30, 2004. Cash provided by operating activities for all years included increasing amounts of net income before the impact of depreciation, amortization and stock compensation (fiscal year 2006 only) expense. During the year ended June 30, 2006, this increase was offset by excess tax benefits from share-based payment arrangements that are required to be presented as a reduction to operating cash flows with a corresponding increase to financing cash flows, in accordance with FASB No. 123(R). The Company also made significant investment in working capital in 2006, including accounts receivable, as a result of the Company s 15% sales growth, and inventories as a result of the Company s growth and new product introductions including the CPAP transition to M Series.

Net cash used by investing activities was $94,135,000, $128,215,000, and $62,386,000 for fiscal years 2006, 2005, and 2004, respectively. During the year ended June 30, 2006, the Company paid $29,227,000 to acquire businesses, intangible assets, and strategic investments. Business acquisitions included: $8,400,000 to acquire an oxygen generation technology company, on October 6, 2005; $10,400,000 to acquire OxyTec on April 21, 2006; $2,510,000 to acquire Omni Therm on May 15, 2006; and $7,917,000 to acquire other businesses, intangible assets and strategic investments. Additional purchase price payments and transaction costs for previously acquired businesses totaled $6,063,000, $3,218,000, and $1,442,000, respectively, for the years ended June 30, 2006, 2005, and 2004. During the years ended June 30, 2006, 2005, and 2004 cash used by investing activities included capital expenditures of $58,484,000, $61,900,000, and $51,391,000 respectively, including the purchase of leasehold improvements, production equipment, computer hardware and software, telecommunications and office equipment, and the production of equipment leased to customers. Prior year capital expenditures also included the purchase of a 138,000 square foot facility near the Company s current Murrysville, Pennsylvania, campus for a purchase price of $5,500,000 (net of rent that was prepaid by the seller for a transitional rental period that is recorded in accrued expenses and other current liabilities in the consolidated balance sheet). During the 2006 fiscal year, cash flows used in investing activities also include $5,847,000 invested in short-term marketable securities and $5,488,000 of proceeds from the sale of AirLogix. During the year ended June 30, 2005, the Company paid $63,097,000 to acquire businesses, including: $43,524,000 to acquire Profile, net of cash acquired in the transaction of $4,675,000 on July 1, 2004; $10,085,000 to acquire Mini-Mitter on April 1, 2005; and $9,488,000 to acquire other businesses and representing additional purchase price payments and transaction costs for previously acquired businesses.

Net cash provided (used) by financing activities was $26,050,000, $35,323,000, and $17,995,000 during the years ended June 30, 2006, 2005, and 2004, respectively. These amounts include proceeds from the issuance of common stock under the Company s stock option plans of $18,625,000, $24,971,000, and $18,070,000, respectively, during the years ended June 30, 2006, 2005, and 2004. The Company also received proceeds from equipment financing at its Fuji subsidiary in Japan, in the amount of $13,084,000, $16,415,000, and $10,419,000, during the years ended June 30, 2006, 2005, and 2004, respectively. These proceeds were partially offset by payments on these equipment financing arrangements and other long-term borrowings in each year of $12,182,000, $6,063,000, and $10,494,000, respectively. Cash provided by financing activities in fiscal year 2006 also includes $6,524,000 of excess tax benefits from share-based payment arrangements.

The Company believes that its sources of funding consisting of projected positive cash flow from operating activities, the availability of additional funds under its revolving credit facility (totaling approximately $148,735,000 at June 30, 2006), and its accumulated cash and cash equivalents and short-term investments will be sufficient to meet its current and presently anticipated short-term and long-term needs for operating activities, investing activities and financing activities (primarily consisting of scheduled payments on long-term debt).

**CONTRACTUAL OBLIGATIONS AND OFF-BALANCE SHEET ARRANGEMENTS**

The Company has contractual financial obligations and commercial financial commitments consisting primarily of long-term debt, capital lease obligations, and non-cancelable operating leases. See Notes H and K to the Consolidated Financial Statements for additional information about these obligations and commitments. The composition and nature of these obligations and commitments have not changed materially since June 30, 2005.

On August 19, 2002 and as subsequently amended, the Company entered into a revolving credit agreement with a group of banks under which a total of $150,000,000 is available through August 31, 2009. The revolving credit agreement is unsecured and contains certain financial covenants with which the Company must comply. The Company is currently in compliance with these covenants. The interest rate on the revolving credit facility is based on a spread over the London Interbank Offered Rate (LIBOR). As of June 30, 2006, no borrowings are

outstanding under the revolving credit agreement.

