CRANE CO /DE/
Form 10-Q
November 09, 2006

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

Mark One:

x **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the Quarterly Period Ended September 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 Number: 1-1657

CRANE CO.

(Exact name of registrant as specified in its charter)

Delaware	**13-1952290**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification No.)**
100 First Stamford Place, Stamford, CT	**06902**
(Address of principal executive offices)	**(Zip Code)**

Registrant s telephone number, including area code: 203-363-7300

(Not Applicable)

(Former name, former address and former fiscal year, if changed since last report)

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer x Accelerated filer ¨ Non-accelerated filer ¨

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

The number of shares outstanding of the issuer s classes of common stock, as of October 25, 2006

Common stock, $1.00 Par Value 61,025,068 shares

Part I - Financial Information

Item 1. Financial Statements

Crane Co. and Subsidiaries

Consolidated Statements of Operations

(In Thousands, except per share amounts)

(Unaudited)

	Three Months Ended September 30, 2006	Three Months Ended September 30, 2005	Nine Months Ended September 30, 2006	Nine Months Ended September 30, 2005
Net sales	$ 567,704	$ 522,231	$ 1,675,237	$ 1,554,912
Operating costs and expenses:				
Cost of sales	378,054	356,058	1,125,978	1,071,033
Selling, general and administrative	118,487	104,414	354,790	325,372
Operating profit	71,163	61,759	194,469	158,507
Other income (expense)				
Interest income	552	503	2,163	1,004
Interest expense	(5,244)	(5,564)	(16,268)	(17,025)
Miscellaneous - net	1,461	778	7,143	2,844
	(3,231)	(4,283)	(6,962)	(13,177)
Income before income taxes	67,932	57,476	187,507	145,330
Provision for income taxes	21,889	17,434	59,602	44,616
Net income	$ 46,043	$ 40,042	$ 127,905	$ 100,714
Basic net income per share:	$ 0.75	$ 0.67	$ 2.10	$ 1.69
Diluted net income per share:	$ 0.74	$ 0.66	$ 2.06	$ 1.67
Average basic shares outstanding	61,110	59,936	60,941	59,676
Average diluted shares outstanding	62,226	60,490	62,192	60,229
Dividends per share	$ 0.150	$ 0.125	$ 0.400	$ 0.325

See Notes to Consolidated Financial Statements.

Part I - Financial Information

Item 1. Financial Statements

Crane Co. and Subsidiaries

Consolidated Balance Sheets

(In Thousands, except share amounts)

(Unaudited)

	September 30, 2006	December 31, 2005
Assets		
Current Assets		
Cash and Cash Equivalents	$ 99,077	$ 180,392
Accounts Receivable	342,865	289,521
Inventories:		
Finished goods	104,386	90,852
Finished parts and subassemblies	39,032	43,069
Work in process	53,551	46,406
Raw materials	104,994	92,027
	301,963	272,354
Deferred Tax Assets	38,426	42,104
Other Current Assets	13,041	14,024
Total Current Assets	795,372	798,395
Property, Plant and Equipment:		
Cost	754,081	738,368
Less accumulated depreciation	486,845	474,577
	267,236	263,791
Insurance Receivable - Asbestos	214,626	224,600
Other Assets	222,793	223,610
Intangible Assets, Net	118,905	60,735
Goodwill	712,377	568,355
Total Assets	$ 2,331,309	$ 2,139,486

See Notes to Consolidated Financial Statements.

Part I - Financial Information

Item 1. Financial Statements

Crane Co. and Subsidiaries

Consolidated Balance Sheets

(In Thousands, except share amounts)

(Unaudited)

	September 30, 2006	December 31, 2005
Liabilities and Shareholders Equity		
Current Liabilities		
Notes payable and current maturities of long-term debt	$ 315	$ 254
Accounts payable	155,557	149,647
Current asbestos liability	55,000	55,000
Accrued liabilities	186,024	174,366
U.S. and foreign taxes on income	28,984	19,322
Total Current Liabilities	425,880	398,589
Long-Term Debt	366,094	293,248
Accrued Pension and Postretirement Benefits	56,440	56,649
Deferred Tax Liability	70,417	71,406
Long-Term Asbestos Liability	486,899	526,830
Other Liabilities	31,875	39,470
Shareholders Equity:		
Preferred Shares, par value $.01; 5,000,000 shares authorized		
Common stock, par value $1.00; 200,000,000 shares authorized, 72,426,139 shares issued	72,426	72,426
Capital surplus	128,997	114,788
Retained earnings	915,629	814,197
Accumulated other comprehensive income	64,579	31,090
Treasury stock	(287,927)	(279,207)
Total Shareholders Equity	893,704	753,294
Total Liabilities and Shareholders Equity	$ 2,331,309	$ 2,139,486
Common Stock Issued	72,426	72,426
Less: Common Stock held in Treasury	(11,442)	(12,018)
Common Stock Outstanding	60,984	60,408

See Notes to Consolidated Financial Statements.

Part I - Financial Information

Item 1. Financial Statements

Crane Co. and Subsidiaries

Consolidated Statements of Cash Flows

(In Thousands)

(Unaudited)

	Nine Months Ended September 30, 2006	2005
Operating activities:		
Net income	$ 127,905	$ 100,714
Income from joint venture	(4,525)	(4,476)
Gain on divestitures	(8,931)	
Depreciation and amortization	39,056	36,509
Stock-based compensation expense	11,288	6,452
Deferred income taxes	4,954	8,293
Cash used for operating working capital	(35,617)	(35,063)
Asbestos-related payments, net of insurance recoveries	(29,957)	(24,556)
Refund associated with terminated Master Settlement Agreement		9,925
Other	(1,257)	6,372
Total provided by operating activities	102,916	104,170
Investing activities:		
Capital expenditures	(22,312)	(17,634)
Proceeds from disposition of capital assets	3,317	1,569
Proceeds from divestitures	26,088	
Payment for acquisitions, net of cash acquired and liabilities assumed	(234,734)	(7,157)
Total used for investing activities	(227,641)	(23,222)
Financing activities:		
Equity:		
Dividends paid	(24,465)	(19,429)
Common shares acquired on the open market	(37,499)	
Stock incentive plan exercises, net of shares acquired	20,606	10,634
Excess tax benefit from stock-based compensation	7,575	
Debt:		
Issuance of Debt	71,700	
Repayments of long-term debt	(410)	(4,446)
Net increase in short-term debt	55	1,030
Total provided by (used for) financing activities	37,562	(12,211)
Effect of exchange rates on cash and cash equivalents	5,848	(5,860)
(Decrease) increase in cash and cash equivalents	(81,315)	62,877
Cash and cash equivalents at beginning of period	180,392	50,727

Cash and cash equivalents at end of period	$ 99,077	$ 113,604
Detail of Cash Used for Operating Working Capital		
Accounts receivable	$ (35,528)	$ (38,549)
Inventories	(16,174)	3,075
Other current assets	1,329	(1,235)
Accounts payable	1,530	(14,243)
Accrued liabilities	8,716	1,428
U.S. and foreign taxes on income	4,510	14,461
Total	$ (35,617)	$ (35,063)
Supplemental disclosure of cash flow information:		
Interest paid	$ 17,333	$ 18,304
Income taxes paid	22,292	13,588

See Notes to Consolidated Financial Statements.

Part I Financial Information

Item 1. Financial Statements

Notes to Consolidated Financial Statements (Unaudited)

1. Basis of Presentation

The accompanying unaudited consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America for interim financial reporting and the instructions to Form 10-Q and, therefore, reflect all adjustments which are, in the opinion of management, necessary for a fair statement of the results for the interim period presented. These interim consolidated financial statements should be read in conjunction with the Consolidated Financial Statements and Notes to Consolidated Financial Statements in the Company s Annual Report on Form 10-K for the year ended December 31, 2005.

2. New Accounting Pronouncements

In July 2006, the Financial Accounting Standards Board (FASB) issued FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes (FIN 48). FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise s financial statements in accordance with FASB Statement No. 109, Accounting for Income Taxes. FIN 48 prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN 48 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition. The requirements of FIN 48 are effective for fiscal years beginning after December 15, 2006. The Company believes that the adoption of FIN 48 will not have a material effect on its financial statements.

In September 2006, the FASB issued Statement of Financial Accounting Standards No. 157, Fair Value Measurements (SFAS 157). SFAS No. 157 defines fair value, provides a framework for measuring fair value under current standards in GAAP, and requires additional disclosure about fair value measurements. In accordance with the Statement, the definition of fair value retains the exchange price notion, and exchange price is defined as the price in an orderly transaction between market participants to sell an asset or transfer a liability. If there is a principal market for the asset or liability, the fair value measurement should reflect that price, whether that price is directly observable or otherwise used in a valuation technique. Depending on the asset or liability being valued, the inputs used to determine fair value can range from objective inputs such as prices based on market data independent from the entity, and subjective inputs such as the entity s own assumptions about the estimates that market participants would use. The Statement applies to other accounting pronouncements that require or permit fair value measurements and will be effective for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. The Company is currently evaluating the provisions of SFAS No. 157 to determine the potential impact, if any, the adoption will have on the Company s financial statements.

In September 2006, the FASB issued Statement of Financial Accounting Standards No. 158, Employers Accounting for Defined Benefit Pension and Other Postretirement Plans (SFAS 158). SFAS 158 requires an employer to recognize the overfunded or underfunded status of a defined benefit postretirement plan (other than a multiemployer plan) as an asset or liability in its statement of financial position and to recognize changes in the funded status in the year in which the changes occur through comprehensive income of a business entity. SFAS 158 also requires an employer to measure the funded status of a plan as of the date of its year-end statement of financial position. As required by SFAS 158, the Company will initially recognize the funded status of its defined benefit and other postretirement plans and provide the required disclosures as of the fiscal year ended December 31, 2006. The Company is currently evaluating the provisions of SFAS No. 158 to determine the impact the adoption will have on the Company s financial statements.

Part I Financial Information

Item 1. Financial Statements

Notes to Consolidated Financial Statements (Unaudited)

In September 2006, the Securities and Exchange Commission (SEC) issued Staff Accounting Bulletin No. 108, Quantifying Misstatements (SAB 108). SAB 108 provides guidance on quantifying and evaluating the materiality of unrecorded misstatements requiring the use of both a balance sheet and an income statement approach when quantifying and evaluating the materiality of a misstatement. SAB 108 is effective for fiscal years ending after November 15, 2006. The Company believes that the adoption of SAB 108 will not have a material effect on its financial statements.

3. Segment Results

Net sales, operating profit and assets by segment are as follows:

(in thousands)	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
Net Sales				
Aerospace & Electronics	$ 142,982	$ 141,722	$ 429,860	$ 409,243
Engineered Materials	71,636	75,558	239,931	235,550
Merchandising Systems	73,384	40,610	179,566	130,050
Fluid Handling	256,249	244,036	755,445	718,504
Controls	23,387	20,413	70,637	61,896
Intersegment Elimination	66	(108)	(202)	(331)
Total	$ 567,704	$ 522,231	$ 1,675,237	$ 1,554,912
Operating Profit				
Aerospace & Electronics	$ 25,272	$ 26,461	$ 73,919	$ 60,679
Engineered Materials	9,661	15,691	38,551	50,835
Merchandising Systems	8,887	3,529	17,101	11,362
Fluid Handling	29,404	21,131	83,780	53,588
Controls	2,112	1,711	7,664	5,287
Corporate	(4,173)	(6,764)	(26,546)	(23,244)
Total	$ 71,163	$ 61,759	$ 194,469	$ 158,507

(in thousands)	As of	
	September 30, 2006	December 31, 2005
Assets		
Aerospace & Electronics	$ 464,016	$ 476,400
Engineered Materials	274,362	189,353
Merchandising Systems	289,430	104,162
Fluid Handling	731,630	692,856
Controls	49,470	48,107
Corporate	522,401	628,608

Total	$ 2,331,309	$ 2,139,486

Part I Financial Information

Item 1. Financial Statements

Notes to Consolidated Financial Statements (Unaudited)

4. Stock-Based Compensation Plans

The Company has two stock-based compensation plans: the Stock Incentive Plan and the Non-Employee Director Stock Compensation Plan. Options are granted under the Stock Incentive Plan to officers and other key employees and directors at an exercise price equal to the fair market value of the shares on the date of grant, which is defined for purposes of the plans as the average of the high and low prices for the Company s common stock on the 10 trading days ending on the date of grant. Options become exercisable at a rate of 50% after the first year, 75% after the second year and 100% after the third year from the date of grant and expire six years after the date of grant (ten years for all options granted to directors and for options granted to officers and employees prior to 2004). The Stock Incentive Plan also provides for awards of restricted common stock to officers and other key employees, subject to forfeiture restrictions which lapse over time.

During the first quarter of 2006, the Company adopted Statement of Financial Accounting Standards No. 123R, Share-Based Payments (SFAS 123R), which requires an entity to measure and recognize the cost of employee services received in exchange for equity instrument awards based on the grant-date fair value of such awards. Previously, in accounting for its stock option compensation plans, the Company applied the intrinsic value method prescribed by Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees (APB 25). Intrinsic value is the amount by which the market price of the underlying stock exceeds the exercise price of the stock option or award on the measurement date, generally the date of grant. Prior to 2006, no stock option-based employee compensation expense was reflected in the Company s net income, as all options granted under the plans had an exercise price equal to the market value of the underlying common stock on the date of grant. However, the required pro forma fair-value based compensation cost disclosure was provided in accordance with Statement of Financial Accounting Standards No. 123, Accounting for Stock-Based Compensation , as amended by Statement of Financial Accounting Standards No. 148, Accounting for Stock-Based Compensation Transition and Disclosure (SFAS 148).

The Company elected to adopt the modified prospective application of SFAS 123R effective January 1, 2006. Under this method, compensation expense is recognized for both new awards and the unvested portion of previously issued awards outstanding as of the effective date over the period the requisite employee services are rendered.

The Company determines the fair value of each grant using the Black-Scholes option pricing model. The following weighted-average assumptions for grants made during the nine-month periods ended September 30, 2006 and 2005 are as follows:

	2006	2005
Dividend yield	1.36%	1.49%
Volatility	26.40%	30.74%
Risk-free interest rate	4.28%	3.62%
Expected lives in years	4.20	4.20

Expected dividend yield is based on the Company s dividend policy. Expected stock volatility was determined based upon the historical volatility for the four-year-period preceding the date of grant. The risk-free interest rate was based on the yield curve in effect at the time the options were granted, using U.S. constant maturities over the expected life of the option. The expected term of the awards represents the period of time that options granted are expected to be outstanding.

Part I Financial Information

Item 1. Financial Statements

Notes to Consolidated Financial Statements (Unaudited)

Activity in the Company s stock option plans for the nine months ended September 30, 2006 was as follows:

Option Activity	Number of Shares (in 000 s)	Weighted Average Exercise Price	Weighted Average Remaining Life (Years)
Options outstanding at beginning of period	6,125	$ 26.05	
Granted	940	36.88	
Exercised	(1,986)	25.29	
Canceled	(181)	31.97	
Options outstanding at end of period	4,898	28.22	4.49
Options exercisable at end of period	3,290	$ 25.77	4.33

During the first nine months of 2006 and 2005, the weighted-average fair value of options granted was $9.22 per share and $7.21 per share, respectively. During the first nine months of 2006 and 2005, the total intrinsic value of options exercised was $33.0 million and $5.1 million, respectively. The total cash received from these option exercises was $50.2 million and $14.2 million, respectively, and the tax benefit realized for the tax deductions from these option exercises was $9.3 million and $1.7 million, respectively. The aggregate intrinsic value of options outstanding and options exercisable as of September 30, 2006 was $66.5 million and $52.8 million, respectively.

Included in the Company s share-based compensation was expense recognized for its restricted stock awards of $6.2 million and $6.5 million in the first nine months of 2006 and 2005, respectively. Changes in the Company s restricted stock for the nine months ended September 30, 2006 were as follows:

Restricted Stock Activity	Restricted Shares (in 000 s)	Weighted Average Grant-Date Fair Value
Unvested restricted stock at beginning of period	642	$ 26.05
Granted	246	36.81
Vested	(244)	26.32
Forfeited	(28)	32.20
Unvested restricted stock at end of period	616	$ 29.97

Prior to January 1, 2006, the Company accounted for stock-based awards using the intrinsic value method in accordance with APB 25. The following table illustrates the effect on three months and nine months ended September 30, 2005 net income and earnings per share if the Company had applied the fair value recognition provisions of SFAS No. 123, as amended by SFAS No. 148:

Part I Financial Information

Item 1. Financial Statements

Notes to Consolidated Financial Statements (Unaudited)

(in thousands)	Three months ended September 30, 2005	Nine months ended September 30, 2005
Net income as reported	$ 40,042	$ 100,714
Add: Stock-based employee compensation of $1,579 and $6,452 for the three and nine months ended September 30, 2005, respectively, included in reported income, net of related tax effects	1,026	4,194
Less: Total stock-based employee compensation expense of $3,580 and $12,930 for the three and nine months ended September 30, 2005, respectively, determined under fair value based method for all awards, net of related tax effects	(2,367)	(8,525)
Net income pro forma	$ 38,701	$ 96,383
Basic earnings per share:		
As reported	$ 0.67	$ 1.69
Pro forma	$ 0.65	$ 1.62
Diluted earnings per share:		
As reported	$ 0.66	$ 1.67
Pro forma	$ 0.64	$ 1.60

The Company recognized share-based compensation expense of $11.3 million ($0.12 per diluted share, after related tax benefit of $3.9 million) in the first nine months of 2006 as a component of selling, general and administrative expense. In the first nine months of 2005, $6.5 million of share-based compensation expense was recognized, but because the Company adopted the new standard (SFAS 123R) prospectively as of January 1, 2006 it excludes expense related to stock options of $6.5 million. At September 30, 2006, there was $22.3 million of total unrecognized compensation cost related to stock-based compensation. That cost is expected to be recognized over a weighted average period of 1.7 years.

Prior to the adoption of SFAS 123R, the Company presented all tax benefits resulting from the exercise of stock-based awards as operating cash flows in the consolidated statement of cash flows. SFAS 123R requires cash flows resulting from excess tax benefits to be classified as financing cash flows. Excess tax benefits result from tax deductions in excess of the compensation cost recognized for those awards. For the nine months ended September 30, 2006, cash flow from operating activities was decreased $7.6 million with a corresponding increase in cash flow from financing activities related to excess tax benefits.

5. Net Income Per Share

The Company s basic earnings per share calculations are based on the weighted average number of common shares outstanding during the period. Diluted earnings per share gives effect to all dilutive potential common shares outstanding during the period.

(In thousands, except per share data)	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
Net income	$ 46,043	$ 40,042	$ 127,905	$ 100,714
Average basic shares outstanding	61,110	59,936	60,941	59,676
Effect of dilutive stock options	1,116	554	1,251	553

Average diluted shares outstanding	62,226	60,490	62,192	60,229
Basic net income per share	$ 0.75	$ 0.67	$ 2.10	$ 1.69
Diluted net income per share	0.74	0.66	2.06	1.67

Part I Financial Information

Item 1. Financial Statements

Notes to Consolidated Financial Statements (Unaudited)

6. Comprehensive Income

Total comprehensive income for the three and nine-month periods ended September 30, 2006 and 2005 is as follows:

(in thousands)	Three Months Ended September 30, 2006	Three Months Ended September 30, 2005	Nine Months Ended September 30, 2006	Nine Months Ended September 30, 2005
Net income	$ 46,043	$ 40,042	$ 127,905	$ 100,714
Foreign currency translation adjustments	1,739	(2,769)	33,489	(34,543)
Comprehensive income	$ 47,782	$ 37,273	$ 161,394	$ 66,171

7. Goodwill and Intangible Assets

Goodwill and intangible assets changes during the nine-month period ended September 30, 2006 primarily relate to the recording of preliminary purchase price allocations from the acquisition of substantially all the assets of CashCode Co. Inc. (CashCode) in January 2006, all of the outstanding capital stock of Telequip Corporation (Telequip) in June 2006, certain assets of Automatic Products international, ltd. (APi) in June and September 2006 and all of the outstanding capital stock of Noble Composites, Inc. (Noble) in September 2006. The final purchase price allocations will be completed during 2006.

Changes to goodwill are as follows:

(in thousands)	Nine Months Ended September 30, 2006	Year Ended December 31, 2005
Balance at beginning of period, net of accumulated amortization	$ 568,355	$ 579,081
Additions	133,521	4,569
Translation and other adjustments	10,501	(15,295)
Balance at end of period, net of accumulated amortization	$ 712,377	$ 568,355

Changes to intangible assets are as follows:

(in thousands)	Nine Months Ended September 30, 2006	Year Ended December 31, 2005
Balance at beginning of period, net of accumulated amortization	$ 60,735	$ 64,450
Additions	65,098	2,570
Translation and other adjustments	3,103	1,448
Amortization expense	(10,031)	(7,733)

Balance at end of period, net of accumulated amortization	$	118,905	$	60,735

Part I Financial Information

Item 1. Financial Statements

Notes to Consolidated Financial Statements (Unaudited)

A summary of intangible assets follows:

(in thousands)	**September 30, 2006**		**December 31, 2005**	
	Gross Asset	**Accumulated Amortization**	**Gross Asset**	**Accumulated Amortization**
Intellectual property rights	$ 104,119	$ 41,734	$ 78,296	$ 37,196
Drawings	10,825	7,562	10,825	7,363
Other	67,922	14,665	24,272	8,099
	$ 182,866	$ 63,961	$ 113,393	$ 52,658

The Other category includes assets such as customer/distributor relationships and customer sales backlog. Amortization expense for these intangible assets is currently estimated to be approximately $17.7 million in 2007, $14.4 million in 2008, $12.1 million in 2009, $11.9 million in 2010 and $10.7 million in 2011. Estimated amounts are subject to change based on the preliminary purchase price allocations currently being completed for CashCode, APi, Telequip and Noble.

Intangible assets totaled $118.9 million, net of accumulated amortization of $64.0 million at September 30, 2006. Included within this amount is $19.1 million of intangibles with indefinite useful lives, consisting of trade names which are not being amortized in accordance with the guidance of Statement of Financial Accounting Standards No. 142, Goodwill and Other Intangible Assets .

8. Acquisitions and Dispositions

In January 2006, the Company acquired substantially all of the assets of CashCode, a privately held company specializing in niche applications for banknote validation, storage and recycling devices for use in vending, gaming, retail and transportation applications, for approximately $85 million in cash. The final purchase price allocations will be completed during 2006; based on the preliminary purchase price allocation, approximately 90% will be for the acquisition of goodwill and intangibles. CashCode had sales of approximately $48 million in 2005. CashCode is located in Concord, Ontario, Canada and employs approximately 350 people worldwide, serving a global marketplace with 75% of its sales outside the United States, of which the majority are in Europe and Russia. CashCode was integrated into the Company s Merchandising Systems segment.

In June 2006, the Company acquired certain assets of APi, a privately held manufacturer of vending equipment, for a cash purchase price of approximately $20 million. In September 2006, additional assets of APi were acquired and a second payment of approximately $8 million was made. The final purchase price allocations will be completed during 2006; based on the preliminary purchase price allocation, approximately 65% will be for the acquisition of goodwill and intangibles. The acquisition included APi s extensive distribution network, product line designs and trade names, manufacturing equipment, aftermarket parts business, inventory and other related assets. The manufacturing equipment has been moved in October to the Crane Merchandising Systems facility in St. Louis, Missouri. The purchase did not include APi s manufacturing facility located in St. Paul, Minnesota. APi will be integrated into the Company s Merchandising Systems segment.

Also in June 2006, the Company acquired all of the outstanding capital stock of Telequip for a cash purchase price of approximately $45 million. The final purchase price allocations will be completed during 2006; based on the preliminary purchase price allocation, approximately 95% will be for the acquisition of goodwill and intangibles. Telequip, with headquarters in Salem, New Hampshire, has been manufacturing coin dispensing solutions since 1974. Telequip provides embedded and free-standing coin dispensing solutions

Part I Financial Information

Item 1. Financial Statements

Notes to Consolidated Financial Statements (Unaudited)

principally focused on the retail market which includes grocery and convenience stores, quick-service restaurants and self-checkout/self-service kiosks. Telequip s coin dispensers have a particularly strong position in automated self-checkout markets. Telequip will be integrated into the Company s Merchandising Systems segment.

In September 2006, the Company acquired all the outstanding capital stock of Noble for a cash purchase price of $72 million. The final purchase price allocations will be completed during 2006; based on the preliminary purchase price allocation, approximately 91% will be for the acquisition of goodwill and intangibles. Noble, located in Goshen, Indiana, is a privately held company specializing in the manufacture and sale of premium, high-gloss finished composite panels used by motor home and travel trailer manufacturers. Noble will be integrated into the Company s Engineered Materials segment.

On October 23, 2006, the Company announced that it had acquired all of the outstanding capital stock of Dixie-Narco Inc., a manufacturer of can and bottle vending machines, for a purchase price of $46 million in cash. Dixie-Narco manufactures can and bottle vending machines primarily for well-known companies such as Coca-Cola, PepsiCo, and Dr. Pepper/Seven Up. Dixie-Narco will be integrated into the Company s Merchandising Systems segment.

In April 2006, the Company completed the sale of the outstanding capital stock of Westad Industri A/S, a small specialty valve business located in Norway. This business had $25 million in sales in 2005. Westad was included in the Company s Fluid Handling segment. In May 2006, the Company completed the sale of substantially all of the assets of Resistoflex Aerospace, a manufacturer of high-performance hose and high pressure fittings located in Jacksonville, FL. This business had sales of $16 million in 2005. Resistoflex Aerospace was included in the Company s Aerospace & Electronics segment. The Company recognized an $8.9 million net gain from these divestitures. Resistoflex Aerospace was sold at a gain which was partly offset by a loss on Westad.

9. Asbestos Liability

Information Regarding Claims and Costs

As of September 30, 2006, the Company was a defendant in cases filed in various state and federal courts alleging injury or death as a result of exposure to asbestos. Activity related to asbestos claims during the periods indicated was as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,		Year Ended December 31,
	2006	**2005**	**2006**	**2005**	**2005**
Beginning claims	88,833	88,563	89,017	84,977	84,977
New claims	1,555	1,544	3,837	6,636	7,986
Settlements	(351)	(449)	(923)	(1,188)	(1,829)
Dismissals	(723)	(733)	(2,617)	(1,500)	(2,117)
Ending claims *	89,314	88,925	89,314	88,925	89,017

* Does not include 36,177 maritime actions that were filed in the United States District Court for the Northern District of Ohio and transferred to the Eastern District of Pennsylvania pursuant to an order by the Federal Judicial Panel on Multi-District Litigation (MDL). These claims have been placed on the inactive docket of cases that are administratively dismissed without prejudice in the MDL.

Part I Financial Information

Item 1. Financial Statements

Notes to Consolidated Financial Statements (Unaudited)

Of the 89,314 pending claims as of September 30, 2006, approximately 25,000 claims were pending in New York, approximately 32,000 claims were pending in Mississippi, approximately 9,200 claims were pending in Texas and approximately 3,400 claims were pending in Ohio, all jurisdictions in which legislation or judicial orders restrict the types of claims that can proceed to trial on the merits.

Since the termination of the comprehensive master settlement agreement (MSA) on January 24, 2005, the Company has been resolving claims filed against it in the tort system. The Company has not re-engaged in discussions with representatives of current or future asbestos claimants with respect to such a comprehensive settlement. While the Company believes that federal legislation to establish a trust fund to compensate asbestos claimants is the most appropriate solution to the asbestos litigation problem, there is substantial uncertainty regarding whether this will occur and, if so, when and on what terms. The Company remains committed to exploring all feasible alternatives available to resolve its asbestos liability in a manner consistent with the best interests of the Company s shareholders. Substantially all of the claims the Company resolves are concluded through settlements. However, the Company recently tried the Joseph Norris asbestos claim (the Norris Claim) to verdict in California and received an adverse jury verdict on September 15, 2006. On October 10, 2006 the court entered judgment on this verdict against the Company in the amount of $2.15 million, together with interest thereon at the rate of 10% per annum until paid. The Company does not believe that the verdict was supported by the evidence. In addition, the Company believes that procedural irregularities prevented an appropriate determination of the Company s alleged responsibility for plaintiffs injuries. The Company intends to challenge the verdict and subsequent judgment by post-trial motions, and it will raise all appropriate issues on appeal, if the post-trial motions are unsuccessful.

The gross settlement and defense costs incurred (before insurance and tax effects) for the Company in the nine-month periods ended September 30, 2006 and 2005 totaled $49.5 million and $32.7 million, respectively. In contrast to the recognition of settlement and defense costs that reflect the current level of activity in the tort system, cash payments and receipts generally lag the tort system activity by several months or more. Cash payments of settlement amounts are not made until all releases and other required documentation are received by the Company, and payments of both settlement amounts and defense costs by insurers are subject to delays due to the transition from the Company s primary insurers to its excess insurers. In addition, during the second quarter of 2006 the Company changed its method of processing payments in order to utilize the services of a third party firm specializing in allocation of settlement and defense costs to insurers resulting in a transitioning delay in payments which the Company caught up in the third quarter. The Company s total pre-tax cash payments for settlement and defense costs, net of payments from insurers and including certain legal fees and expenses relating to the terminated MSA in the nine-month periods ended September 30, 2006 and 2005 totaled $30.0 million and $24.6 million respectively, and are expected to be $45 million for the full year 2006. Detailed below are the comparable amounts for the periods indicated.

Part I Financial Information

Item 1. Financial Statements

Notes to Consolidated Financial Statements (Unaudited)

(In millions)	Three Months Ended September 30, 2006	Three Months Ended September 30, 2005	Nine Months Ended September 30, 2006	Nine Months Ended September 30, 2005	Year Ended December 31, 2005	Cumulative to date through Sept. 30, 2006
Settlement costs incurred (1)	$ 6.4	$ 5.5	$ 17.7	$ 13.6	$ 17.4	$ 73.9
Defense costs incurred (1)	11.9	7.3	31.8	19.1	27.7	105.5
Total costs incurred	$ 18.3	$ 12.8	$ 49.5	$ 32.7	$ 45.1	$ 179.4
Pre-tax cash payments (receipts) (2)	$ 20.9	$ 5.3	$ 30.0	$ 24.6	$ 45.3	$ 115.0
(Refund) associated with terminated MSA				$ (9.9)	$ (9.9)	$ .1

(1) Before insurance recoveries and tax effects.

(2) Net of payments received from insurers. Amounts include advance payments to third parties that are reimbursable by insurers and certain legal fees and expenses related to the terminated MSA.

The amounts shown for settlement and defense costs incurred, and cash payments, are not necessarily indicative of future period amounts, which may be higher or lower than those reported.

In 2005, the Company did not receive significant reimbursements from insurers as the Company s cost sharing agreement with primary insurers was essentially exhausted. The Company continues to negotiate with various of its excess insurers whose policies provide substantial insurance coverage for asbestos liabilities. Reimbursements from such insurers for past and ongoing settlement and defense costs allocable to their policies will be made as coverage-in-place and other agreements are reached with such insurers.

On July 22, 2005, the Company entered into an agreement to settle its insurance coverage claims for asbestos and other liabilities against certain underwriters at Lloyd s of London reinsured by Equitas Limited (Equitas) for a total payment of $33 million. Under the agreement, $1.5 million was paid to the Company in the third quarter of 2005. The balance was placed into escrow for the payment of future asbestos claims and funds remaining in escrow will be paid to the Company on January 3, 2007, if no federal asbestos legislation is enacted by that date. If federal asbestos reform is enacted before January 3, 2007, the money then remaining in escrow would be paid to Equitas, subject to a payment of $1.5 million to the Company and a hold-back of certain funds in escrow for the payment of asbestos claims during the year following enactment of asbestos legislation. The Company s settlement with Equitas resolves all its claims against pre-1993 policies issued to the Company by certain underwriters at Lloyd s of London and reinsured by Equitas.

Effective March 1, 2006, the Company entered into two agreements with Hartford Accident and Indemnity Company and certain affiliated companies (Hartford) settling all outstanding claims under the Company s primary policies with Hartford for a final payment of $1.3 million and establishing a coverage-in-place arrangement for asbestos claims under the Company s excess policies with Hartford, including a payment of $2.6 million for claims billed to Hartford through September 1, 2005. The Company received these payments in March 2006 and April 2006, respectively. The agreements with Hartford also include provisions for mutual releases, indemnification of Hartford and claims handling procedures.

Part I Financial Information

Item 1. Financial Statements

Notes to Consolidated Financial Statements (Unaudited)

Effective April 10, 2006, the Company and Everest Reinsurance Company and Mt. McKinley Insurance Company (collectively, Everest) reached a settlement agreement pursuant to which, among other things, Everest s insurance coverage obligations for asbestos claims under the three historical Everest policies issued to Crane Co. were released. A $3.8 million cash payment under this settlement agreement was received by the Company on April 21, 2006.

On June 30, 2006, the Company and Fireman s Fund Insurance Company (Fireman s Fund) entered into an agreement, effective July 3, 2006, establishing a coverage-in-place arrangement for asbestos claims under the Company s excess policies with Fireman s Fund, including a payment of $2.3 million for claims billed to Fireman s Fund through June 26, 2006, which was received by the Company in August 2006. The agreement with Fireman s Fund also includes provisions for mutual releases, indemnification of Fireman s Fund and claims handling procedures.

Effective September 7, 2006, the Company entered into a coverage-in-place agreement with Sentry Insurance (Sentry), regarding an excess policy issued by Sentry s predecessor, Dairyland Insurance Company.

The Company anticipates that one or more additional agreements with other excess insurers, such as coverage-in-place agreements, may be executed in 2006, and the Company believes that the payment terms of such agreements will be consistent with the overall estimated future reimbursement rate of 40%, although the actual reimbursement rate will vary from period to period due to policy terms and certain gaps in coverage as described below.

Effects on the Consolidated Financial Statements

The Company has retained the firm of Hamilton, Rabinovitz & Alschuler, Inc. (HR&A), a nationally recognized expert in the field, to assist management in estimating the Company s asbestos liability in the tort system. HR&A reviewed information provided by the Company concerning claims filed, settled and dismissed, amounts paid in settlements and relevant claim information such as the nature of the asbestos-related disease asserted by the claimant, the jurisdiction where filed and the time lag from filing to disposition of the claim. The methodology used by HR&A to project future asbestos costs was based largely on the Company s experience during 2004 and 2005 for claims filed, settled and dismissed. The Company s experience was compared to the results of previously conducted epidemiological studies estimating the number of people likely to develop asbestos-related diseases. Those studies were undertaken in connection with national analyses of the population of workers believed to have been exposed to asbestos. Using that information, HR&A estimated the number of future claims that would be filed, as well as the related settlement or indemnity costs that would be incurred to resolve those claims. This methodology has been accepted by numerous courts and is the same methodology that is utilized by the expert who is routinely retained by the asbestos claimants committee in asbestos-related bankruptcies. After discussions with the Company, HR&A assumed that costs of defending asbestos claims in the tort system would increase to $37 million in 2006 and remain at that level (with increases of 4.5% per year for inflation) indexed to the number of estimated pending claims in future years. Based on this information, HR&A compiled an estimate of the Company s asbestos liability for pending and future claims, based on claim experience over the past two years and covering claims expected to be filed through the year 2011. Although the methodology used by HR&A will also show claims and costs for periods subsequent to 2011 (up to and including the endpoint of the asbestos studies referred to above), management believes that the level of uncertainty is too great to provide for reasonable estimation of the number of future claims, the nature of such claims or the cost to resolve them for years beyond 2011, particularly given the possibility of federal legislation within that time frame. While it is reasonably possible that the Company will incur additional charges for asbestos liabilities and defense costs in excess of the amounts currently provided, the Company does not believe that any such amount can be reasonably estimated beyond 2011. Accordingly, no accrual has been recorded for any costs which may be incurred beyond 2011.

Part I Financial Information

Item 1. Financial Statements

Notes to Consolidated Financial Statements (Unaudited)

Management has made its best estimate of the costs through 2011 based on the analysis by HR&A completed in January 2006. The Company compared the current asbestos claim activity as of September 30, 2006 to the assumptions in the HR&A analysis and determined that the accrual continues to be appropriate. A liability of $541.9 million has been recorded to cover the estimated cost of asbestos claims now pending or subsequently asserted through 2011, of which approximately 56% is attributable to settlement and defense costs for future claims projected to be filed through 2011. The liability is reduced when cash payments are made in respect of settled claims and defense costs. It is not possible to forecast when cash payments related to the asbestos liability will be fully expended; however, it is expected such cash payments will continue for many years, due to the significant proportion of future claims included in the estimated asbestos liability. An asset of $224.6 million has been recorded representing the probable insurance reimbursement for such claims using a rate of 40% for future recoveries.

Historically, a significant portion of the Company s settlement and defense costs have been paid by its primary insurers. Following the exhaustion of most of that primary coverage, and in accordance with the settlement agreements discussed above, certain of the Company s excess insurers have begun reimbursing the Company for a significant portion of its settlement and defense costs. The Company has substantial excess coverage policies in addition to those bound by the settlement agreements described above that are also expected to respond to asbestos claims as settlements and other payments exhaust the underlying policies. The same factors that affect developing estimates of probable settlement and defense costs for asbestos-related liabilities also affect estimates of the probable insurance payments, as do a number of additional factors. These additional factors include the financial viability of the insurance companies, the method by which losses will be allocated to the various insurance policies and the years covered by those policies, how settlement and defense costs will be covered by the insurance policies and interpretation of the effect on coverage of various policy terms and limits and their interrelationships. In addition, the timing and amount of reimbursements will vary because the Company s insurance coverage for asbestos claims involves multiple insurers, with different policy terms and certain gaps in coverage. In addition to consulting with legal counsel on these insurance matters, the Company retained insurance consultants to assist management in the estimation of probable insurance recoveries based upon the aggregate liability estimate described above and assuming the continued viability of all solvent insurance carriers. After considering the foregoing factors and consulting with legal counsel and such insurance consultants, the Company determined its probable insurance reimbursement rate to be 40%.

Estimation of the Company s ultimate exposure for asbestos-related claims is subject to significant uncertainties, as there are multiple variables that can affect the timing, severity and quantity of claims. The Company cautions that its estimated liability is based on assumptions with respect to future claims, settlement and defense costs based on recent experience during the last few years that may not prove reliable as predictors. A significant upward or downward trend in the number of claims filed, depending on the nature of the alleged injury, the jurisdiction where filed and the quality of the product identification, or a significant upward or downward trend in the costs of defending claims, could change the estimated liability, as would any substantial adverse verdict at trial. A legislative solution or a revised structured settlement transaction could also change the estimated liability.

Since many uncertainties exist surrounding asbestos litigation, the Company will continue to evaluate its estimated asbestos-related liability and corresponding estimated insurance reimbursement as well as the underlying assumptions and process used to derive these amounts. These uncertainties may result in the Company incurring future charges or increases to income to adjust the carrying value of recorded liabilities and assets, particularly if the number of claims and settlement and defense costs change significantly or if

Part I Financial Information

Item 1. Financial Statements

Notes to Consolidated Financial Statements (Unaudited)

legislation or another alternative solution is implemented; however, the Company is currently unable to estimate such future changes. Although the resolution of these claims may take many years, the effect on results of operations and financial position in any given period from a revision to these estimates could be material.