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The following table summarizes significant contractual obligations and commercial commitments of the Company as of June 30, 2006:

Contractual Obligations and Commercial Commitments

| | | Payments Due by Period | | | |
|---|---|---|---|---|---|
| **Contractual Obligations** | **Total** | **Up to 1 Year** | **1-3 Years** | **3-5 Years** | **Over 5 Years** |
| Short-term and long-term debt | $ 1,244,000 | $ 964,000 | $ 280,000 | $ | $ |
| Capital lease obligations | 43,712,000 | 17,237,000 | 21,734,000 | 4,741,000 | |
| Operating leases | 41,155,000 | 9,667,000 | 13,727,000 | 9,236,000 | 8,525,000 |
| Amounts payable to selling parties of previously acquired businesses | 7,364,000 | 6,864,000 | 500,000 | | |
| Total contractual obligations | $ 93,475,000 | $ 34,372,000 | $ 36,241,000 | $ 13,977,000 | $ 8,525,000 |

| | | Amount of Commitment Expiration Per Period | | | |
|---|---|---|---|---|---|
| **Other Commercial Commitments** | **Total Amounts Committed** | **Up to 1 Year** | **1-3 Years** | **3-5 Years** | **Over 5 Years** |
| Letters of Credit | $ 1,265,000 | $ 1,265,000 | $ | $ | $ |

In addition to the amounts payable to the selling parties of previously acquired businesses that are set forth in the contractual obligations and commercial commitments table above, the Company may be obligated to make additional future payments under earn-out provisions pertaining to the acquisitions of Mini-Mitter, the acquired oxygen generation technology company, and OxyTec, for which the total amount of the obligations will not be known until the occurrence of future events. Obligations pertaining to the Fuji acquisitions are scheduled to be paid by December 31, 2006 and are reflected in the table above. The amounts reflected in the contractual obligations and commercial commitments table above include the future payments that are accrued as of June 30, 2006 in accordance with the earn-out provisions and the Company s other fixed obligations under the acquisition agreements. See Note R to the Consolidated Financial Statements for additional information about these obligations.

The Contractual Obligations and Commercial Commitments table above does not reflect obligations under purchase orders that arise in the ordinary course of business and that are typically fulfilled within ninety days. In addition to ordinary course purchase orders, the Company enters into supply agreements and distribution agreements in the ordinary course of business, some of which make the purchase of minimum quantities of products a condition to exclusivity or to obtaining or retaining more favorable pricing. Since failure to purchase the minimum amounts under these agreements generally does not result in a breach of contract, but only to an option on the part of the vendor to terminate the Company s exclusivity or increase the product prices the Company pays to the vendor, they are not included in the Contractual Obligations and Commercial Commitments table above.

In connection with customer leasing programs, the Company uses independent leasing companies for the purpose of providing financing to certain customers for the purchase of the Company s products. In some cases, the Company is contingently liable, in the event of a customer default, to the leasing companies within certain limits for unpaid installment receivables initiated by or transferred to the leasing companies. The transfer of certain of these installment receivables meets the criteria of FASB No. 140 and therefore are not recorded on the Company s financial statements.

As of June 30, 2006, the total exposure for unpaid installment receivables approximates $15,718,000, compared to $16,835,000 as of June 30, 2005. Included in these amounts are unpaid installment receivables totaling $14,970,000 and $16,087,000 that meet the FASB No. 140 criteria and are not recorded on the Company s financial statements at June 30, 2006 and June 30, 2005, respectively. The estimated fair value of the Company s contingent recourse guarantee is $3,406,000 and $1,765,000 as of June 30, 2006 and June 30, 2005, respectively. Approximately 9% of the Company s net sales were made under these financing arrangements during the year ended June 30, 2006 and 8% during the years ended June 30, 2005 and 2004. A portion of these sales was made with recourse. The Company is not dependent on these off-balance sheet arrangements.

**Item 7A. Quantitative and Qualitative Disclosures About Market Risk**

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

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

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

For the year ended June 30, 2006, sales denominated in currencies other than the U.S. Dollar totaled $178,814,000, or approximately 17% of net sales (compared to 19% in the prior year). An adverse change of 10% in exchange rates would have resulted in a decrease in sales of $16,256,000 for the year ended June 30, 2006. Foreign currency losses included in the determination of the Company s net income, net of gains related to designated cash flow hedges, were $956,000 for the year ended June 30, 2006.