Certain Legal Proceedings

On January 21, 2005, five of the Company s insurers within two corporate insurer groups filed suit in Connecticut state court seeking injunctive relief against the Company and declaratory relief against the Company and dozens of the Company s other insurers. The suit also sought temporary and permanent injunctive relief restraining the Company from participating in any further settlement discussions with representatives of asbestos plaintiffs or agreeing to any settlement unless the Company permitted the plaintiff insurers to both participate in such discussions and have a meaningful opportunity to consider whether to consent to any proposed settlement, or unless the Company elected to waive coverage under the insurers policies. The plaintiffs also sought expedited discovery on, among other things, the Company s proposed global settlement. At a hearing on February 22, 2005, the Company (i) contested the application for temporary injunctive relief and expedited discovery; (ii) moved to dismiss the count of the Complaint seeking injunctive relief on the grounds that the count was moot insofar as it addressed the proposed global settlement terminated on January 24, 2005 and not appropriate for determination insofar as it sought relief regarding any future negotiations with representatives of asbestos claimants; and (iii) moved to dismiss counts of the Complaint seeking declaratory relief with respect to the proposed global settlement as moot. At the hearing, the Court denied the plaintiff insurers application for temporary injunctive relief and expedited discovery. In denying temporary injunctive relief, the Court stated that the plaintiffs could not show irreparable injury and that the plaintiff insurers would have an adequate remedy at law. In light of the Court s ruling and the Company s motions to dismiss, the insurer plaintiffs sought and received leave to amend their Complaint to remove certain declaratory relief counts and to remove or restate the remaining allegations.

On April 8, 2005, the insurer plaintiffs filed an Amended Complaint raising five counts against the Company**.** The Amended Complaint seeks: (i) declaratory relief regarding the Company s rights to coverage, if any, under the policies; (ii) declaratory relief regarding the Company s alleged breaches of the policies in connection with an alleged increase in asbestos claim counts; (iii) a declaration of no coverage in connection with allegedly time-barred claims; (iv) declaratory relief against the Company and the other insurer defendants for allocation of damages that may be covered under the insurance policies; and (v) preliminary and permanent injunctive relief. On April 18, 2005, the Company moved to dismiss the claims for injunctive relief on the grounds that the Court had no jurisdiction to consider the claims because they were speculative and unripe. On October 19, 2005, the Court denied the Company s motion to dismiss, ruling that the injunctive claims were not unripe. Nonetheless, the Court noted that the Company later could seek summary judgment in connection with the injunctive claims if discovery shows them to be without factual basis. Everest Reinsurance Company and Mt. McKinley Insurance Company (collectively, Everest) are two of the plaintiffs in the Connecticut state court action. As referenced above, effective April 10, 2006, the Company and Everest reached a settlement agreement pursuant to which, among other things, Everest s insurance coverage obligations for asbestos claims under the three historical Everest policies issued to Crane Co. were released in exchange for a $3.8 million cash payment, which was received by the Company on April 21, 2006. The Company continues to believe it has meritorious defenses to all the counts of the Amended Complaint and intends to defend this matter vigorously.

Part I Financial Information

Item 1. Financial Statements

Notes to Consolidated Financial Statements (Unaudited)

10. Pension and Other Postretirement Benefit Plans

The components of net periodic cost are as follows:

	Three Months Ended September 30,				Nine Months Ended September 30,			
(in thousands)	**Pension Benefits**		**Other Postretirement Benefits**		**Pension Benefits**		**Other Postretirement Benefits**	
	2006	**2005**	**2006**	**2005**	**2006**	**2005**	**2006**	**2005**
Service cost	$ 4,050	$ 3,692	$ 41	$ 43	$ 12,151	$ 12,350	$ 123	$ 129
Interest cost	7,706	7,129	284	294	23,117	22,711	852	882
Expected return on plan assets	(9,871)	(9,583)			(29,611)	(29,169)		
Amortization of prior service cost	147	319	(40)	(42)	440	603	(120)	(126)
Amortization of net loss (gain)	262	(15)	(21)	(21)	786	165	(63)	(63)
Net periodic cost	$ 2,294	$ 1,542	$ 264	$ 274	$ 6,883	$ 6,660	$ 792	$ 822

The Company expects, based on current actuarial calculations, to contribute cash in the range of $6.0 to $12.0 million to its domestic and foreign defined benefit plans and $2 million to its other postretirement benefit plans in 2006. The Company contributed cash of $5.7 million to its defined benefit plans and $1.9 million to its other postretirement benefit plans in 2005. During the first nine months of 2006, the Company contributed $6.7 million to its defined benefit plans and $1.5 million to its other postretirement benefit plans. However, cash contributions for the remainder of 2006 and subsequent years will depend on a number of factors, including the impact of the Pension Protection Act signed into law in August 2006, changes in minimum funding requirements, long-term interest rates, the investment performance of plan assets and changes in employee census data affecting the Company s projected benefit obligations.

Part I Financial Information

Item 1. Financial Statements

Notes to Consolidated Financial Statements (Unaudited)

11. Income Taxes

The Company calculated its income tax provision for the three and nine months ended September 30, 2006 in accordance with the requirements of Statement of Financial Accounting Standards No. 109, Accounting for Income Taxes, Accounting Principles Board Opinion No. 28, Interim Financial Reporting, and Financial Accounting Standards Board Interpretation No. 18, Accounting for Income Taxes in Interim Periods.

The Company s effective tax rates of 32.2% and 31.8% for the three and nine months ended September 30, 2006, respectively, are higher than the Company s effective tax rates of 30.3% and 30.7% for the three and nine months ended September 30, 2005, respectively, primarily due to the expiration of the U.S. federal research and development tax credit on December 31, 2005 and the statutory phase-out of the U.S. export tax benefit.

The Company s effective tax rates for the three and nine months ended September 30, 2006 vary from the statutory U.S. federal tax rate primarily as a result of state taxes, net of federal tax benefit, offset by earnings in foreign jurisdictions with tax rates below the U.S. statutory rate and U.S. federal tax benefits on export sales and domestic manufacturing activities.

12. Miscellaneous - Net

(in thousands)	**Three Months Ended September 30,**		**Nine Months Ended September 30,**	
	2006	**2005**	**2006**	**2005**
Gain (loss) on sales of assets	$ 309	$ (629)	$ 5,263	$ (245)
Equity joint venture income	1,305	1,894	4,525	4,476
Other	(153)	(487)	(2,645)	(1,387)
	$ 1,461	$ 778	$ 7,143	$ 2,844

The gain on sales of assets in the nine month period ended September 30, 2006 was higher than in the prior year from the 2006 gain on the sale of Resistoflex Aerospace partially offset by the loss on the Westad divestiture, a net gain of $8.9 million, coupled with 2006 costs of $4.2 million from the sale of unused property resulting from prior plant consolidations and legal costs associated with previous divestitures.

13. Long-term Debt and Notes Payable

Long-term debt, net of deferred financing costs, was $366 million at September 30, 2006 comprised primarily of fixed rate borrowings under the $100 million 6.75% notes due 2006, $200 million 5.50% notes due 2013 and $72 million borrowed under uncommitted lines of credit. Because the Company has the intention and ability to refinance the $100 million 6.75% notes due October 2006 at maturity and the $72 million borrowed under the uncommitted lines of credit with long-term borrowings, they are classified as long-term at September 30, 2006.

Part I Financial Information

Item 2. Management s Discussion and Analysis of Financial Condition and Results of Operations

This Form 10-Q contains forward-looking statements as defined by the Private Securities Litigation Reform Act of 1995. These statements present management s expectations, beliefs, plans and objectives regarding future financial performance, and assumptions or judgments concerning such performance. Any discussions contained in this 10-Q, except to the extent that they contain historical facts, are forward-looking and accordingly involve estimates, assumptions, judgments and uncertainties. There are a number of other factors that could cause actual results or outcomes to differ materially from those addressed in the forward-looking statements. Such factors are detailed in the Company s Annual Report on Form 10-K for the fiscal year ended December 31, 2005 filed with the Securities and Exchange Commission and are incorporated by reference herein.

Results from Operations

Third quarter of 2006 compared with third quarter of 2005

Third quarter 2006 sales increased $45.5 million, or 9%, including core business growth of $9.3 million (2%), sales from acquired businesses (Edlon, APi, Telequip, and CashCode) of $34.8 million (7%) and favorable foreign currency translation of $9.8 million (2%), reduced by lower sales from divested businesses (Resistoflex Aerospace and Westad) of $8.4 million (2%). Operating profit of $71.2 million rose 15% compared with $61.8 million in the prior year quarter. Corporate expenses were $4.2 million compared to $6.8 million in the prior year quarter primarily as result of a $4.9 million reimbursement from the U.S. government for environmental clean-up costs at a former manufacturing site in Arizona, which previously manufactured products for the government. The effective tax rate in the third quarter of 2006 was 32.2% compared to 30.3% in the third quarter of 2005 primarily because of the absence of the federal research and development tax credit in 2006. Third quarter 2006 net income was $46.0 million, or $.74 per share, compared with net income of $40.0 million, or $.66 per share, in the third quarter of 2005.

Net sales related to operations outside the United States were 37.9% and 36.2% of total net sales for the three-month periods ended September 30, 2006 and 2005, respectively.

Segment Results

All comparisons below refer to the third quarter 2006 versus the third quarter 2005, unless otherwise specified.

Aerospace & Electronics

(dollars in millions)	**Third Quarter**			
	2006	**2005**	**Change**	
Sales	$ 143.0	$ 141.7	$ 1.3	1%
Operating Profit	$ 25.3	$ 26.5	$ (1.2)	(5)%
Profit Margin	17.7%	18.7%		

The third quarter 2006 sales increase of $1.3 million reflected a sales increase of $6.2 million in the Aerospace Group and a decrease of $4.9 million in the Electronics Group. Segment operating profit decreased by $1.2 million, as an increase of $2.8 million in Aerospace was more than offset by a $4.0 million decline in Electronics.

Aerospace Group sales of $90.3 million increased $6.2 million, or 7%, from $84.1 million in the prior year period. Resistoflex Aerospace, which was sold in mid May 2006, had sales of $4.2 million in the third quarter of 2005. Excluding Resistoflex Aerospace, sales increased $10.4 million or 12% over the third quarter of 2005. Backlog at the end of the third quarter of 2006 (excluding Resistoflex) increased 20% over the third quarter of 2005.

Electronics Group sales of $52.7 million decreased $4.9 million, or 9%, from $57.6 million in the prior year period, with increased sales in Power Solutions more than offset by lower sales primarily in Microwave and Electronic Manufacturing Services Solutions. Operating profit decreased by $4.0 million from the third quarter of 2005 because of lower volumes in Microwave and Electronic Manufacturing Services Solutions and higher costs.

Part I Financial Information

Item 2. Management s Discussion and Analysis of Financial Condition and Results of Operations

Engineered Materials

(dollars in millions)	Third Quarter			
	2006	**2005**	**Change**	
Sales	$ 71.6	$ 75.6	$ (4.0)	(5)%
Operating Profit	$ 9.7	$ 15.7	$ (6.0)	(38)%
Profit Margin	13.5%	20.8%		

The third quarter 2006 sales decrease of $4.0 million, or 5%, reflects lower volumes to recreational vehicle customers, who experienced an industry-wide decline in sales late in the third quarter. Operating profit in 2006 decreased $6.0 million as a result of higher expenses for recreational vehicle customers product support activities and lower sales. On September 29, 2006, Crane acquired Noble, a privately held company specializing in the manufacture and sale of premium, high-gloss finished composite panels used by motorhome and travel trailer manufacturers. The purchase price was approximately $72 million in cash, subject to normal closing adjustments. No sales or operating results from the September 29, 2006, acquisition of Noble were included in the third quarter.

Merchandising Systems

(dollars in millions)	Third Quarter			
	2006	**2005**	**Change**	
Sales	$ 73.4	$ 40.6	$ 32.8	81%
Operating Profit	$ 8.9	$ 3.5	$ 5.4	152%
Profit Margin	12.1%	8.7%		

Merchandising Systems sales increased $32.8 million, or 81%, reflecting increased Payment Solutions sales of $21.6 million primarily from CashCode and Telequip Corporation and an $11.2 million increase in Vending Solutions sales primarily from the acquisition of APi. European and North American vending machine sales (excluding APi) were lower than last year as the vending machine industry continues to experience weak demand from route operators whose cash flow has been diminished by higher gas prices and food costs. The $5.4 million increase in operating profit reflected the solid performance of the three acquisitions and a $1.0 million favorable adjustment to the intangible amortization associated with the purchase accounting for CashCode.

On October 23, 2006, the Company announced that it had acquired Dixie-Narco, a manufacturer of can and bottle vending machines, for a purchase price of $46 million in cash. Dixie-Narco manufactures can and bottle vending machines primarily for well-known companies such as Coca-Cola, PepsiCo, and Dr. Pepper/Seven Up. This business is currently unprofitable and significant changes to Dixie-Narco s current business practices will be required to return it to profitability. While these changes will take a number of months to implement, management is confident about the longer term attractiveness of this acquisition.

Fluid Handling

(dollars in millions)	Third Quarter			
	2006	**2005**	**Change**	
Sales	$ 256.2	$ 244.0	$ 12.2	5%
Operating Profit	$ 29.4	$ 21.1	$ 8.3	39%
Profit Margin	11.5%	8.7%		

The third quarter sales increased $12.2 million, or 5%, including $8.2 million (3%) of core sales, favorable foreign currency translation of $8.2 million (3%), reduced by lower sales from the divestiture of Westad of $4.2 million (1%). Backlog at the end of the third quarter of 2006 (excluding Westad) increased 18% over the third quarter of 2005. Operating profit increased $8.3 million, or 39%, and margins continued to improve, versus the third quarter of 2005, reflecting strengthened management teams and improved operational processes.

Part I Financial Information

Item 2. Management s Discussion and Analysis of Financial Condition and Results of Operations

Valve Group sales were $179.4 million in the third quarter of 2006 compared with $170.0 million in the third quarter of 2005, an increase of 6%. Valve Group core sales growth was $8.8 million (5%), the favorable currency translation was $4.8 million (3%), partially offset by $4.2 million (2%) of sales of Westad. Core sales improved from increased demand for industrial valves, particularly from the chemical process and refining industries, and generally higher demand from many commercial applications. Operating profit increased 42% versus the prior year, reflecting higher sales and improved operating costs with price increases covering rising material and other costs. Profit margin of 11.1% was up strongly from 8.3% in the prior year.

Crane Pumps & Systems sales of $26.0 million decreased $1.6 million, or 6%, compared to the third quarter of 2005, reflecting generally softer market demand. Profit margin of 7.9% was up from 6.8% in the prior year due to productivity gains from facilities consolidation and customer price increases.

Crane Supply sales of $48.2 million increased $4.8 million, or 11%, benefiting from $3.3 million (8%) of favorable foreign currency translation, and an increase in core sales of $1.5 million (3%). The sales increase was due to higher project orders. Profit margin increased from 11.5% in 2005 to 12.8% in 2006.

Controls

(dollars in millions)	**Third Quarter**			
	2006	**2005**	**Change**	
Sales	$ 23.4	$ 20.4	$ 3.0	15%
Operating Profit	$ 2.1	$ 1.7	$ 0.4	24%
Profit Margin	9.0%	8.4%		

Sales improvements of $3.0 million, or 15%, were largely attributable to increased demand for products in the transportation, oil and gas exploration, and gas transmission markets. Operating profit was higher than the prior year period as volume gains were leveraged to achieve higher operating margins.

Results from Operations

Year-to-date period ended September 30, 2006 compared to year-to-date period ended September 30, 2005

Year-to-date 2006 sales increased $120.3 million, or 8%, including core business growth of $60.6 million (4%), sales from acquired businesses of $68.7 million (4%) and favorable foreign currency translation of $7.8 million (1%) partially offset by the absence of revenue from divestitures of $16.8 million (1%). Operating profit of $194.5 million rose 23% compared with $158.5 million in the prior year. Strong operating performance in the Fluid Handling and Aerospace segments together with incremental profit from acquisitions in the Merchandising segment and a $4.9 million reimbursement for prior environmental costs incurred drove the improved performance. Net miscellaneous income of $7.1 million in the nine month period ended September 30, 2006 was higher than the prior year income of $2.8 million because of the gain on the sale of Resistoflex Aerospace partially offset by the loss on the Westad divestiture, the sale of unused property resulting from prior plant consolidations and legal costs associated with previous divestitures. Net income for the nine months ended September 30, 2006 increased to $127.9 million, or $2.06 per share, compared with net income of $100.7 million, or $1.67 per share, for the prior year.

Net sales related to operations outside the United States were 37.2% and 37.0% of total net sales for the nine-month periods ended September 30, 2006 and 2005, respectively.

Order backlog at September 30, 2006 totaled $639.0 million, compared with backlog of $597.1 million at December 31, 2005 and $604.8 million at September 30, 2005.

Part I Financial Information

Item 2. Management s Discussion and Analysis of Financial Condition and Results of Operations

Segment Results

All comparisons below reference the year-to-date period ended September 30, 2006 versus the year-to-date period ended September 30, 2005 (prior period), unless otherwise specified.

Aerospace & Electronics

(dollars in millions)	Year-to-Date			
	2006	**2005**	**Change**	
Sales	$ 429.9	$ 409.2	$ 20.7	5%
Operating Profit	$ 73.9	$ 60.7	$ 13.2	22%
Profit Margin	17.2%	14.8%		

The year-to-date 2006 sales increase of $20.7 million reflected sales increases of $18.8 million in the Aerospace Group and $1.9 million in the Electronics Group. The sales increase was effectively leveraged as segment operating profit margins increased to 17.2% from 14.8% in the prior year.

Aerospace Group sales of $269.8 million increased $18.8 million, or 7%, from $251.0 million in the prior year period. Core sales growth of $24.7 million (10%) was partially offset by a $5.9 million (2%) decline in sales from the absence of Resistoflex Aerospace, which was sold in May 2006. Sales increased largely due to higher commercial OEM and commercial after-market volumes. Operating profit increased $11.7 million reflecting higher volumes, improved margins in part due to lower severance charges incurred in the first nine months of 2005.

Electronics Group sales of $160.1 million increased $1.9 million, or 1%, from $158.2 million in the prior year period, with sales increases in Power Solutions partly offset by lower Electronic Manufacturing and Micro Electronic Solutions sales. Operating profit improved by $1.5 million due to the reduction of charges for losses on contracts.

The Aerospace & Electronics Segment backlog was $380.2 million at September 30, 2006, compared with $365.0 million at December 31, 2005 and $366.1 million at September 30, 2005.

Engineered Materials

(dollars in millions)	Year-to-Date			
	2006	**2005**	**Change**	
Sales	$ 239.9	$ 235.6	$ 4.3	2%
Operating Profit	$ 38.6	$ 50.8	$ (12.2)	(24)%
Profit Margin	16.1%	21.6%		

The year-to-date 2006 sales increase of $4.3 million, or 2%, reflects higher pricing across all market segments, higher volumes in building products and transportation market segments partly offset by lower volumes to recreational vehicle customers who experienced an industry-wide decline in sales late in the third quarter. Profit margin decreased to 16.1% primarily as a result of higher expenses largely for recreational vehicle customers product support activities, material costs and new and existing market development activities.

On September 29, 2006, Crane acquired Noble, a privately held company specializing in the manufacture and sale of premium, high-gloss finished composite panels used by motorhome and travel trailer manufacturers. The purchase price was approximately $72 million in cash, subject to normal closing adjustments.

The Engineered Materials segment backlog was $13.2 million at September 30, 2006, compared with $17.2 million at December 31, 2005 and $20.7 million at September 30, 2005.

Part I Financial Information

Item 2. Management s Discussion and Analysis of Financial Condition and Results of Operations

Merchandising Systems

(dollars in millions)	**Year-to-Date**			
	2006	**2005**	**Change**	
Sales	$ 179.6	$ 130.1	$ 49.5	38%
Operating Profit	$ 17.1	$ 11.4	$ 5.7	50%
Profit Margin	9.5%	8.7%		

Merchandising Systems sales increased $49.5 million, or 38%, reflecting increased Payment Solutions sales of $50.9 million primarily from the CashCode and Telequip acquisition offset by a slight decline in total Vending Solutions sales. Sales from the acquisition of APi mostly offset a significant decline in existing European and North American vending machine sales from last year as the vending machine industry continues to experience declining demand from route operators whose cash flow has been diminished by higher gas prices and food costs.

In response to lower sales, Crane s vending operations in the United States reduced employment and incurred severance costs of $2.0 million in the first nine months of 2006. The $5.7 million increase in operating profit reflected the solid performance of the three acquisitions partly offset by the effect of the reduced sales volume and severance costs in vending.