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

**NEW ACCOUNTING PRONOUNCEMENTS**

In June 2005, the FASB issued Statement No. 154, Accounting Changes and Error Corrections , a replacement of APB Opinion No. 20, Accounting Changes, and FASB No. 3, Reporting Accounting Changes in Interim Financial Statements. FASB No. 154 changes the requirements for the accounting and reporting of a change in accounting principles. Previously, most voluntary changes in accounting principles required recognition via a cumulative effect adjustment within net income of the period of the change. FASB No. 154 requires retrospective application to prior periods financial statements, unless it is impracticable to determine either the period-specific effects or the cumulative effect of the change. FASB No. 154 is effective for accounting changes made in fiscal years beginning after December 15, 2005, however, the Statement does not change the transition provisions of any existing accounting pronouncements. The Company will adopt FASB No. 154 as of July 1, 2006.

In February 2006, the FASB issued Statement No. 155, Accounting for Certain Hybrid Financial Instruments an amendment of FASB Statements No. 133 and 140 (FASB No. 155). FASB No. 155 permits fair value remeasurement for any hybrid financial instrument that contains an embedded derivative that otherwise would require bifurcation, clarifies which interest-only strips and principal-only strips are not subject to the requirements of FASB Statement No. 133, and establishes a requirement to evaluate interests in securitized financial assets to identify interests that are freestanding derivatives or that are hybrid financial instruments that contain an embedded derivative requiring bifurcation. In addition, FASB No. 155 clarifies that concentrations of credit risk in the form of subordination are not embedded derivatives and amends FASB No. 140 to eliminate the prohibition on a qualifying special purpose entity from holding a derivative financial instrument that pertains to a beneficial interest other than another derivative financial instrument. FASB No. 155 is effective for all financial instruments acquired or issued after the beginning of an entity s first fiscal year that begins after September 15, 2006. The Company will adopt FASB No. 155 as of July 1, 2007, and does not expect that this statement will have a material impact on its consolidated financial statements.

In March 2006, the FASB issued Statement No. 156, Accounting for Servicing of Financial Assets an amendment of FASB Statement No. 140 (FASB No. 156). FASB No. 156 requires that an entity separately recognize a servicing asset or a servicing liability when it undertakes an obligation to service a financial asset under a servicing contract in certain situations. Such servicing assets or servicing liabilities are required to be initially measured at fair value, if practicable. FASB No. 156 also allows an entity to choose either the amortization method or the fair value measurement method to account for servicing assets and servicing liabilities within the scope of this Statement. FASB No. 156 is effective after the beginning of an entity s first fiscal year that begins after September 15, 2006. The Company will adopt FASB No. 156 as of July 1, 2007, and does not believe it will have a material impact to its consolidated financial statements.

In April 2006, the FASB issued FASB Staff Position (FSP) FIN 46R-6, Determining the Variability to Be Considered in Applying FASB Interpretation No. 46(R) (FIN 46R-6). FIN 46R-6 addresses certain implementation issues related to FASB Interpretation No. 46 (revised December 2003), Consolidation of Variable Interest Entities (FIN 46R). Specifically, FSP FIN 46R-6 addresses how a reporting enterprise should determine the variability to be considered in applying FIN 46R. The variability that is considered in applying FIN 46R affects the determination of (a) whether an entity is a variable interest entity (VIE), (b) which interests are variable interests in the entity, and (c) which party, if any, is the primary beneficiary of the VIE. That variability affects any calculation of expected losses and expected residual returns, if such a calculation is

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necessary. The Company is required to apply the guidance in FIN 46R-6 prospectively to all entities (including newly created entities) and to all entities previously required to be analyzed under FIN 46R when a reconsideration event has occurred, beginning July 1, 2006. The Company will evaluate the impact of this FSP at the time any such reconsideration event occurs and for any new entities created.