In January 2006, Crane acquired substantially all of the assets of CashCode Co. Inc., a privately held company specializing in niche applications for banknote validation, storage and recycling devices for use in vending, gaming, retail and transportation applications. The purchase price was approximately $85 million in cash. CashCode had sales of approximately $48 million in 2005.

In June 2006, Crane acquired all of the outstanding stock of Telequip for a cash purchase price of approximately $45 million. Telequip provides embedded and free-standing coin dispensing solutions principally focused on the retail market which includes grocery and convenience stores, quick-service restaurants and self-checkout/self-service kiosks.

In June 2006, the Company acquired certain assets of APi, a privately held manufacturer of vending equipment, for a cash purchase price of approximately $20 million. In September 2006, additional assets of APi were acquired and a second payment of approximately $8 million was made. The manufacturing operations of APi are going to be consolidated into the Crane Merchandising Systems St. Louis facility to realize cost savings.

On October 23, 2006, the Company announced that it had acquired all of the outstanding capital stock of Dixie-Narco Inc., a manufacturer of can and bottle vending machines, for a purchase price of $46 million in cash. Dixie-Narco manufactures can and bottle vending machines primarily for well-known companies such as Coca-Cola, PepsiCo, and Dr. Pepper/Seven Up. This business is currently unprofitable and significant changes to Dixie-Narco s current business practices will be required to return it to profitability. While these changes will take a number of months to implement, management is confident about the longer term attractiveness of this acquisition.

The Merchandising Systems segment backlog was $18.6 million at September 30, 2006, compared with $9.2 million at December 31, 2005 and $8.4 million at September 30, 2005.

Fluid Handling

(dollars in millions)	**Year-to-Date**			
	2006	**2005**	**Change**	
Sales	$ 755.4	$ 718.5	$ 36.9	5%
Operating Profit	$ 83.8	$ 53.6	$ 30.2	56%
Profit Margin	11.1%	7.5%		

Part I Financial Information

Item 2. Management s Discussion and Analysis of Financial Condition and Results of Operations

The year-to-date 2006 sales increase of $36.9 million, or 5%, included $35.4 million (5%) of core sales, $8.4 million (1%) from favorable foreign currency translation and $4.0 million (1%) from an acquired business, but was offset by a $10.9 million (2%) decline in sales caused by the absence of Westad, which was sold effective April 1, 2006. Operating profit increased 56%, and margin continued to improve due to strengthened management teams and improved operational processes. The first nine months of 2005 included severance costs of $2.2 million and facility closure costs of $1.5 million.

To better align our external financial reporting with our strategic focus and management structure, beginning with the first quarter of 2006, the Company included Resistoflex and Crane Ltd. in the Valve Group. Crane Pumps & Systems and Crane Supply remain unchanged.

Valve Group sales of $534.9 million increased $19.6 million, or 4%, from the prior year on a comparable basis. Core sales growth was $28.9 million (6%) and an acquisition contributed $4.0 million (1%), partially offset by a $10.9 million (2%) decline in sales caused by the absence of Westad, which was sold effective April 1, 2006, and $2.4 million (1%) from unfavorable foreign currency translation. Core sales improved from increased demand for industrial valves, particularly from the chemical process and refining industries, and generally higher demand from many commercial applications. Operating profit increased 54% versus the prior year reflecting higher sales and improved operating costs with price increases covering rising material and other costs. Profit margin of approximately 11% improved from approximately 7% in the prior year. The first nine months of 2005 included severance costs of $1.9 million.

Crane Pumps & Systems sales of $80.0 million increased $4.0 million, or 5%, from the prior year. Sales increased across most of the served markets. Profit margin of approximately 11% was up from approximately 5% in the prior year due to productivity gains from facilities consolidation and customer price increases.

Crane Supply sales of $133.6 million increased $13.8 million, or 12%, of which 3% was net core volume growth and 9% from favorable foreign currency translation. Profit margin of approximately 12%, was up from approximately 10% in the prior year.

The Fluid Handling Segment backlog was $209.7 million at September 30, 2006, compared with $188.8 million at December 31, 2005 and $194.4 million at September 30, 2005. Excluding Westad, the backlog was $165.6 million and $178.1 million at December 31, 2005 and September 30, 2005, respectively.

Controls

(dollars in millions)	**Year-to-Date**			
	2006	**2005**	**Change**	
Sales	$ 70.6	$ 61.9	$ 8.7	14%
Operating Profit	$ 7.7	$ 5.3	$ 2.4	45%
Profit Margin	10.8%	8.5%		

Sales improvements of $8.7 million, or 14%, were largely attributable to increased demand for products in the transportation, oil and gas exploration, and gas transmission markets. Operating profit was higher than the prior year period as volume gains were leveraged to achieve higher operating margins.

The Controls segment backlog was $17.3 million at September 30, 2006, compared with $16.9 million at December 31, 2005 and $15.2 million at September 30, 2005.

Financial Position

Net debt (total debt less cash and cash equivalents) totaled 23.0% of total capital (net debt plus shareholders equity) at September 30, 2006 compared with 13.1% at December 31, 2005, driven primarily by the $235 million expended year-to-date for the acquisitions of CashCode, APi, Telequip and Noble Composites. Net debt is a non-GAAP measure that provides useful information about the Company s ability to satisfy its debt obligations with currently available funds.

Part I Financial Information

Item 2. Management s Discussion and Analysis of Financial Condition and Results of Operations

Liquidity and Capital Resources

For the nine months ended September 30, 2006, the Company generated $102.9 million of cash from operating activities, including $30.0 million for asbestos related payments, net of insurance recoveries. This compares to $104.2 million that was generated in the prior year period, including $24.6 million for asbestos-related payments, net of insurance recoveries, and the refund of $9.9 million associated with the termination of the comprehensive asbestos settlement. During the nine months ended September 30, 2006, the Company invested $22.3 million in capital expenditures as compared to $17.6 million in the prior year period. During the first nine months of 2006, the Company invested $235 million in acquisitions and received $26.1 million in proceeds from the divestitures of Westad and Resistoflex Aerospace. In the third quarter of 2005 and the third quarter of 2006, the dividend was increased by 25% and 20%, respectively. As a result, the Company paid $24.5 million in dividends to shareholders in the first nine months of 2006, compared with $19.4 million in the first nine months of 2005. In the first nine months of 2006, the Company repurchased 948,070 shares of its common stock on the open market at a cost of approximately $37.5 million. As a result of the acquisitions, the Company s debt increased $72 million through the utilization of uncommitted lines of credit.

At September 30, 2006, there were no loans outstanding under the Company s domestic $300 million revolving credit facility. This contractually committed facility is available for general corporate purposes, including acquisitions, subject to the terms and conditions of the credit facility.

Long-term debt, net of deferred financing costs, was $366 million at September 30, 2006 comprised primarily of fixed rate borrowings under the $100 million 6.75% Notes due 2006, $200 million 5.50% Notes due 2013 and $72 million borrowed under uncommitted lines of credit. Because the Company has the intention and ability to refinance the $100 million 6.75% Notes due October 2006 at maturity and the $72 million borrowed under the uncommitted lines of credit with long-term borrowings, they are classified as long-term at September 30, 2006.

Change in Accounting Principle

On January 1, 2006 the Company adopted Statement of Financial Accounting Standards No. 123R, Share-Based Payment (SFAS 123R), which supersedes Accounting Principles Board Opinion No. 25. The pronouncement requires an entity to measure the cost of employee services received in exchange for an award of equity instruments based on the grant-date fair value of the award. The cost will be recognized over the period during which an employee is required to provide service in exchange for the award. The Company elected to adopt the modified prospective approach. Under the modified prospective method, compensation expense is recorded for the unvested portion of previously issued awards that were outstanding at January 1, 2006 using the same estimate of the grant date fair value and the same attribution method used to determine the pro forma disclosure under SFAS 123. The Company determines fair value of such awards using the Black-Scholes option pricing model. The Black-Scholes option pricing model incorporates certain assumptions, such as risk-free interest rate, expected volatility, expected dividend yield and expected life of options, in order to arrive at a fair value estimate. See Note 4 for additional information.

Recently Issued Accounting Standard

In July 2006, the Financial Accounting Standards Board (FASB) issued FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes (FIN 48). FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise s financial statements in accordance with FASB Statement No. 109, Accounting for Income Taxes. FIN 48 prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN 48 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition. The requirements of FIN 48 are effective for fiscal years beginning after December 15, 2006. The Company believes that the adoption of FIN 48 will not have a material effect on its financial statements.

Part I Financial Information

Item 2. Management s Discussion and Analysis of Financial Condition and Results of Operations

In September 2006, the FASB issued Statement of Financial Accounting Standards No. 157, Fair Value Measurements (SFAS 157). SFAS No. 157 defines fair value, provides a framework for measuring fair value under current standards in GAAP, and requires additional disclosure about fair value measurements. In accordance with the Statement, the definition of fair value retains the exchange price notion, and exchange price is defined as the price in an orderly transaction between market participants to sell an asset or transfer a liability. If there is a principal market for the asset or liability, the fair value measurement should reflect that price, whether that price is directly observable or otherwise used in a valuation technique. Depending on the asset or liability being valued, the inputs used to determine fair value can range from objective inputs such as prices based on market data independent from the entity, and subjective inputs such as the entity s own assumptions about the estimates that market participants would use. The Statement applies to other accounting pronouncements that require or permit fair value measurements and will be effective for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. The Company is currently evaluating the provisions of SFAS No. 157 to determine the potential impact, if any, the adoption will have on the Company s financial statements.

In September 2006, the FASB issued Statement of Financial Accounting Standards No. 158, Employers Accounting for Defined Benefit Pension and Other Postretirement Plans (SFAS 158). SFAS 158 requires an employer to recognize the overfunded or underfunded status of a defined benefit postretirement plan (other than a multiemployer plan) as an asset or liability in its statement of financial position and to recognize changes in the funded status in the year in which the changes occur through comprehensive income of a business entity. SFAS 158 also requires an employer to measure the funded status of a plan as of the date of its year-end statement of financial position. As required by SFAS 158, the Company will initially recognize the funded status of its defined benefit and other postretirement plans and provide the required disclosures as of the fiscal year ended December 31, 2006. The Company is currently evaluating the provisions of SFAS No. 158 to determine the impact the adoption will have on the Company s financial statements.

In September 2006, the Securities and Exchange Commission (SEC) issued Staff Accounting Bulletin No. 108, Quantifying Misstatements (SAB 108). SAB 108 provides guidance on quantifying and evaluating the materiality of unrecorded misstatements requiring the use of both a balance sheet and an income statement approach when quantifying and evaluating the materiality of a misstatement. SAB 108 is effective for fiscal years ending after November 15, 2006. The Company believes that the adoption of SAB 108 will not have a material effect on its financial statements.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

There have been no material changes in the information called for by this item since the disclosure in the Company s Annual Report on Form 10-K for the year ended December 31, 2005.

Item 4. Controls and Procedures

Disclosure Controls and Procedures. The Company s Chief Executive Officer and Chief Financial Officer evaluated the effectiveness of the design and operation of the Company s disclosure controls and procedures as of the end of the period covered by this quarterly report. The Company s disclosure controls and procedures are designed to ensure that information required to be disclosed by the Company in the reports that are filed or submitted under the Securities Exchange Act of 1934 is recorded, processed, summarized, and reported within the time periods specified in the Securities and Exchange Commission s rules and forms. Based on this evaluation the Company s Chief Executive Officer and Chief Financial Officer have concluded that these controls are effective as of the end of the period covered by this quarterly report.

Changes in Internal Control over Financial Reporting. During the fiscal quarter ended September 30, 2006, there have been no changes in the Company s internal control over financial reporting, identified in connection with the evaluation thereof by the Company s Chief Executive Officer and Chief Financial Officer described above, that have materially affected, or are reasonably likely to materially affect, its internal control over financial reporting.

Part II Other Information

Item 1. Legal Proceedings

The Company s asbestos claims and certain other legal proceedings are discussed in Note 9 to the consolidated financial statements; which is incorporated herein by reference.

Other Contingencies

For environmental matters, the Company records a liability for estimated remediation costs when it is probable that the Company will be responsible for such costs and they can be reasonably estimated. Generally, third party specialists assist in the estimation of remediation costs. The environmental remediation liability at September 30, 2006 is primarily for the former manufacturing site in Goodyear, Arizona (the Site) discussed below.

The Site was operated by UniDynamics/Phoenix, Inc. (UPI), which became an indirect subsidiary of the Company in 1985 when the Company acquired UPI s parent company, UniDynamics Corporation. UPI manufactured explosive and pyrotechnic compounds, including components for critical military programs, for the U.S. government at the Site from 1962 to 1993, under contracts with the Department of Defense and other government agencies and certain of their prime contractors. No manufacturing operations have been conducted at the Site since 1994. The Site was placed on the National Priorities List in 1983, and is now part of the Phoenix-Goodyear Airport North Superfund site. In 1990, the Environmental Protection Agency (EPA) issued administrative orders requiring UPI to design and carry out certain remedial actions, which UPI has done. Groundwater extraction and treatment systems have been in operation at the Site since 1994. A soil vapor extraction system was in operation from 1994 to 1998, was restarted in 2004, and is currently in operation.

In September 2004, after extensive negotiations regarding the scope of work to be undertaken at the Site after discovery of additional trichloroethylene contamination and the detection of perchlorate during routine testing, the Company reached an agreement with the EPA on a work plan for further investigation and remediation activities at the Site. This agreement was incorporated into a consent decree between the Company and the EPA which was entered by the United States District Court for the Northern District of Arizona on June 27, 2006. The Company recorded a pre-tax charge of $40 million in the third quarter 2004 for the estimated costs through 2014 of further environmental investigation and remediation at the Site, based on this agreement with the EPA.

In July 2004, the Environment & Natural Resources Division of the U.S. Department of Justice filed a lawsuit against the Company and UPI seeking reimbursement of costs allegedly incurred by the EPA at the Site. The government s action also sought an injunction requiring UPI to comply with the terms of two earlier administrative orders; entry of a declaratory judgment regarding the Company s and UPI s liabilities; and both civil penalties and punitive damages. After extensive discussions regarding the nature and scope of such EPA costs and review of relevant documentation, the Company reached agreement with the EPA to pay $6.7 million in past costs, a civil penalty of $0.5 million and $1.0 million to fund a supplemental environmental project for the city of Goodyear, Arizona. These payment terms were incorporated in the consent decree mentioned above and the payments have been made as of September 30, 2006. The Company does not believe that the ultimate liability, in excess of the $23.3 million accrued at September 30, 2006, will have a material effect on the Company s financial condition or cash flows; however, there can be no assurance that such costs will not have a material adverse effect on the Company s results of operations in any given period.

The investigation, monitoring and remediation activities undertaken by the Company at the Site have cost over $36 million since 1985. In November 2003, the Company and UPI brought suit under Section 113 of the Comprehensive Environmental Response, Compensation and Liability Act against the federal government and several of its agencies for contribution and indemnification for these costs. As investigation and clean-up activities at the Site are expected to continue for a number of years, the Company s action against the U.S. government also sought contribution with respect to future costs. In July 2006, the Company reached an agreement with representatives of the U.S. government on the terms of a consent decree resolving these claims, approved by the Court on July 31, 2006. Under the terms of this consent decree, the Company received a payment of approximately $4.9 million in September 2006 for past clean-up costs at the site which was recorded in Miscellaneous Net

Part II Other Information

Item 1. Legal Proceedings

Income and will receive a contribution of 21 percent for qualifying costs incurred after January 1, 2006. As of September 30, 2006, the Company has not recorded any contribution from the United States for its 21 percent share of qualifying costs incurred and paid after January 1, 2006.

The Company is engaged in discussions with attorneys from the Civil Division of the U.S. Justice Department regarding allegations that certain valves sold by the Company s Crane Valves North America unit (CVNA) to private customers that ultimately were delivered to U.S. military agencies did not conform to certain contractual specifications relating to the place of manufacture and the origin of component parts. These discussions relate to: (i) the alleged failure by CVNA to notify the correct U.S. military agency when its manufacturing location for Mil-Spec valves listed on the Qualified Products List was moved from Long Beach, California to Conroe, Texas in 2003, and (ii) the alleged delivery of Mil-Spec valves with certain component parts containing specialty steel that was not melted or produced in the United States or a qualifying country as required by federal law (the so-called Berry Amendment). The allegations do not question the quality of the valves or the component parts, nor is any intentional misconduct alleged. The Company believes that CVNA satisfied its notice obligations regarding the relocation of its manufacturing facility, and its investigation of the alleged Berry Amendment violation has revealed that the component value of the relevant parts contained within Mil-Spec valves sold by CVNA within the past five years was approximately $418,000. The Justice Department has stated to the Company that CVNA s alleged noncompliance with these contract terms represents a violation of the civil False Claims Act, that the potential measure of damages could be the invoice price of the valves rather than the component cost of noncompliant parts and that under the False Claims Act such damages may be trebled. The Justice Department has asserted that the potential damages on this basis could exceed $29 million. The Company disputes this position, which to the Company s knowledge would be an unprecedented application of the False Claims Act, and the Company maintains that these are contract administration issues, not false claims. The Company is engaged in ongoing discussions with the Justice Department and believes that its view of the matter should prevail. If the Justice Department were to prevail with its theories of liability and damages, the resulting judgment could have a material adverse effect on the Company s results of operations in the periods affected.

The Company is defending two separate lawsuits brought by customers alleging failure of the Company s fiberglass-reinforced plastic material in recreational vehicle sidewalls manufactured by such customers. The aggregate damages sought in these two lawsuits is approximately $15.5 million, covering primarily the cost of repairing and replacing the affected sidewalls. These lawsuits are in very early stages of pre-trial discovery and the Company believes that it has valid defenses to the claims raised in these lawsuits. The Company has given notice of these lawsuits to its insurance carriers and will seek coverage for any liability in excess of $5 million per occurrence or $10 million in the aggregate.

A number of other lawsuits, claims and proceedings have been or may be asserted against the Company relating to the conduct of its business, including those pertaining to product liability, patent infringement, commercial, employment, employee benefits, environmental and stockholder matters. While the outcome of litigation cannot be predicted with certainty, and some of these other lawsuits, claims or proceedings may be determined adversely to the Company, the Company does not believe that the disposition of any such other pending matters is likely to have a material adverse effect on its financial condition or liquidity, although the resolution in any reporting period of one or more of these matters could have a material adverse effect on the Company s results of operations for that period.

Except as in Note 9 to the consolidated financial statements and described above, there have been no other material developments in any legal proceedings described in the Company s Annual Report on Form 10-K for the year ended December 31, 2005.

Item 1A. Risk Factors

Other than as disclosed in Item 1, Legal Proceedings, above, there has been no significant change to the risk factors disclosed in the Company s Annual Report on Form 10-K for the year ended December 31, 2005.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

(c) Share Repurchases

	Total number of shares purchased	**Average price paid per share**	**Total number of shares purchased as part of publicly announced plans or programs**	**Maximum number (or approximate dollar value) of shares that may yet be purchased under the plans or programs**

January 1-31			
February 1-28	77,200	$	38.87
March 1-31	233,400	$	38.73
April 1-30			
May 1-31	143,900	$	40.21
June 1-30	181,800	$	39.45
July 1-31			
August 1-31	114,900	$	39.18
September 1-30	196,870	$	40.62
Total	948,070	$	39.55

The table above only includes the open-market repurchases of the Company s common stock in 2006. The Company also routinely receives shares of its common stock from option holders as payment for stock option exercises and the resultant withholding taxes due on such exercises.

Item 6. Exhibits

Exhibit 31.1	Certification of Chief Executive Officer pursuant to Rule 13a-14(a) or 15d-14(a)
Exhibit 31.2	Certification of Chief Financial Officer pursuant to Rule 13a-14(a) or 15d-14(a)
Exhibit 32.1	Certification of Chief Executive Officer pursuant to Rule13a-14(b) or 15d-14(b)
Exhibit 32.2	Certification of Chief Financial Officer pursuant to Rule 13a-14(b) or 15d-14(b)

SIGNATURES

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

CRANE CO.
REGISTRANT

Date November 9, 2006	By	/s/ Eric C. Fast Eric C. Fast President and Chief Executive Officer
Date November 9, 2006	By	/s/ J. Robert Vipond J. Robert Vipond Vice President, Finance and Chief Financial Officer

Exhibit Index

Exhibit No.	Description
Exhibit 31.1	Certification of Chief Executive Officer pursuant to Rule 13a-14(a) or 15d-14(a)
Exhibit 31.2	Certification of Chief Financial Officer pursuant to Rule 13a-14(a) or 15d-14(a)
Exhibit 32.1	Certification of Chief Executive Officer pursuant to Rule 13a-14(b) or 15d-14(b)
Exhibit 32.2	Certification of Chief Financial Officer pursuant to Rule 13a-14(b) or 15d-14(b)

32

"> homemaker services; social worker visits; spiritual counseling; bereavement counseling for up to 13 months after the patient s death; dietary counseling; physical, occupational and speech therapy; medical equipment and supplies; and medications.

Our services are available twenty-four hours a day, seven days a week and can be provided in a patient s home or other residence of choice, such as a nursing home or assisted living facility, or in a hospital or other inpatient facility. We currently operate two inpatient facilities, a 12-bed, stand-alone facility in Cincinnati, Ohio, and a 10-bed hospital-based facility in Albuquerque, New Mexico.

Marketing and Referral Relationships

The primary focus of our marketing activities is on increasing patient referrals from existing referral sources and establishing new referral sources. Our referral sources include:

nursing homes;

assisted living facilities;

hospitals;

physicians;

44

Table of Contents

home health care organizations;

managed care companies;

community social service organizations; and

religious organizations.

Historically, we have dedicated relatively few resources to formal marketing activities. Most of our referrals have been the result of word of mouth among referral sources about the high quality of our care. We have recently, however, implemented a standardized marketing strategy. A key element of our marketing strategy is training our professional relations representatives and providing them with the tools to communicate effectively to a variety of different types of referral sources, including referral sources with which an individual professional relations representative may not have had significant prior experience.

Each of our hospice care programs has a marketing team led by the program director who is assisted by at least one director of professional relations. Each program employs between one and four professional relations representatives. At March 31, 2003, we employed 94 professional relations representatives company-wide. Consistent with our belief that marketing is a team effort, each program s marketing team is supported by other program employees, including admissions coordinators, patient care managers, medical directors, chaplains, social workers, counselors and nurses. Each professional relations representative seeks to develop patient referral sources located in the representative s territory by regularly calling on those referral sources and educating them regarding our services and hospice care generally. Our professional relations representatives provide feedback to those sources regarding the status of referred patients when appropriate and with the patient s consent. Our marketing efforts also include educational seminars for physicians and hospital personnel and community-based events.

Information Technology

We believe that information technology can significantly enhance our financial, operational, clinical, and compliance performance, and that by building our own information technology infrastructure and software, we can achieve important cost efficiencies as we grow. We employ an in-house software development team of experienced professionals capable of developing solutions in a complex data environment. We believe that by building our own information technology solutions, we can reduce or eliminate outside training costs, expensive third-party applications, and many third-party license or other fees which typically increase when the number of transactions processed or number of users increases.

In addition to the proprietary applications already in place, we are in the process of developing applications we believe will reduce paperwork and travel costs for our nurses, aides and other clinicians in the field, and allow for the automated transfer of enrollment information to suppliers, which we expect to lead to faster delivery of items needed to appropriately care for patients. We are also developing applications designed to monitor and produce timely reports on key expenses such as labor and pharmaceuticals, which we anticipate will enable us to make better staffing, procurement and budgetary decisions. In the second half of 2003, we expect to begin testing a new billing system that will operate on our CareNation platform. We expect to complete the conversion to this new billing system in the second half of 2003 after all technical components have passed all critical criteria tests and once we have completed the training, compliance and reporting systems associated with the new system.

Compliance

We have a strong commitment to operating our business in a manner that adheres to all regulatory requirements, internal company policies and procedures and our corporate philosophy. We have adopted a proactive approach to compliance that includes:

developing information systems that allow us to continuously monitor our performance in key areas;

performing internal compliance audits;

Table of Contents

implementing a continuous quality improvement process designed to ensure regulatory compliance and improve patient care; and

developing a priority index that enables us to shift compliance resources to those hospice programs more likely to experience compliance-related issues before they arise.

Education and Training

We have devoted substantial time and resources to the development of a comprehensive education and training program. We have contracted with a national provider of healthcare educational resources to develop company and industry specific written materials, videos and on-line training and educational resources. We believe these resources will help us deliver consistently high quality service and increase employee confidence, satisfaction and retention.

Competition

Hospice care in the United States is competitive. The hospice care industry is highly fragmented and we compete with a large number of organizations, some of which may have significantly greater financial and marketing resources than we have. Based on industry data, we estimate that approximately 73% of existing hospice programs in 2000 were local, not-for-profit hospice programs. Most hospice programs are small and community-based. We also compete with other multi-program hospice companies including Odyssey Healthcare Inc., SouthernCare Hospice, Inc. and Vitas Healthcare Corporation.

In addition, we compete with a number of hospitals, nursing homes, home health agencies and other health care providers which offer home care to patients who are terminally ill, or market palliative care and hospice-like programs. In addition, various health care companies have diversified into the hospice market, including Beverly Enterprises, Inc. and Manor Care, Inc.

Relatively few barriers to entry exist in the markets we serve. Accordingly, other companies that are not currently providing hospice care may enter these markets and expand the variety of services they offer.

Insurance

We maintain general liability insurance coverage on an occurrence basis with limits of $1.0 million per occurrence and $3.0 million in the aggregate. We maintain healthcare professional liability insurance coverage on a claims-made basis with limits of $1.0 million per occurrence and $3.0 million in the aggregate. We also maintain umbrella coverage with a limit of $10.0 million excess over both general and healthcare professional liability coverage. While we believe our insurance coverage is adequate for our current operations, we cannot assure you that it will cover all future claims or will be available in adequate amounts or at a reasonable cost.

Offices

Our principal executive office is located in Scottsdale, Arizona. Although the lease for this facility does not expire until December 2006, we entered into an agreement with the landlord in January 2003 to terminate it in the second quarter of 2003. We have entered into a seven year lease for a new principal executive office, which is also located in Scottsdale, Arizona, and we expect to relocate to this new office in the second quarter of 2003.

As of March 31, 2003, we operated 39 hospice care programs, including one stand-alone inpatient facility and one hospital-based inpatient facility, serving patients in 14 states from leased program offices in 13 states. We believe that our properties are adequate for our current business needs. In addition, we believe that adequate space can be obtained to meet our foreseeable business needs. With the exception of our principal executive office leases, we have no material operating leases.

Table of Contents

Government Regulation

General

As a provider of healthcare services, we are subject to extensive federal, state and local statutes and regulations. These laws and regulations significantly affect the way in which we operate various aspects of our business. For example, we must comply with federal, state and local laws relating to hospice care eligibility, the development and maintenance of plans of care, and the coordination of services with nursing homes or assisting living facilities where many of our patients live. In addition, each state in which we operate has its own licensing requirements with which we must comply.

We also must comply with regulations and conditions of participation to be eligible to receive payments from various federal and state government-sponsored healthcare programs, such as Medicare and Medicaid. Medicare is a federally funded and administered health insurance program, primarily for individuals entitled to Social Security benefits who are 65 years of age or older or who are disabled. Medicaid is a medical assistance program, jointly funded by the states and the federal government that provides certain medical and psychiatric care services to qualifying low-income persons. States are not required to provide Medicaid coverage for hospice services, but 43 states and the District of Columbia currently do so. All fourteen states in which we currently provide services offer coverage for Medicaid hospice services. Those states in which we operate that do provide a Medicaid benefit may limit the days for which hospice service will be covered, establish pre-authorization processes that can deny or delay access to hospice care, or establish Medicaid managed care programs that include only limited forms of hospice care coverage.

In the future, we may choose to provide hospice care services in one of the few states that do not provide Medicaid coverage for hospice services. All of our current hospice programs have been certified as Medicare providers and are eligible to receive payments from applicable state Medicaid programs.

Medicare Conditions of Participation for Hospice Programs

Federal regulations established as part of the Medicare program require that every hospice program continue to satisfy various conditions of participation to be certified and receive payment for the services it provides. Compliance with the conditions of participation is monitored by state survey agencies designated by the Medicare program. In some cases, failure to comply with the conditions may result in payment denials, the imposition of fines or penalties, or the implementation of a corrective action plan. In extreme cases or cases where there is a history of repeat violations, a state survey agency may recommend a suspension of new admissions to the program or termination of the program in its entirety.

The Medicare conditions of participation for hospice programs include the following:

Governing Body. Each hospice must have a governing body that assumes full responsibility for the policies and the overall operation of the hospice and for ensuring that all services are provided in a manner consistent with accepted standards of practice. The governing body must designate one individual who is responsible for the day-to-day administrative operations of the hospice.

Direct Provision of Core Services. Medicare limits those services for which the hospice may use individual independent contractors or contract agencies to provide care to patients. Specifically, substantially all nursing, social work, and counseling services must be provided directly by hospice employees meeting specific educational and professional standards. During periods of peak patient loads or under extraordinary circumstances, the hospice may be permitted to use contract workers, but the hospice must agree in writing to maintain professional, financial and administrative responsibility for the services provided by those individuals or entities.

Medical Director. Each hospice must have a medical director who is a physician and who assumes responsibility for overseeing the medical component of the hospice s patient care program.

Professional Management of Non-Core Services. A hospice may arrange to have non-core services such as therapy services, home health aide services, medical supplies or drugs provided by a non- employee or outside entity. If the hospice elects to use an independent contractor to provide non-core services, however, the hospice must retain professional management responsibility for the arranged services and ensure that the services are furnished in a safe and effective manner by qualified personnel, and in accordance with the patient s plan of care.

Plan of Care. The patient s attending physician, the medical director or designated hospice physician, and the interdisciplinary team must establish an individualized written plan of care prior to providing care to any hospice patient. The plan must assess the patient s needs and identify services to be provided to meet those needs and must be reviewed and updated at specified intervals.

Continuation of Care. A hospice may not discontinue or reduce care provided to a Medicare beneficiary if the individual becomes unable to pay for that care.

Informed Consent. The hospice must obtain the informed consent of the hospice patient, or the patient s representative, that specifies the type of care services that may be provided as hospice care.

Training. A hospice must provide ongoing training for its employees.

Quality Assurance. A hospice must conduct ongoing and comprehensive self-assessments of the quality and appropriateness of care it provides and that its contractors provide under arrangements to hospice patients.

Interdisciplinary Team. A hospice must designate an interdisciplinary team to provide or supervise hospice care services. The interdisciplinary team develops and updates plans of care, and establishes policies governing the day-to-day provision of hospice services. The team must include at least a physician, registered nurse, social worker and spiritual or other counselor. A registered nurse must be designated to coordinate the plan of care.

Volunteers. Hospice programs are required to recruit and train volunteers to provide patient care services or administrative services. Volunteer services must be provided in an amount equal to at least five percent of the total patient care hours provided by all paid hospice employees and contract staff.

Licensure. Each hospice and all hospice personnel must be licensed, certified or registered in accordance with applicable federal, state and local laws and regulations.

Central Clinical Records. Hospice programs must maintain clinical records for each hospice patient that are organized in such a way that they may be easily retrieved. The clinical records must be complete and accurate and protected against loss, destruction, and unauthorized use.

In addition to the conditions of participation governing hospice services generally, Medicare regulations also establish conditions of participation related to the provision of various services and supplies that many hospice patients receive from us. These services include therapy services (physical therapy, occupational therapy, speech-language pathology), home health aide and homemaker services, pharmaceuticals, medical supplies, short-term inpatient care and respite inpatient care, among other services.

Surveys and Audits

Hospice programs are subject to periodic survey by federal and state governmental authorities to ensure compliance with various licensing and certification requirements. Regulators conduct periodic surveys of hospice programs and provide reports containing statements of deficiencies for alleged failure to comply with various regulatory requirements. Survey reports and statements of deficiencies are common in the healthcare industry. In most cases, the hospice program and reviewing agency will agree upon the steps to be taken to bring the hospice into compliance with applicable regulatory requirements. In some cases, however, a state or federal agency may take a number of adverse actions against a facility, including:

the imposition of fines;

temporary suspension of admission of new patients to the hospice s service;

Table of Contents

- in extreme circumstances, de-certification from participation in the Medicaid or Medicare programs; or
- in extreme circumstances, revocation of the hospice s license.

From time to time we receive survey reports containing statements of deficiencies. We review these reports, prepare responses, work with the relevant regulator and take appropriate corrective action, if required. In June 2000, the Medicare provider agreement for our Odessa, Texas hospice program was terminated and we voluntarily surrendered our state hospice license for that program. In July 1999, our Las Vegas, Nevada hospice program was given a Medicare termination notice. We elected to voluntarily terminate our provider status for that program. We believe that each of our current hospice programs is in material compliance with Medicare and Medicaid certification requirements and state licensure requirements.

Billing Audits/ Claims Reviews. Medicare fiscal intermediaries and other payors periodically conduct pre-payment or post-payment medical reviews or other audits of our claims. In order to conduct these reviews, the payor requests documentation from us and then reviews that documentation to determine compliance with applicable rules and regulations, including the eligibility of patients to receive hospice benefits, the appropriateness of the care provided to those patients, and the documentation of that care.

Certificate/ Determination of Need Laws and Other Restrictions. Approximately 14 states continue to have certificate/determination of need laws that seek to limit the number or size of hospice care providers. These states require some form of state agency review or approval before a hospice may add new services or undertake significant capital expenditures. Approval under these certificate of need laws is generally conditioned on the showing of a demonstrable need for services in the community. In the future we may seek to develop or acquire hospice programs in states having certificate of need laws. To the extent that state agencies require us to obtain a certificate of need or other similar approvals to expand services at our existing hospice programs or to make acquisitions or develop hospice programs in new or existing geographic markets, our plans could be adversely affected by a failure to obtain a certificate or approval.

Limitations on For-Profit Ownership. A few states have laws that restrict the development and expansion of for-profit hospice programs. For example, Florida does not permit the operation of a hospice by a for-profit corporation unless it was operated in that capacity on or before July 1, 1978, although the law might permit us to purchase a grandfathered for-profit hospice and continue to operate it. New York law states that a hospice cannot be owned by a corporation that has another corporation as a stockholder. These types of additional state law restrictions could affect our ability to expand into New York or Florida, or other locations with similar restrictions.

Limits on the Acquisition or Conversion of Non-Profit Health Care Corporations. An increasing number of states have enacted laws that restrict the ability of for-profit entities to acquire or otherwise assume the operations of a non-profit health care provider. Some states may require government review, public hearings, and/or government approval of transactions in which a for-profit entity proposes to purchase a non-profit healthcare facility or insurer. Heightened scrutiny of these transactions may significantly increase the costs associated with future acquisitions of non-profit hospice programs in some states, otherwise increase the difficulty in completing those acquisitions, or prevent them entirely. We cannot assure you that we will not encounter regulatory or governmental obstacles in connection with our acquisition of non-profit hospice programs in the future.

Professional Licensure and Participation Agreements. Many of our employees are subject to federal and state laws and regulations governing the ethics and practice of their chosen profession, including physicians, physical, speech and occupational therapists, social workers, home health aides, pharmacists, and nurses. In addition, those professionals who are eligible to participate in the Medicare, Medicaid or other federal health care programs as individuals must not have been excluded from participation in those programs at any time.

Overview of Government Payments General

Payments from Medicare and Medicaid are subject to legislative and regulatory changes as well as susceptible to budgetary pressures. Our revenues and profitability are therefore subject to the effect of those changes and to possible reductions in coverage or payment rates by private third-party payors. For the year ended December 31, 2002 and the three months ended March 31, 2003, 96.6% and 95.9%, respectively, of our net patient revenue was attributable to Medicare and Medicaid payments. As a result, any changes in the regulatory, payment or enforcement landscape may significantly affect our operations.

Overview of Government Payments Medicare

Medicare Eligibility Criteria. To receive Medicare payment for hospice services, the hospice medical director and, if the patient has one, the patient s attending physician, must certify that the patient has a life expectancy of six months or less if the illness runs its normal course. This determination is made based on the physician s clinical judgment. Due to the uncertainty of such prognoses, however, it is likely that some percentage of our patients will not die within six months of entering the hospice program. The Medicare program (among other third-party payors) recognizes that terminal illnesses often do not follow an entirely predictable course, and therefore the hospice benefit remains available to beneficiaries so long as the hospice physician or the patient s attending physician continues to certify that the patient s life expectancy remains six months or less. Specifically, the Medicare hospice benefit provides for two initial 90-day benefit periods followed by an unlimited number of 60-day periods. A Medicare beneficiary may revoke his or her election of the Medicare hospice benefit at any time and resume receiving regular Medicare benefits. The patient may elect the hospice benefit again at a later date so long as he or she remains eligible.

Levels of Care. Medicare pays for hospice services on a prospective payment system basis under which we receive an established payment for each day that we provide hospice services to a Medicare beneficiary, depending upon the level of service provided. These rates are then subject to annual adjustments for inflation and may also be adjusted based upon the location where the services are provided due to variability in labor costs the greatest single expense for hospice programs. The rate we receive will vary depending on which of the following four levels of care is being provided to the beneficiary:

Routine Home Care. We are paid the routine home care rate for each day that a patient is in our program and is not receiving one of the other categories of hospice care or when a patient is receiving hospital care for a condition that is not related to his or her terminal illness. We are paid the same daily rate regardless of the volume or intensity of the services provided to the patient and his or her family or caregivers.

General Inpatient Care. General inpatient care is provided when a patient requires inpatient services for a short period for pain control or symptom management that typically cannot be provided in other settings. General inpatient care services must be provided in a Medicare or Medicaid certified hospital or long-term care facility or at a freestanding inpatient hospice facility with the required registered nurse staffing.

Continuous Home Care. Continuous home care is provided only during periods of crisis when a hospice patient requires predominantly nursing care to achieve palliation or management of acute medical problems while at home. Medicare requires that at least eight hours of services be provided (licensed nursing care must be provided for more than one half of the time) within a single day in order to qualify for reimbursement under the continuous home care provisions. While the Medicare published continuous home care rates are daily rates, Medicare actually pays for continuous home care services on an hourly basis. This hourly rate can be obtained by dividing the daily rate by 24.

Respite Care. Respite care permits a hospice patient to receive services on an inpatient basis for a short period of time in order to relieve the patient s family or other caregivers from the demands of caring for the patient. We can receive payment for respite care provided to a patient for up to five consecutive days at a time on an occasional basis. Any additional consecutive days of respite care will be reimbursed at the routine home care rate.

Program Limits on Hospice Care Payments. Medicare payments for hospice services are subject to two additional limits or caps, both of which are assessed on a provider-wide basis. The first of these two caps is commonly known as the 80-20 rule and applies only to Medicare inpatient services. Specifically, the 80-20 rule states that if the number of inpatient care days any of our hospice programs provides to Medicare beneficiaries exceeds 20.0% of the total days of hospice care it provides, those days in excess of the 20.0% figure may be reimbursed only at the routine home care rate. Compliance with the 80-20 rule is measured by examining all claims submitted by a hospice program between November 1 and the following October 31.

None of our hospice programs has exceeded the cap on inpatient care services. However, we cannot assure you that one or more of our hospice programs will not exceed the inpatient cap in the future.

Overall Medicare payments to our hospice programs are also subject to an annual per-beneficiary limitation or cap. This per-beneficiary cap amount is revised annually to account for inflation. For the twelve-month period ended October 31, 2002, the annual hospice benefit cap was $17,391. Medicare has not yet announced the per-beneficiary cap amount that will be effective for services performed during the twelve months ending October 31, 2003. Medicare may not announce the new cap amount until the third quarter 2003. Once announced, the new cap amount will become effective retroactively for all services performed since November 1, 2002. Compliance with the cap, however, is not determined on the basis of individual beneficiary experiences. Instead, compliance is measured by calculating the total Medicare payments received by a program with respect to services provided to all Medicare hospice care beneficiaries between November 1 of each year and October 31 of the following year and comparing the result with the product of the per-beneficiary cap amount and the number of Medicare beneficiaries electing hospice care for the first time from that hospice program during the relevant period.