In July 2006, the FASB issued Interpretation No. 48, Accounting for Uncertainty in Income Taxes (FIN 48). FIN 48 creates a single model to address uncertainty in income tax positions. FIN 48 clarifies the accounting for income taxes by prescribing the minimum recognition threshold a tax position is required to meet before being recognized in the financial statements. It also provides guidance on de-recognition, measurement, classification, interest and penalties, accounting in interim periods, disclosure and transition. FIN 48 scopes income taxes out of FASB Statement No. 5, Accounting for Contingencies. FIN 48 is effective for an entity s fiscal year beginning after December 15, 2006. The Company will adopt FIN 48 as of July 1, 2007, as required, and is currently evaluating the impact of such adoption on its financial statements.

**CRITICAL ACCOUNTING POLICIES**

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

**Stock Based Compensation** In conjunction with the adoption of FASB 123(R), the Company is required to record the fair value of stock-based compensation awards as expenses in the consolidated statement of operations. In order to determine the fair value of stock options on the date of grant, the Company applies the Black-Scholes option-pricing model. Inherent in this model are assumptions related to expected stock-price volatility, option life, risk-free interest rate and dividend yield. While the risk-free interest rate and dividend yield are less subjective assumptions, typically based on factual data derived from public sources, the expected stock-price volatility and option life assumptions require a greater level of judgment which makes them critical accounting estimates.

The Company s expected stock-price volatility assumption is based on both current and historical implied volatilities of the underlying stock which is obtained from public data sources. For stock option grants issued during the year ended June 30, 2006, the Company used a weighted-average expected stock-price volatility of 24.6% based upon the calculated volatility at the time of issuance.

The Company determined the weighted-average option life assumption based on the exercise behavior that different employee groups exhibited historically, adjusted for specific factors that may influence future exercise patterns. For stock option grants made during the year ended June 30, 2006, the Company used a weighted-average expected option life assumption of 3.5 years. As of June 30, 2006, the total unrecognized stock-based compensation expenses related to non-vested stock awards was $21,335,000, which will be recognized over a weighted-average period of 1.75 years.

The Company believes the above critical estimates are based on outcomes that are reasonably likely to occur. However, if the expected option life of grants made during the year ended June 30, 2006 were to increase by one year and simultaneously the expected volatility was to increase by 100 basis points, recognized compensation expenses would have increased by approximately $412,000 for the year ended June 30, 2006, and unrecognized compensation expense would have increased by $2,236,000 as of June 30, 2006.

**Revenue Recognition** The Company s revenues are recognized when title to product passes to the customer, which generally occurs upon shipment to a customer location and, in the case of rental revenue and long-term service contracts, is recognized ratably over the period the product is rented or service is performed. For those sales shipped FOB destination, revenue is recognized upon receipt by the customer. The Company s standard conditions of sale do not include customer acceptance, installation, price protection agreements, or other post-shipment obligations. At times, the Company performs installation and/or training after certain products are shipped as a service to customers (at their request). As of June 30, 2006 and 2005 the amounts of deferred service revenue for post-shipment obligations were immaterial in relation to the Company s financial condition and results of operations. The Company s revenue transactions are sometimes made pursuant to standard terms and conditions included in distributor agreements and customer contracts. These contracts generally include price lists that apply to specified products shipped to customers during the terms of their agreement. These contracts also generally include rights of return provisions that only permit customers to return sold product in the case of a defective product or order entry, shipping, or similar error made by the Company. Product returns, which are recorded as a reduction of net sales and cost of sales, are generally insignificant in relation to net sales. The Company accrues for estimated sales returns and allowances based on historical trends, adjusted for specific product programs and individual transactions where appropriate.

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The Company does not offer variable sales prices for subsequent events; all prices are fixed when customers orders are received. Certain customers and group purchasing organizations contracts provide customers with price rebates based on their level of purchases from the Company. Rebates are accrued by the Company as a reduction in net sales as they are earned by customers. Price discounts that may be awarded to customers for payment of invoices within specified periods are recorded as reductions to net sales at the time of payment and are generally insignificant in relation to net sales. As part of the Company s sales process, pricing discounts may be provided for large orders to support sales initiatives, including new product introductions. In the Company s domestic sales activities, a number of independent manufacturers representatives are used to sell the Company s products. These independent representatives are paid a direct commission on sales made to customers in their respective territories and are an integral component of the Company s domestic sales force. The Company does not ship or sell its products to these representatives, and therefore does not recognize any revenue from transactions with these independent representatives. The SEC s SAB Nos. 101 and 104, Revenue Recognition, provides guidance on the application of generally accepted accounting principles to selected revenue recognition issues. The Company has concluded that its revenue recognition policy is appropriate and in accordance with generally accepted accounting principles and SAB Nos. 101 and 104.