Between 1999 and 2001, five of our hospice programs exceeded the Medicare per-beneficiary cap amount. As a result, we were required to repay a portion of our payments to Medicare. We actively monitor the per-beneficiary cap amount at each of our programs and implement corrective measures if necessary. We maintain what we believe are adequate reserves in the event that we exceed the cap in the future. We cannot assure you that one or more of our hospice programs will not exceed the cap amount in the future.

Medicare Managed Care Programs. The Medicare program has entered into contracts with managed care companies to provide a managed care benefit to those Medicare beneficiaries who wish to participate in managed care programs, commonly referred to as Medicare HMOs, Medicare + Choice or Medicare risk products. We provide hospice care to Medicare beneficiaries who participate in these managed care programs. Our payments for services provided to Medicare beneficiaries enrolled in Medicare HMO programs are processed in the same way and at the same rates as those of Medicare beneficiaries who are not in Medicare HMOs. Under current Medicare policy, Medicare pays the hospice directly for services provided to Medicare HMO, Medicare + Choice or risk product patients and then reduces the standard per member per month payment that the managed care program receives.

Adjustments to Payment Rates and Payment Methodology. In the last several years there have been a number of adjustments to the base rates paid by Medicare for all four levels of hospice services. Specifically, the Balanced Budget Act of 1997 (BBA of 1997), Balanced Budget Refinement Act of 1999 (BBRA of 1999), and Medicare, Medicaid and SCHIP Benefits Improvement and Protection Act of 2000 (BIPA 2000), have all modified hospice payment rates in recent fiscal years. The Medicare fiscal year begins on October 1 of each year and runs through September 30 of the following year. The BBA of 1997 made several changes in Medicare coverage of and payment for hospice care services. One change tied payment rate increases for Medicare hospice services to the market basket inflation rate minus one percentage point for each of the Medicare fiscal years 1998 through 2002. In addition, the BBA of 1997 required us to begin filing annual cost reports with the Department of Health and Human Services effective in fiscal year 2000 for each of our hospice programs for informational purposes and to submit claims on the basis of the location where we furnished hospice services rather than the location of the hospice agency, as was previously allowed. The BBRA of 1999 increased the Medicare payment for hospice services by 0.5% for Medicare fiscal year 2001 and 0.75% for Medicare fiscal year 2002. Subsequently, effective April 1, 2001, BIPA 2000 increased the base Medicare daily payment rates for hospice care by another 5.0%. On October 1, 2001, the base Medicare payment rates for hospice care were again increased by approximately 3.2% over the base rates previously in effect. Most recently, the base Medicare payment rates were increased an additional 3.4%, effective October 1, 2002.

Table of Contents

It is possible that there will be further modifications to the rate structure under which Medicare certified hospice programs are currently paid. As part of BIPA 2000, Congress ordered MedPAC to conduct a review of Medicare beneficiaries access to and use of hospice care and to report their results and recommendations to Congress in June 2002. In its May 2002 report to Congress, MedPAC recommended that the Secretary for the Department of Health and Human Services review the adequacy of hospice payment rates to ensure that the rates are adequate given the realities of the costs associated with providing hospice services in today s market, and further recommended that the Secretary consider the possibility of moving to a case-mix adjusted payment system or create a separate payment mechanism to deal with more costly outlier patients who present with unusually complex cases or cases requiring significantly more intensive services than most hospice patients.

Sequential Billing. The Center for Medicare and Medicaid Services has implemented a process known as sequential billing that prevents hospice programs from billing a period of service for a patient before the prior billed period has been reimbursed. This billing process can negatively impact a hospice program s cash flow when pre-payment audits or medical reviews are ongoing, or lost or incorrect bills are encountered.

Overview of Government Payments Medicaid

Medicaid Coverage and Reimbursement. State Medicaid programs are another source of our net patient revenue. Medicaid is a state-administered program financed by state funds and matching federal funds to provide medical assistance to the indigent and certain other eligible persons. In 1986, hospice services became an optional state Medicaid benefit. For those states that elect to provide a hospice benefit, the care must be provided by a Medicare-certified hospice, and the scope of hospice services available must include at least all of the services provided under the Medicare hospice benefit. Most of those states providing a Medicaid hospice benefit pay us at rates equal to or greater than the rates provided under Medicare and calculated using the same methodology. States maintain flexibility to establish their own hospice election procedures and to limit the number and duration of benefit periods for which they will pay for hospice services.

Nursing Home Residents. For our patients who receive nursing home care under state Medicaid programs in states other than Arizona, Oklahoma, Pennsylvania and South Carolina, the applicable Medicaid program pays us an amount equal to no more than 95.0% of the Medicaid per diem nursing home rate for room and board services furnished to the patient by the nursing home in addition to the applicable Medicare or Medicaid hospice per diem payment. Then, pursuant to our standard agreements with nursing homes, we pay the nursing home for these room and board services at a rate between 95.0% and 100.0% of the full Medicaid per diem room and board.

Other Healthcare Regulations

Federal and State Anti-Kickback Laws and Safe Harbor Provisions. The federal anti-kickback law makes it a felony to knowingly and willfully offer, pay, solicit or receive any form of remuneration in exchange for referring, recommending, arranging, purchasing, leasing or ordering items or services covered by a federal health care program including Medicare or Medicaid. The anti-kickback prohibitions apply regardless of whether the remuneration is provided directly or indirectly, in cash or in kind. Although the anti-kickback statute does not prohibit all financial transactions or relationships that providers of healthcare items or services may have with each other, interpretations of the law have been very broad. Under current law, courts and federal regulatory authorities have stated that this law is violated if even one purpose (as opposed to the sole or primary purpose) of the arrangement is to induce referrals.

Violations of the anti-kickback law carry potentially severe penalties including imprisonment of up to five years, criminal fines of up to $25,000 per act, civil money penalties of up to $50,000 per act, and additional damages of up to three times the amounts claimed or remuneration offered or paid. Federal law also authorizes exclusion from the Medicare and Medicaid programs for violations of the anti-kickback statute.

The OIG, has published numerous safe harbors that exempt some practices from enforcement action under the anti-kickback statute and related laws. These statutory and regulatory safe harbors protect various bona fide employment relationships, contracts for the rental of space or equipment, personal service arrangements, and management contracts, among other things, provided that certain conditions set forth in the statute or regulations are satisfied. The safe harbor regulations, however, do not comprehensively describe all lawful relationships between healthcare providers and referral sources, and the failure of an arrangement to satisfy all of the requirements of a particular safe harbor does not mean that the arrangement is unlawful. Failure to comply with the safe harbor provisions, however, may mean that the arrangement will be subject to scrutiny by the OIG. It is possible for us to request an advisory opinion from the OIG regarding an existing or proposed business arrangement and the possible anti-kickback concerns raised by that arrangement.

Many states, including some states where we do business, have adopted similar prohibitions against payments that are intended to induce referrals of patients, regardless of the source of payment. Some of these state laws lack explicit safe harbors that may be available under federal law. Sanctions under these state anti-remuneration laws may include civil money penalties, license suspension or revocation, exclusion from Medicare or Medicaid, and criminal fines or imprisonment. Little precedent exists regarding the interpretation or enforcement of those statutes.

We contract with a significant number of healthcare providers and practitioners, including physicians, hospitals and nursing homes, and arrange for these individuals or entities to provide services to our patients. In addition, we have contracts with other suppliers, including pharmacies, ambulance services and medical equipment companies. Some of these individuals or entities may refer, or be in a position to refer, patients to us, and we may refer, or be in a position to refer, patients to these individuals or entities. These arrangements may not qualify for a safe harbor. We believe that our contracts and arrangements with providers, practitioners and suppliers are not in violation of applicable anti-kickback or related laws. We cannot assure you, however, that these laws will ultimately be interpreted in a manner consistent with our practices.

HIPAA Anti-Fraud Provisions. HIPAA includes several revisions to existing health care fraud laws by permitting the imposition of civil monetary penalties in cases involving violations of the anti-kickback statute or contracting with excluded providers. In addition, HIPAA created new statutes making it a federal felony to engage in fraud, theft, embezzlement, or the making of false statements with respect to healthcare benefit programs, which include private, as well as government programs. In addition, for the first time, federal enforcement officials have the ability to exclude from the Medicare and Medicaid programs any investors, officers and managing employees associated with business entities that have committed healthcare fraud, even if the investor, officer or employee had no actual knowledge of the fraud.

OIG Fraud Alerts, Advisory Opinions and Other Program Guidance. In 1976, Congress established the OIG to, among other things, identify and eliminate fraud, abuse and waste in HHS programs. To identify and resolve such problems, the OIG conducts audits, investigations and inspections across the country and issues public pronouncements identifying practices that may be subject to heightened scrutiny. In the last several years, there have been a number of hospice related audits and reviews conducted. These reviews and recommendations have included the following:

- better ensuring that Medicare hospice eligibility determinations are made in accordance with the Medicare regulations; and

- revising the annual cap on hospice benefits to better reflect the cost of care provided.

In 2002, the OIG specifically called for a review of hospice plans of care to examine the variance among hospice plans of care and the extent to which services are provided in accordance with plans of care, and to determine whether there should be uniform standards or minimum requirements for their completion. In addition, the OIG called for a review of payments for the care of hospice patients residing in nursing homes and the level of services they receive. We cannot predict what, if any changes may be implemented in coverage, reimbursement, or enforcement policies as a result of these OIG reviews and recommendations.

Table of Contents

In order to provide guidance to healthcare providers regarding various business practices and how to avoid scrutiny under the fraud and abuse statutes, the OIG occasionally issues targeted fraud alerts or advisory bulletins addressing specific practices in the industry that may be vulnerable to abuse. For example, in March 1998, the OIG issued a special fraud alert titled Fraud and Abuse in Nursing Home Arrangements with Hospices. This special fraud alert focused on payments received by nursing homes from hospice programs.

Federal False Claims Acts. The federal law includes several criminal and civil false claims provisions, which provide that knowingly submitting claims for items or services that were not provided as represented may result in the imposition of multiple damages, administrative civil money penalties, criminal fines, imprisonment, and/or exclusion from participation in federally funded healthcare programs, including Medicare and Medicaid. In addition, the OIG may impose extensive and costly corporate integrity requirements upon a healthcare provider that is the subject of a false claims judgment or settlement. These requirements may include the creation of a formal compliance program, the appointment of a government monitor, and the imposition of annual reporting requirements and audits conducted by an independent review organization to monitor compliance with the terms of the agreement and relevant laws and regulations.

The Civil False Claims Act prohibits the known filing of a false claim or the known use of false statements to obtain payments. Penalties for violations include fines ranging from $5,500 to $11,000, plus treble damages, for each claim filed. Provisions in the Civil False Claims Act also permit individuals to bring actions against individuals or businesses in the name of the government as so called qui tam relators. If a qui tam relator s claim is successful, he or she is entitled to share in the government s recovery.

State False Claims Laws. At least 10 states and the District of Columbia, including Massachusetts, Nevada and Texas where we currently do business, have adopted state false claims laws that mirror to some degree the federal false claims laws. While these statutes vary in scope and effect, the penalties for violating these false claims laws include administrative, civil and/or criminal fines and penalties, imprisonment, and the imposition of multiple damages.

The Stark Law and State Physician Self-Referral Laws. Section 1877 of the Social Security Act, commonly known as the Stark Law, prohibits physicians from referring Medicare or Medicaid patients for designated health services to entities in which they hold an ownership or investment interest or with whom they have a compensation arrangement, subject to a number of statutory or regulatory exceptions. Penalties for violating the Stark Law are severe, and include:

denial of payment;

civil monetary penalties of $15,000 per referral or $1,000,000 for circumvention schemes;

assessments equal to 200.0% of the dollar value of each such service provided; and

exclusion from the Medicare and Medicaid programs.

Hospice care itself is not specifically listed as a designated health service, however, a number of the services that we provide including physical therapy, pharmacy services and certain infusion therapies are among the services identified as designated health services for purposes of the self-referral laws. We cannot assure you that future regulatory changes will not result in hospice services becoming subject to the Stark Law s ownership, investment or compensation prohibitions in the future.

Many states where we operate have laws similar to the Stark Law, but with broader effect because they apply regardless of the source of payment for care. Penalties similar to those listed above as well the loss of state licensure may be imposed in the event of a violation of these state self-referral laws. Little precedent exists regarding the interpretation or enforcement of these statutes.

Civil Monetary Penalties. The Civil Monetary Penalties Statute state that civil penalties ranging between $10,000 and $50,000 per claim or act may be imposed on any person or entity that knowingly submits improperly filed claims for federal health benefits, or makes payments to induce a beneficiary or provider to reduce or limit the use of health care services or to use a particular provider or supplier. Civil monetary penalties may be imposed for violations of the anti-kickback statute and for the failure to return known overpayments, among other things.

Prohibition on Employing or Contracting with Excluded Providers. The Social Security Act and federal regulations state that individuals or entities that have been convicted of a criminal offense related to the delivery of an item or service under the Medicare or Medicaid programs or that have been convicted, under state or federal law, of a criminal offense relating to neglect or abuse of residents in connection with the delivery of a healthcare item or service cannot participate in any federal health care programs, including Medicare and Medicaid. Additionally, individuals and entities convicted of fraud, that have had their licenses revoked or suspended, or that have failed to provide services of adequate quality also may be excluded from the Medicare and Medicaid programs. Federal regulations prohibit Medicare providers, including hospice programs, from submitting claims for items or services or their related costs if an excluded provider furnished those items or services. The OIG maintains a list of excluded persons and entities. Nonetheless, it is possible that we might unknowingly bill for services provided by an excluded person or entity with whom we contract. The penalty for contracting with an excluded provider may range from civil monetary penalties of $50,000 and damages of up to three times the amount of payment that was inappropriately received.

Corporate Practice of Medicine and Fee Splitting. Most states have laws that restrict or prohibit anyone other than a licensed physician, including business entities such as corporations, from employing physicians and/or prohibit payments or fee-splitting arrangements between physicians and corporations or unlicensed individuals. Violations of corporate practice of medicine and fee-splitting laws vary from state to state, but may include civil or criminal penalties, the restructuring or termination of the business arrangements between the physician and unlicensed individual or business entity, or even the loss of the physician s license to practice medicine. These laws vary widely from state to state both in scope and origin (e.g. statute, regulation, Attorney General opinion, court ruling, agency policy) and in most instances have been subject to only limited interpretation by the courts or regulatory bodies.

We employ or contract with physicians to provide medical direction and patient care services to our patients. We have made efforts in those states where certain contracting or fee arrangements are restricted or prohibited to structure those arrangements in compliance with the applicable laws and regulations. Despite these efforts, however, we cannot assure you that agency officials charged with enforcing these laws will not interpret our contracts with employed or independent contractor physicians as violating the relevant laws or regulations. Future determinations or interpretations by individual states with corporate practice of medicine or fee splitting restrictions may force us to restructure our arrangements with physicians in those locations.

Health Information Practices. Portions of HIPAA were intended to reduce administrative expenses and burdens associated with the transmission and use of electronic health records and claims for payment. While it is likely that these provisions may reduce costs in the long-term, we believe that they will bring about significant and, in some cases, costly changes in the short-term. HIPAA requires the United States Department of Health and Human Services to issue rules to define and implement standards for the following:

- electronic transactions and code sets;
- unique identifiers for providers, employers, health plans and individuals;
- security and electronic signatures;
- privacy; and
- enforcement.

To date, the United States Department of Health and Human Services has released three final rules mandating the use of new standards with respect to certain health care transactions and health information.

The first rule establishes standard code sets to be used to complete common health care transactions, including:

- health care claims information;
- plan eligibility, referral certification and authorization;
- claims status;
- plan enrollment and disenrollment;
- payment and remittance advice;
- plan premium payments; and
- coordination of benefits.

The Department of Health and Human Services finalized these transaction and code set standards on August 17, 2000 and they became effective October 16, 2002. In compliance with the law, we requested a one-year extension of this compliance deadline and provided CMS with information regarding our strategy for implementing the requirements by October 16, 2003.

The second set of rules, issued in final form on December 28, 2000, relates to the privacy of individually identifiable health information in whatever manner it is maintained (e.g. electronic, paper, oral) and the patient s access to and control over health information. These standards require our compliance and the compliance of nearly all health care providers, plans and clearinghouses with rules governing the use and disclosure of protected health information for a wide range of purposes including treatment, payment, operations, fundraising, marketing and research. The rules also require us to enter into written agreements with any business associates to whom we disclose information, explaining the manner in which they are to maintain, use or disclose protected health information that they obtain from us.

The privacy regulations became effective on April 14, 2001, with a compliance date of April 14, 2003. Proposed modifications to the privacy regulations were published in the Federal Register on March 27, 2002 and final regulations were issued on August 14, 2002.

Sanctions for failing to comply with the HIPAA privacy rules could include civil monetary penalties of $100 per incident, up to a maximum of $25,000 per person, per year, per standard. The final rule also provides for criminal penalties of up to $50,000 and one year in prison for knowingly and improperly obtaining or disclosing protected health information, up to $100,000 and five years in prison for obtaining protected health information under false pretenses, and up to $250,000 and ten years in prison for obtaining or disclosing protected health information with the intent to sell, transfer or use such information for commercial advantage, personal gain or malicious harm.

On August 12, 1998, the Department of Health and Human Services issued a proposed security rule establishing standards requiring affected entities like us to establish and maintain reasonable and appropriate administrative, technical and physical safeguards to ensure the integrity, confidentiality and availability of health information. These security regulations were modified and published in final form on February 20, 2003, and we must be in compliance with these regulations by April 21, 2005.

Employees

As of March 31, 2003, we had 1,567 full time employees and 143 part-time employees. None of our employees are covered by collective bargaining agreements. We believe that our relations with our employees are good.

Legal Proceedings

From time to time, we may be involved in litigation relating to claims arising out of our operations in the normal course of business. We and one of our former employees are currently defendants in an action initiated on February 5, 2003 in the United States District Court in the District of Nevada. The action,

Table of Contents

Bradeen et al. v. Vista Hospice Care, Inc. and Edward Raymond Lowe, relates to a fatal motor vehicle accident involving a former employee. The plaintiffs in the action allege that the now former employee, while acting within the scope of his employment by us, negligently and recklessly caused a motor vehicle collision that resulted in the death of two people. The plaintiffs seek pecuniary and punitive damages in an unspecified amount. Our motion to dismiss the plaintiffs claim for punitive damages is currently pending before the court. We maintained aggregate liability insurance of $4.0 million at the time of the accident. As of the date of this prospectus, we are not aware of any other pending or threatened legal proceeding that we expect could have a material adverse effect on us.

MANAGEMENT

Executive Officers and Directors

Set forth below is information concerning our executive officers and directors, including their ages, as of March 31, 2003.

Name	Age	Position
Barry M. Smith	49	Chairman of the Board of Directors
Richard R. Slager	49	President and Chief Executive Officer, Director
Perry G. Fine, M.D.	50	National Medical Director, Director
Carla Davis Hughes	31	Senior Vice President of Operations
Stephen Lewis	56	Senior Vice President and General Counsel
Mark E. Liebner	50	Chief Financial Officer
David A. Freeman(1)(3)	41	Director
Pete A. Klisares(1)(2)(3)	67	Director
Ronald A. Matricaria(1)(2)	60	Director
William J. McBride(2)(3)	58	Director

(1) Member of the compensation committee.

(2) Member of the audit committee.

(3) Member of the corporate governance committee.

Barry M. Smith co-founded VistaCare in July 1995. In January 1996, Mr. Smith was appointed to serve as our President, Chief Executive Officer and as the Chairman of our board of directors. In May 2001, Mr. Smith resigned as our President and Chief Executive officer and is less involved in our operations on a day-to-day basis, but remains the Chairman of our board of directors. From June 1990 until January 1996, he served as Chief Executive Officer and Chairman of the board of directors of ValueRx, Inc., a pharmacy benefits manager. He was Vice President of Operations for PCS Health Systems Inc., a prescription benefit management company, from May 1988 to June 1990. From July 1981 until May 1988, Mr. Smith served in a variety of management positions in the Medical Products, Renal Care and Prescription Drug divisions of Baxter Healthcare Corporation. Mr. Smith currently serves on the board of directors of Inpatient Consultants, Inc., a company focused on delivering patient care in acute care hospitals.

Richard R. Slager has served as our President and Chief Executive Officer and as a member of our board of directors since May 2001. From June 1999 until May 2001, he was Chairman of the board of directors and Chief Executive Officer of SilverAge LLC, an online monitoring and interactive technical company for seniors. In May 1989, Mr. Slager founded Karrington Health, Inc., an assisted living provider, and he served as Chairman of the board of directors and Chief Executive Officer of Karrington Health, Inc. until June 1999.

Perry G. Fine, M.D. has served as our National Medical Director since June 1996 and as a member of our board of directors since September 2001. Dr. Fine is currently a Professor of Anesthesiology in the School of Medicine at the University of Utah, a post he has held since July 1985. Dr. Fine has extensive clinical, educational, research and public policy experience dating back to the inception of the Medicare hospice benefit. He is a founding member of the American Academy of Hospice and Palliative Medicine. Dr. Fine serves on the board of directors of the Partnership for Caring, the vanguard advocacy organization to improve end-of-life care, and he is Chairman of the ethics committee for the National Hospice and Palliative Care Organization.

Carla Davis Hughes has served as our Senior Vice President of Operations since May 2002. From December 1998 until May 2002, Ms. Hughes held several senior operational positions at VistaCare including Program Director, Southeastern Area Director, Atlantic Coast Regional Director and Eastern Regional Vice President of Operations. From June 1996 until June 1998, Ms. Hughes served as the East Coast Development

Table of Contents

Manager for Vencor Hospice Programs, a national hospice program. From January 1994 until June 1996, Ms. Hughes served as a Provider Education Consultant for Palmetto GBA, a Medicare fiscal intermediary for hospice and home health providers.

Stephen Lewis has served as one of our Senior Vice Presidents since May 2002 and as our General Counsel since November 2001. From December 1999 until November 2001, he served as Assistant Director, Office of General Services of the Ohio Department of Insurance. From August 1993 until June 1999, Mr. Lewis served as Vice President of Development and General Counsel for Karrington Health, Inc., a publicly traded assisted living provider. From August 1986 until December 1992, he served as Vice President and General Counsel of VOCA Corporation, a developer and operator of residential facilities for persons with mental retardation and developmental disabilities. From November 1974 until August 1986, Mr. Lewis was a practicing attorney with the law firm of Topper, Alloway, Goodman, Deleone & Duffy, which merged with Benesch, Friedlander, Coplan & Aronoff in January 1986.

Mark E. Liebner has served as our Chief Financial Officer since April 2002. From March 2000 until April 2002, he served as Managing Director of Searchlight Partners LLC, a corporate advisory services firm. From October 1991 until March 2000, Mr. Liebner served as Chief Financial Officer of Rural Metro Corporation, a publicly traded provider of healthcare transportation services. From July 1988 until September 1991, Mr. Liebner served as Vice President in the healthcare investment banking group of Van Kampen Merritt.

David A. Freeman has served as a member of our board of directors since July 2001. In October 1995, Mr. Freeman co-founded Ferrer Freeman & Co., LLC, a private equity firm that invests exclusively in healthcare companies. Since October 1995, he has served as a Member of the General Partner of Ferrer Freeman & Co. From January 1994 until August 1995, Mr. Freeman served as Managing Director of J.P. Morgan & Co. Incorporated, where he worked in Global Health Care Investment Banking and had substantial responsibility for J.P. Morgan s Private Equity Investment activity in health care. Mr. Freeman serves on the board of directors of National Surgical Hospitals, Inc., a surgical hospital company that partners with local physicians to develop freestanding hospitals, Provider HealthNet Services, Inc., a provider of information technology, medical records and other business process outsourcing services for the healthcare industry, and Webmedx, Inc., a provider of software and services for the production and distribution of clinical reports. Mr. Freeman also serves on the finance committee of Waveny Care Center.

Pete A. Klisares has served as a member of our board of directors since November 2001. Since November 1999, Mr. Klisares has been a principal owner and manager of MiGG Capital Investment Company, a private capital investment fund, and a business consultant. From August 1997 until June 1999, he served as President and Chief Operating Officer of Karrington Health, Inc., an assisted living provider. From November 1991 until August 1997, Mr. Klisares was an Executive Vice President of Worthington Industries, Inc., a steel processing and specialty steel product manufacturer. From August 1960 until May 1991, he was employed by AT&T Corp., where he retired as a Vice President of Manufacturing. Mr. Klisares currently serves on the board of directors of Huntington National Bank, Dominion Homes, Inc., a homebuilder, Sunrise Assisted Living, Inc., an assisted living provider, and MPW Industrial Services Group, Inc., a provider of industrial cleaning and related facilities support services.

Ronald A. Matricaria has served as a member of our board of directors since August 2002. From April 1993 to December 2002, Mr. Matricaria served, at various times, as the Chairman, Chief Executive Officer and President of St. Jude Medical, Inc., a developer, manufacturer and distributor of cardiovascular medical devices. He retired from the St. Jude board in December 2002. Mr. Matricaria currently serves as the non-executive Chairman of the board of directors of Haemonetics Corporation, a manufacturer and global marketer of automated blood processing systems. He is also a director of Cyberonics, Inc., Cardiodynamics International Corporation, and Endocare, Inc., all medical device companies.

William J. McBride has been one of our directors since 1995. Between 1993 and the time of his retirement in 1995, Mr. McBride served as President, Chief Operating Officer and a director of Value Health, Inc., a provider of specialty managed healthcare benefit programs and healthcare information services. Between 1987 and 1993, Mr. McBride served as Chief Financial Officer of Value Health, Inc., Mr. McBride

Table of Contents

currently serves on the board of directors of AMERIGROUP Corporation, a managed healthcare company focused on providing healthcare services to people eligible to receive Medicaid, Children s Health Insurance Program and Family Care benefits, and on the boards of directors of several privately held companies.

Board of Directors

The terms of office of the members of our board of directors are divided into three classes. Messrs. Freeman and Smith serve as Class I Directors (whose terms expire in 2003), Mr. McBride and Dr. Fine serve as Class II Directors (whose terms expire in 2004) and Messrs. Slager, Klisares and Matricaria serve as Class III Directors (whose terms expire in 2005). At each annual meeting of stockholders, the successors to directors whose terms will then expire will be elected to serve from the time of election and qualification until the third annual meeting following election. Additional directorships resulting from an increase in the number of directors will be distributed among the three classes so that, as nearly as possible, each class will consist of one-third of the total number of directors. The classification of our board of directors may have the effect of delaying or preventing changes in control or management of VistaCare. For more information, see the section of this prospectus entitled Description of Capital Stock Delaware Anti-Takeover Law and certain Charter and By-law Provisions.

Each executive officer is appointed by, and serves at the discretion of, our board of directors. There are no family relationships among any of our directors or officers.

Committees of Our Board of Directors

Our compensation committee consists of Messrs. Freeman, Klisares and Matricaria. It establishes the salaries and incentive compensation of our executive officers and administers our stock plans.

Our audit committee consists of Messrs. Klisares, McBride and Matricaria. It reviews the results and scope of audits and other services provided by our independent public accountants and reviews our system of internal accounting and financial controls. Our audit committee also reviews such other matters with respect to our accounting, auditing and financial reporting practices and procedures as it may find appropriate or may be brought to its attention.

Our corporate governance committee consists of Messrs. Freeman, Klisares and McBride. It provides oversight and recommendations to our board of directors and its committees regarding:

- the size, composition and functioning of the board of directors and its committees;
- evaluation of director nominees;
- compensation and benefits of directors; and
- other matters of corporate governance.

Director Compensation

Non-employee directors are reimbursed for their reasonable out-of-pocket expenses incurred in attending meetings of our board of directors. In addition, each non-employee director receives a $20,000 annual retainer and $1,500 per board meeting and $750 per board conference call attended. Each non-employee director who serves on a board committee receives $750 per committee meeting and $375 per committee conference call attended. Each non-employee director who serves as the chairman of a board committee receives an additional $500 per committee meeting and $125 per committee conference call attended. In August 2002, Ronald A. Matricaria, one of our non-employee directors, was granted an option to purchase 40,000 shares of our common stock at $12.50 per share under our 1998 Stock Option Plan. In November 2002, each of our

Table of Contents

non-employee directors was granted an option to purchase the number of shares of our common stock set forth opposite such director s name in the table below at $12.50 per share under our 1998 Stock Option Plan:

Name	Number of Shares
David A. Freeman	50,000
Pete A. Klisares	10,000
Ronald A. Matricaria	10,000
William J. McBride	10,000

Our non-employee directors are also entitled to participate in our 2002 Non-Employee Director Stock Option Plan.

Executive Compensation

The table below sets forth summary information concerning the compensation awarded to our Chief Executive Officer and our four other most highly compensated executive officers. The individuals listed below are referred to in this prospectus as our named executive officers .

Summary Compensation Table

	Annual Compensation				
Name And Principal Position	**Year**	**Salary**	**Bonus**	**Other Annual Compensation**	**Securities Underlying Options**
Richard R. Slager	2002	$302,673	$ 80,313		320,000
President and Chief Executive Officer	2001	$158,635	$ 90,475	$106,298(1)	480,000
Barry M. Smith	2002	$331,250	$ 87,546		
Chairman	2001	$282,067	$100,000		
Mark E. Liebner[(2)]	2002	$145,076	$105,183		140,000
Chief Financial Officer					
Carla Davis Hughes[(3)]	2002	$159,425	$ 63,015		26,000
Senior Vice President of Operations	2001	$124,615	$ 14,558		4,000
Stephen Lewis[(4)]	2002	$124,000	$ 41,558		40,000
Senior Vice President and General Counsel	2001	$ 7,241	$ 300		

(1) Represents amounts paid to Mr. Slager for relocation and temporary living expenses.

(2) Mr. Liebner was hired in May 2002.

(3) Ms. Hughes became an executive officer in May 2002.

(4) Mr. Lewis was hired in November 2001.

Table of Contents

Option Grants in 2002

The following table presents information concerning stock options granted during 2002 to our named executive officers who received grants in 2002.

	Individual Grants				Potential Realizable Value at Assumed Rate of Stock Price Appreciation for Option Term		
	Number of Shares Underlying Options Granted	Percent of Total Options Granted to Employees in Year	Exercise Price Per Share(1)	Expiration Date	0%	5%	10%
Richard R. Slager(2)	320,000	36.7%	$12.50	November 11, 2012		$2,254,955	$5,959,971
Mark E. Liebner(3)	140,000	16.0%	$ 6.25	May 6, 2012	$ 451,500 (4)	$1,861,543	$3,482,487
Carla Davis Hughes(3)	26,000	3.0%	$ 6.25	May 6, 2012	$ 83,850 (4)	$ 345,715	$ 646,748
Stephen Lewis(3)	40,000	4.6%	$ 3.75	February 28, 2012	$ 135,000 (5)	$ 631,869	$1,094,996

(1) Amounts reported in this column represent amounts that may be realized upon exercise of the option immediately prior to the expiration of its term assuming the specified compound rates of appreciation (5% or 10%) in the market value of our common stock over the term of the option. These numbers are calculated based on rules promulgated by the Securities and Exchange Commission and do not reflect our estimate of future stock price growth. The shares underlying the options were not publicly traded on the dates on which they were granted. Accordingly, we have assumed that the fair market value on the date of grant was equal to the initial public offering price of our common stock of $12.00 per share. The gains shown are net of the option exercise price, but do not include deductions for taxes or other expenses associated with the exercise of the option or the sale of the underlying shares. The actual gains, if any, on the exercise of any stock option will depend on the future performance of our common stock, the optionholder s continued employment through the option period, and the date on which the option is exercised.

(2) This option is fully vested.

(3) This option vests in equal annual installments over five years, subject to acceleration upon the occurrence of certain events.

(4) In connection with our initial public offering, it was determined that the exercise price of $6.25 per share for this stock option was less than the deemed fair value of our common stock on the date of grant, which was determined to be $9.48 per share. This amount represents the difference between the deemed fair value of our common stock on the date of grant and the exercise price, multiplied by the number of shares underlying the option.

(5) In connection with our initial public offering, it was determined that the exercise price of $3.75 per share for this stock option was less than the deemed fair value of our common stock on the date of grant, which was determined to be $7.13 per share. This amount represents the difference between the deemed fair value of our common stock on the date of grant and the exercise price, multiplied by the number of shares underlying the option.

Table of Contents

Year End Option Values

None of our named executive officers exercised any stock options in 2002. The following table presents information concerning the unexercised stock options held by each of our named executive officers as of December 31, 2002.

	Number of Shares Underlying Unexercised Options at Year-End(1)		Value of Unexercised in-the-Money Options at Year-End	
	Exercisable	Unexercisable	Exercisable	Unexercisable
Richard R. Slager	96,000	704,000	$1,176,960	$5,831,040
Barry M. Smith	16,000	24,000	$ 190,160	$ 285,240
Mark E. Liebner		140,000		$1,366,400
Carla Davis Hughes	16,800	43,200	$ 205,968	$ 464,632
Stephen Lewis		40,000		$ 490,400

Employment and Compensation Arrangements

Management Agreements

In October 2002, we entered into management agreements with each of Richard R. Slager, our Chief Executive Officer, Mark E. Liebner, our Chief Financial Officer, Carla Davis Hughes, our Senior Vice President of Operations, and Stephen Lewis, our Senior Vice President and General Counsel.

Under these agreements, the executives are entitled to compensation in the event of their employment termination or a sale of the company, as described below.

Compensation Upon Termination of Employment Prior to Change of Control

In the event that, prior to a change of control of VistaCare, the employment of any of the executives is terminated by us for any reason other than for cause or the executive s death or disability or by the executive for good reason, we are required to:

continue to pay the executive his or her then current salary for twelve months following employment termination; and

continue to provide the executive with health and life insurance benefits for twelve months following employment termination, or pay the full value of such benefits in cash.

Compensation Upon Termination of Employment After a Change of Control

In the event that, within two years following a change in control of VistaCare, the employment of Mr. Slager is terminated for any reason, including Mr. Slager s death, disability or voluntary resignation, but excluding a termination by VistaCare for cause, we are required to:

pay Mr. Slager a lump sum amount equal to three times his then current salary; and

continue to provide Mr. Slager with health and life insurance benefits for three years following employment termination, or pay the full value of such benefits in cash.

In addition, upon a change in control of VistaCare, regardless of whether Mr. Slager s employment is terminated, the vesting of all of his options to purchase common stock will be accelerated in full.

Table of Contents

In the event that, within two years following a change in control of VistaCare, the employment of Messrs. Liebner or Lewis or Ms. Davis Hughes is terminated by (i) VistaCare for any reason other than cause or the executive s death or disability or (ii) the executive for good reason, we are required to:

pay the executive a lump sum amount equal to two times his or her then current salary;

continue to provide the executive with health and life insurance benefits for two years following employment termination, or pay the full value of such benefits in cash; and

accelerate the vesting of all options to purchase common stock held by the executive.

Compensation Upon Sale of the Company

The management agreements for Messrs. Slager and Liebner and Ms**.** Hughes provide that, if there is a sale of the company, as defined below, in which the per-share equity value of VistaCare implied by the transaction is at least $12.50, we are required to pay the executive a fee, the amount of which depends on the date of the sale. The table below sets forth the amount of the fee we would be required to pay to Mr. Slager, depending on the date of the sale:

Date of Sale	Fee
Between September 30, 2002 and December 31, 2002	$ 5.0 million
Between January 1, 2003 and December 31, 2003	$ 4.0 million
Between January 1, 2004 and December 31, 2004	$ 3.0 million
Between January 1, 2005 and December 31, 2005	$ 2.0 million
Between January 1, 2006 and December 31, 2006	$ 1.0 million

The table below sets forth the amount of the fee that we would be required to pay to each of Mr. Liebner and Ms. Hughes, depending on the date of the sale:

Date of Sale	Fee
Between September 30, 2002 and December 31, 2002	$ 1.0 million
Between January 1, 2003 and December 31, 2003	$ 0.8 million
Between January 1, 2004 and December 31, 2004	$ 0.6 million
Between January 1, 2005 and December 31, 2005	$ 0.4 million
Between January 1, 2006 and December 31, 2006	$ 0.2 million

As used in the management agreements, a sale of the company means:

the acquisition of more than 50% of our voting securities by any person, party or group, other than in connection with a sale of securities by us; or

the acquisition of VistaCare by means of reorganization, merger, consolidation or asset sale, unless our stockholders prior to such acquisition hold, in substantially the same proportions as prior to the acquisition, more than 50% of the voting securities of the acquiring entity following the acquisition.

In exchange for the foregoing rights, each of the executives has agreed to covenants restricting them from competing with our business or soliciting our employees or patient referral sources for two years following their employment termination and from disclosing or divulging any of our confidential information.

Stock Option Agreement

In November 2002, we entered into a stock option agreement with Richard R. Slager, our President and Chief Executive Officer, pursuant to which we granted Mr. Slager an option to purchase 320,000 shares of our common stock at $12.50 per share under our 1998 Stock Option Plan. At the time the stock option was granted, the shares subject to the option were scheduled to vest in November 2012, subject to acceleration upon the occurrence of certain events. In February 2003, we accelerated the vesting of this option in full such that the option is now immediately exercisable as to all 320,000 shares.

Severance Agreement

In November 1995, we entered into an employee confidentiality and non-competition agreement with Barry M. Smith, the Chairman of our board of directors. This agreement provides that if Mr. Smith s employment is terminated for any reason, we are obligated to pay him severance of twelve months salary, and he is prohibited, for a period of twelve months following the date of his termination, from engaging in any business that competes with our hospice business, and soliciting any of our employees or attempting to divert any business away from us. The agreement also requires Mr. Smith to maintain the confidentiality of certain information relating to our business.

Stock Plans

1998 Stock Option Plan

General. Our 1998 Stock Plan, or the 1998 plan, provides for the grant of incentive stock options and non-statutory stock options. The 1998 plan authorizes us to issue up to 3,200,000 shares of our common stock upon exercise of options granted under the plan. As of March 31, 2003, 1,981,900 shares were subject to outstanding options under the plan. The 1998 plan is administered by our board of directors and the compensation committee.

Eligibility to Receive Awards. Employees, officers, directors and consultants of VistaCare and our subsidiaries are eligible to be granted stock options under the 1998 plan. Under present law, however, incentive stock options qualifying under Section 422 of the Internal Revenue Code may only be granted to employees.

Incentive Stock Options and Non-statutory Stock Options. Stock options entitle the holder to purchase a specified number of shares of common stock at a specified option price, subject to the other terms and conditions contained in the option grant. Under present law, incentive stock options and options intended to qualify as performance-based compensation under Section 162(m) of the Internal Revenue Code may not be granted at an exercise price less than the fair market value of the common stock on the date of grant (or less than 110% of the fair market value in the case of incentive stock options granted to optionees holding more than 10% of the voting power of VistaCare). Options may not be granted for a term in excess of ten years. Our board of directors or our compensation committee determines:

- the recipients of stock options;
- the number of shares subject to each option granted;
- the exercise price of non-statutory stock options;
- the vesting schedule of the option (generally over five years);
- the duration of the option (generally ten years, subject to earlier termination in the event of the termination of the optionee s employment); and
- the manner of payment of the exercise price of the option.

Acquisition of VistaCare. The 1998 plan provides that, in the event that we merge with or are acquired by another company, outstanding stock options shall be assumed by the acquiring or surviving company, or equivalent options of the acquiring or surviving company shall be substituted for VistaCare options. If the acquiring or surviving company refuses to assume or substitute its options for VistaCare options, outstanding VistaCare options may be exercised in full prior to the acquisition regardless of vesting restrictions, provided, that if such options are not exercised prior to the acquisition or merger, they will terminate.