**Allowance for Uncollectible Accounts Receivable** Accounts receivable are reduced by an allowance for amounts that may become uncollectible in the future. Provisions to increase the allowance for uncollectible accounts receivable are recorded as a component of general and administrative expenses in the Company s Consolidated Statements of Operations during the fiscal years ended June 30, 2006, 2005, and 2004. Substantially all of the Company s receivables are due from homecare providers, distributors, hospitals, and independent leasing companies. The Company s customers are located throughout the U.S. and around the world. A significant portion of products sold to homecare providers, distributors and hospitals, both foreign and domestic, is ultimately funded through government reimbursement or private insurance programs. As a consequence, changes in these programs can have an adverse impact on a homecare provider, distributor and hospital liquidity and profitability. In addition, because a concentration of market share exists in the sleep and home respiratory product industry in the U.S. among national and large regional homecare providers, the Company experiences a comparable concentration of credit risk with these customers. The company records an estimated allowance for uncollectible amounts based primarily on the Company s evaluation of the payment pattern, financial condition, cash flows, and credit history of its customers as well as current industry and economic conditions. Adverse changes in these factors may impair the ability of the Company s customers to make payments; as a consequence, additional allowances for uncollectible accounts receivable may be required. The Company is also contingently liable, within certain limits, in the event of a customer default on unpaid installment receivables initiated by or transferred to several independent leasing companies in connection with customer leasing programs. The Company monitors the collection status of these installment receivables and provides amounts necessary for estimated losses in the allowance for doubtful accounts.

**Inventories and Related Allowance for Obsolete and Excess Inventory** Inventories are valued at the lower of cost or market value and have been reduced by an allowance for excess and obsolete inventories. Provisions to increase the allowance for obsolete and excess inventory are recorded as a component of cost of goods sold in the Company s Consolidated Statements of Operations during the fiscal years ended June 30, 2006, 2005, and 2004. The estimated allowance is based on the Company s review of inventories on hand compared to historical and estimated future usage and sales. If it is determined that inventory on hand is in excess of estimated future usage and sales because of changes in competitive conditions, new product introductions, product obsolescence, changes in customer demand, or other reasons, additional allowances for obsolete and excess inventory may need to be provided. The establishment of these additional allowances may have an adverse impact on earnings, depending on the extent and amount of inventory affected.

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

**Contingencies** As a normal part of its business operations, the Company incurs liabilities that may be difficult to quantify precisely, such as future warranty obligations, potential liabilities relating to legal or regulatory matters, and tax exposures. The Company follows the requirements of FASB No. 5, Accounting for Contingencies, which dictate when a charge to income should be taken to accrue for a loss contingency. These requirements necessitate the application of judgment regarding the likelihood and amount of the liability. The Company will adopt FIN 48 effective on July 1, 2007 to address uncertainty in income tax positions.

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

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

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**Item 8. Consolidated Financial Statements**

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Report of Independent Registered Public Accounting Firm

Board of Directors and Shareholders

Respironics, Inc. and Subsidiaries

We have audited the accompanying consolidated balance sheets of Respironics, Inc. and subsidiaries as of June 30, 2006 and 2005, and the related consolidated statements of operations, shareholders equity, and cash flows for each of the three years in the period ended June 30, 2006. Our audits also included the financial statement schedule listed in the Index at Item 15(a). These financial statements and schedule are the responsibility of the Company s management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Respironics, Inc. and subsidiaries at June 30, 2006 and 2005, and the consolidated results of their operations and their cash flows for each of the three years in the period ended June 30, 2006, in conformity with U.S. generally accepted accounting principles. Also in our opinion, the related financial statement schedule, when considered in relation to the basic financial statements taken as a whole, presents fairly in all material respects the information set forth therein.

As discussed in Note A to the Consolidated Financial Statements, the Company adopted Statement of Financial Accounting Standards No. 123(R), Share-Based Payment , effective July 1, 2005.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of the Company s internal control over financial reporting as of June 30, 2006, based on criteria established in Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated September 8, 2006 expressed an unqualified opinion thereon.

/s/ Ernst & Young LLP

Pittsburgh, Pennsylvania

September 8, 2006

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**CONSOLIDATED BALANCE SHEETS**

**RESPIRONICS, INC. AND SUBSIDIARIES**

**At June 30**