2002 Non-Employee Director Stock Option Plan

Our 2002 Non-Employee Director Stock Option Plan, or the director plan, authorizes the grant of options to purchase up to 300,000 shares of common stock to our non-employee directors. Under the director plan, each future non-employee director will be granted a stock option to purchase 20,000 shares of common

Table of Contents

stock on the date he or she is first elected to our board of directors. In addition, on November 11 of each year, each non-employee director will be granted an option to purchase 10,000 shares of our common stock, provided that he or she attended at least 75% of the meetings of the board of directors and each board committee on which he or she served in the preceding year. The exercise price for all options granted under the director plan will be equal to the fair market value of the common stock on the date of grant. Each option granted under the director plan will be immediately exercisable in full. Each option will expire on the earlier of ten years from the date of grant or on the first anniversary of the date on which the optionee ceases to be a director. To date, we have not granted any options under the director plan.

2002 Employee Stock Purchase Plan

Our 2002 Employee Stock Purchase Plan, or the purchase plan, provides for the issuance of up to 200,000 shares of our common stock to participating employees.

All of our employees, including directors who are employees, and all employees of any participating subsidiaries, whose customary employment is more than 20 hours per week for more than five months in a calendar year are eligible to participate in the purchase plan. Employees who would immediately after the grant own five percent or more of the total combined voting power or value of our stock or any subsidiary are not eligible to participate.

The purchase plan will be implemented through a series of offerings, the dates of which shall be established from time to time by our board of directors. Participating employees may purchase shares under the purchase plan through periodic payroll deductions, lump sum payments, or both. The purchase price of the shares in each offering period will be 85% of the closing price per share of the common stock on either the first or last day of the offering period, whichever is lower. To date, we have not implemented any offerings under the purchase plan.

Employee Bonus Plan

Our Employee Bonus Plan, or the bonus plan, provides for quarterly and annual cash bonuses to all of our full and part-time employees. General terms of the bonus plan include:

- quarterly bonuses are paid to eligible employees 45 days after the end of the applicable quarter;

- employees must be employed on the date on which bonuses are paid;

- bonuses are based on a predetermined percentage of an employee s quarterly earnings; and

- all bonuses are subject to approval by our board of directors.

Bonuses are determined as follows:

Operations Staff. Members of our operations staff are paid quarterly bonuses based on a combination of factors including program, region and company-wide economic performance and internal compliance ratings for the program in which the staff members are employed. Annual bonuses, which constitute 20% of bonuses paid to operations staff members, are based on the fulfillment of personal objectives and are paid following the completion of annual performance reviews.

Area and Regional Staff. Members of our area and regional staff are paid quarterly bonuses based on area or regional and company-wide economic performance. Annual bonuses, which constitute 50% of bonuses paid to area and regional staff members, are based on the fulfillment of personal objectives and are paid following the completion of annual performance reviews.

Corporate Office Staff. Members of our corporate office staff, other than senior managers, are paid both quarterly and annual bonuses. Senior managers are paid only annual bonuses. One half of bonuses paid to corporate office staff members are based on company-wide economic performance. The remainder is based on personal performance.

Table of Contents

Key Employee Sale Bonus Plan

In October 2002, our board of directors adopted a Key Employee Sale Bonus Plan, or the sale bonus plan. The sale bonus plan is designed to provide incentives for our key employees to remain employed by us during the period leading up to a potential sale of the company, as defined below, in order to maximize the proceeds from any such sale.

As used in the sale bonus plan, a sale of the company means:

the acquisition of more than 50% of our voting securities by any person, party or group, other than in connection with a sale of securities by us; or

the acquisition of VistaCare by means of reorganization, merger, consolidation or asset sale, unless our stockholders prior to such acquisition hold, in substantially the same proportions as prior to the acquisition, more than 50% of the voting securities of the acquiring entity following the acquisition.

The sale bonus plan provides that if there is a sale of the company prior to December 31, 2006, and the per-share equity value of VistaCare implied by the transaction is at least $12.50, we will establish a bonus pool. The amount of the bonus pool depends on when the sale closes, as described in the table below.

Date of Sale	Bonus Pool Amount
Between September 30, 2002 and December 31, 2002	$ 1.0 million
Between January 1, 2003 and December 31, 2003	$ 0.8 million
Between January 1, 2004 and December 31, 2004	$ 0.6 million
Between January 1, 2005 and December 31, 2005	$ 0.4 million
Between January 1, 2006 and December 31, 2006	$ 0.2 million

The sale bonus plan provides that our Chief Executive Officer shall allocate the bonus pool amount among key employees after consultation with the compensation committee of our board of directors. The sale bonus plan prohibits the allocation of a bonus to the Chief Executive Officer and any person not employed by us immediately prior to the sale of the company. Payments under this plan have priority over any payments to our stockholders in connection with a sale of the company. Sale bonuses are to be paid in the same form and same proportion as the consideration that we, or our stockholders, receive in connection with any sale of the company.

The sale bonus plan terminates on December 31, 2006, or, if earlier, following a sale of the company.

401(k) Plans

We maintain two plans qualified under Section 401(k) of the Internal Revenue Code. Under our 401(k) plans, a participant may contribute a maximum of 10% or 15%, depending on the plan under which he or she participates, of his or her pre-tax salary, commissions and bonuses through payroll deductions, up to the statutorily prescribed annual limit ($12,000 in calendar year 2003). The percentage elected by more highly compensated participants may be required to be lower. In addition, at the discretion of our board of directors, we may make discretionary matching and/or profit-sharing contributions into our 401(k) plans for eligible employees.

Compensation Committee Interlocks and Insider Participation

None of our executive officers has served as a director or member of the compensation committee of any other entity whose executive officers served as a director or member of our compensation committee.

Limitation of Liability and Indemnification Matters

Our certificate of incorporation limits the liability of our directors to the maximum extent permitted by Delaware law. Delaware law provides that a corporation s certificate of incorporation may contain a provision

Table of Contents

eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breach of his or her fiduciary duties as a director, except for liability

- for any breach of his or her duty of loyalty to the corporation or its stockholders;
- for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law;
- for unlawful payments of dividends or unlawful stock repurchases or redemptions as provided in Section 174 of the Delaware General Corporation Law; or
- for any transaction from which he or she derived an improper personal benefit.

Our certificate of incorporation provides that we will indemnify our directors and officers to the fullest extent permitted by law. Our certificate of incorporation permits us to advance expenses incurred by an indemnified director or officer in connection with the defense of any action or proceeding arising out of such director s or officer s status as a director or officer upon an undertaking by such director or officer to repay such advances if it is ultimately determined that the director or officer is not entitled to such indemnification.

We maintain directors and officers liability insurance.

Indemnification Agreements

We have entered into indemnification agreements with each of our directors and officers. These indemnification agreements provide that we will indemnify our directors and officers to the fullest extent permitted by law for liabilities they may incur because of their status as directors and officers. These agreements also provide that we will advance expenses to our directors and officers relating to claims for which they may be entitled to indemnification. Upon a potential change of control of VistaCare, our directors and officers may request that we create a trust for their benefit in an amount sufficient to satisfy any expenses that they may reasonably expect to incur in connection with a claim against them. These indemnification agreements also provide that we will maintain directors and officers liability insurance.

Table of Contents

CERTAIN TRANSACTIONS

Vista Care Foundation

The Vista Care Foundation is a non-profit corporation established by Barry M. Smith, the Chairman of our board of directors, in March 1996 for the purpose of soliciting, investing and distributing funds to advance the cause of end-of-life care. The foundation:

- provides grants directly to terminally ill patients to fulfill basic needs and last wishes;
- funds hospice services for patients who lack the means to pay for hospice care;
- provides funding for end-of-life research and community and professional education; and
- provides grants that help the bereaved overcome their grief of the loss of a loved one.

The business and affairs of the foundation are currently governed by a five member board of trustees. Perry G. Fine, M.D., one of our directors, and David W. Rehm, our Senior Vice President of Business Development, serve on the foundation s board of trustees. In addition, Mr. Rehm serves as the foundation s President and Chief Executive Officer. Prior to September 2002, Barry M. Smith, the Chairman of our board of directors, served on the foundation s board of trustees. At any meeting of the foundation s board of trustees at which at least three, but fewer than four, trustees are present, it is possible that Dr. Fine and Mr. Rehm could control the outcome of all actions taken at such meeting.

Since March 2002, we have been making charitable contributions to the foundation, which as of March 31, 2003 aggregated $0.5 million. A portion of our contributions to the foundation are used to cover the foundation s operating expenses. We also provide-in-kind contributions to the foundation, including office space and office equipment at our Phoenix, Arizona program site.

Between March and December 2002, the foundation provided an aggregate of $159,000 to pay for a portion of the care we provided to some of our patients who lacked the means to pay for such care. Beginning in 2003, we will no longer receive any such funding from the foundation. We may amend or terminate our arrangements with the foundation at any time for any reason.

Employment Termination Arrangements with Former Officers

In March 1996, we extended a loan to Lloyd S. Wylie, our former Chief Financial Officer, in the original principal amount of $66,000 and bearing interest at 7.5% per annum. The loan was secured by a pledge of the shares of common stock issuable upon exercise of a stock option granted to Mr. Wylie. Such stock option, which was exercisable for 48,000 shares of common stock at $1.68 per share, was fully vested when Mr. Wylie s employment terminated in June 1999. In September 2002, we entered into a settlement agreement and mutual release with Mr. Wylie pursuant to which we agreed to repurchase Mr. Wylie s stock option for $105,839, reduced by the outstanding principal and accrued interest on Mr. Wylie s loan as of June 30, 1999 in the amount of $72,979, and deem such loan fully paid.

In November 2000, we entered into a severance agreement and full release of claims with Carolyn Cassin, a former Vice President, in connection with her termination of employment. Under this agreement, we made severance payments to Ms. Cassin totaling $102,000 and agreed to continue her health benefits for a period of six months following the date of her termination of employment. In exchange for the severance payments, Ms. Cassin waived all claims against us arising from her employment, agreed to maintain the confidentiality of information relating to our business and not to compete with our business or solicit our employees for six months following her termination of employment.

In October 2001, we entered into a full and final release of claims with Lois Armstrong, our former Chief Operating Officer, in connection with the termination of her employment. At that time, we made a severance payment to Ms. Armstrong totaling $250,000. In exchange for the severance payment, Ms. Armstrong waived all claims against us arising from her employment, agreed to maintain the

Table of Contents

confidentially of information relating to our business, and agreed not to compete with our business prior to December 31, 2001 or to solicit our employees for six months following her termination of employment.

In February 2002, we entered into a settlement agreement, buy-sell agreement and mutual release with David Daucher, our former Chief Financial Officer, in connection with his termination of employment. Pursuant to that agreement, we made a severance payment of $247,500 to Mr. Daucher. We also paid Mr. Daucher $502,500 to repurchase 5,000 shares of our Series D Preferred Stock and to settle all claims arising prior to the date of the agreement, including claims arising from Mr. Daucher s employment.

In October 2002, we entered into a severance agreement and mutual release of claims with Philip B. Arnold, a former Executive Vice President, in connection with the termination of his employment. Pursuant to that agreement, we agreed to make aggregate severance payments to Mr. Arnold of $194,000. In addition, we agreed to provide him with continuing health insurance benefits for a period of six months following the termination of his employment. In exchange for these benefits, Mr. Arnold waived all claims against us arising from his employment, and agreed to maintain the confidentiality of information relating to our business and not to compete with our business for a period of one year following his termination of employment.

Table of Contents

PRINCIPAL AND SELLING STOCKHOLDERS

The following table sets forth certain information regarding beneficial ownership of our common stock as of March 31, 2003, and as adjusted to reflect the sale of the shares of common stock in this offering, by:

each stockholder who we know beneficially owns more than 5% of our common stock;

each of our directors;

each of our named executive officers;

each selling stockholder; and

all of our executive officers and directors as a group.

Beneficial ownership is determined in accordance with the rules and regulations of the Securities and Exchange Commission. For the purpose of calculating the percentage of shares beneficially owned by any stockholder, the number of shares of common stock deemed outstanding Prior to Offering includes:

15,604,035 shares of common stock outstanding as of March 31, 2003, assuming the conversion of all 58,096 outstanding shares of our Class B Common Stock, which are convertible at any time at the option of the holder into an equal number of shares of our common stock; and

the shares of common stock subject to options and warrants held by the beneficial owner that are currently exercisable within 60 days after March 31, 2003.

Except as indicated in the footnotes to this table and subject to applicable community property laws, the persons named in this table have the sole voting power with respect to all shares of common stock listed as beneficially owned by them.

71

Table of Contents

Name of Beneficial Owner	Shares Beneficially Owned Prior to Offering		Number of Shares Offered in this Offering(1)	Shares to be Beneficially Owned After Offering(1)	
	Number of Shares	Percent		Number of Shares	Percent
Selling Stockholders:					
Ferrer Freeman & Company, LLC(2)	4,034,787	25.8%	3,622,534	412,253	2.6%
Bessemer Venture Partners III L.P. and certain related persons(3)	2,132,862	13.7%	1,302,579	830,283	5.3%
Adam P. Godfrey	1,097	*	997	100	*
Barbara M. Henagan	4,330	*	2,953	1,377	*
Belisarius Corporation	5,564	*	5,058	506	*
Bradford Mills	4,330	*	2,953	1,377	*
Diane N. McPartlin	1,297	*	885	412	*
Gerald N. Christopher	588	*	535	53	*
Quentin Corporation	8,334	*	5,683	2,651	*
Richard R. Davis	5,564	*	3,794	1,770	*
Robert J.S. Roriston	833	*	757	76	*
Robi L. Soni	3,879	*	2,645	1,234	*
Rodney A. Cohen	560	*	509	51	*
Russell D. Sternlicht	434	*	296	138	*
Thomas F. Ruhm	861	*	587	274	*
Barry M. Smith(4)	2,025,000	13.0%	494,420	1,530,580	9.8%
Banc of America Commercial Finance Corporation(5)	58,096	*	52,815	5,281	*
Directors and Executive Officers:					
Richard R. Slager(6)	417,000	2.6%		417,000	2.6%
Barry M. Smith(4)	2,025,000	13.0%	494,420	1,530,580	9.8%
Carla Davis Hughes(7)	22,000	*		22,000	*
Perry G. Fine, M.D.(8)	80,000	*		80,000	*
Stephen Lewis(9)	8,000	*		8,000	*
Mark E. Liebner		*			*
William J. McBride(10)	70,000	*		70,000	*
David A. Freeman(11)	4,034,787	25.8%	3,622,534	412,253	2.6%
Pete A. Klisares(12)	30,000	*		30,000	*
Ronald A. Matricaria(13)	30,000	*		30,000	*
All executive officers and directors as a group (10 persons)(14)	6,716,787	41.4%	4,116,954	2,599,833	16.0%

* Less than one percent of the outstanding common stock.

(1) Assumes no exercise of the underwriters over-allotment option.

(2) Ferrer Freeman & Company, LLC s address is 10 Glenville Street, Greenwich, Connecticut, 06831. Shares beneficially owned prior to offering consists of 3,826,479 shares held of record by FFC Partners I, L.P., 158,308 shares held of record by FFC Executive Partners I, L.P. and options to purchase 50,000 shares held by David A. Freeman that are exercisable within 60 days of March 31, 2003, the benefit of which options accrues to FFC Partners I, L.P. pursuant to its partnership agreement. Number of shares to be beneficially owned after offering consists of 347,861 shares held of record by FFC Partners I, L.P., 14,392 shares held of record by FFC Executive Partners I, L.P. and options to purchase 50,000 shares held by David A. Freeman that are exercisable within 60 days of March 31, 2003, the benefit of which options accrues to FFC Partners I, L.P. pursuant to its partnership agreement. Ferrer Freeman & Company, LLC is the general partner of both FFC Partners I, L.P. and FFC Executive Partners I, L.P.

Each of David A. Freeman and Carlos A. Ferrer is a managing member of Ferrer Freeman & Company, LLC, and as such has shared voting and dispositive power with respect to the shares held by FFC Partners I, L.P. and FFC Executive Partners I, L.P. Each of David A. Freeman and Carlos A. Ferrer is a Managing Member of Ferrer Freeman & Company, LLC, and each of Thomas J. Flynn, Keith J. Longson and Patricia A. Summers is a Member of Ferrer Freeman & Company, LLC, and as such has shared voting and dispositive power with respect to the shares held by FFC Partners I, L.P. and FFC Executive Partners I, L.P. Each of Messrs Ferrer, Freeman, Flynn and Longson and Ms. Summers disclaims beneficial ownership with respect to the shares held by FFC Partners I, L.P. and FFC Executive Partners I, L.P., except to the extent of their pecuniary interests therein.

(3) Bessemer Venture Partners III L.P. s address is 1865 Palmer Avenue, Suite 104, Larchmont, NY 10538. Shares beneficially owned prior to offering consists of 1,802,064 shares held of record by Bessemer Venture Partners III L.P., 20,000 of which may be purchased within 60 days of March 31, 2003 upon exercise of a warrant, 42,060 shares held of record by BVP III Special Situations L.P., 78,465 shares held of record by Mr. William T. Burgin, 39,226 shares held of record by Brimstone Island Co. L.P. 7,785 shares held of record by Mr. Robert H. Buescher, 38,905 shares held of record by The Hardymon Family Limited Partnership, 108,643 shares held of record by Christopher F.O. Gabrieli, 9,043 shares held of record by the Gabrieli Family Foundation and 6,671 shares of record held by Mr. David J. Cowan. Shares to be beneficially owned after offering consists of 573,385 shares held of record by Bessemer Venture Partners III L.P., 13,384 shares held of record by BVP III Special Situations L.P., 78,465 shares held of record by Mr. William T. Burgin, 39,226 shares held of record by Brimstone Island Co. L.P., 2,477 shares held of record by Mr. Robert H. Buescher, 3,537 shares held of record by The Hardymon Family Limited Partnership, 108,643 shares held of record by Christopher F.O. Gabrieli, 9,043 shares held of record by the Gabrieli Family Foundation and 2,123 shares held of record by Mr. David J. Cowan. Each of Mr. William T. Burgin, Mr. Robert H. Buescher, Mr. G. Felda Hardymon, Mr. Christopher F.O. Gabrieli and Mr. David J. Cowan is a manager of Deer III & Co., LLC, which is the general partner of both Bessemer Venture Partners III L.P. and BVP III Special Situations, L.P., and as such each has sole voting power and dispositive power with respect to the shares held by Bessemer Venture Partners III L.P. and BVP III Special Situations L.P. except to the extent of each such manager s pecuniary interest therein. Mr. William T. Burgin and Brimstone Island Co. L.P. disclaim beneficial ownership of the shares held by Messrs. Buescher, Gabrieli and Cowan and The Hardymon Family Limited Partnership and the Gabrieli Family Foundation. Mr. Robert H. Buescher disclaims beneficial ownership of the shares held by Messrs. Burgin, Gabrieli and Cowan and The Hardymon Family Limited Partnership, Brimstone Island Co. L.P. and the Gabrieli Family Foundation. Mr. Gabrieli and the Gabrieli Family Foundation disclaim beneficial ownership of the shares held by Messrs. Burgin, Buescher and Cowan and The Hardymon Family Limited Partnership and Brimstone Island Co. L.P. Mr. G. Felda Hardymon is the general partner of The Hardymon Family Limited Partnership, and as such has sole voting power and dispositive power with respect to the shares held by The Hardymon Family Limited Partnership. Mr. Hardymon and the Hardymon Family Foundation disclaim beneficial ownership of the shares held by Messrs. Burgin, Buescher, Gabrieli and Cowan, Brimstone Island Co. L.P. and the Gabrieli Family Foundation. Mr. David J. Cowan disclaims beneficial ownership of the shares held by Messrs. Burgin, Buescher and Gabrieli and The Hardymon Family Limited Partnership, Brimstone Island Co. L.P. and the Gabrieli Family Foundation. Number of shares offered in this offering and shares to be beneficially owned after offering will be revised depending on the public offering price.

(4) Mr. Smith s address is c/o Vista Care, Inc., 8125 North Hayden Road, Suite 300, Scottsdale, AZ 85258. Shares beneficially owned prior to offering consists of 602,850 shares held by the Barry and Julia Smith Family Trust, 1,406,650 shares held by B&J Smith Associates, Limited Partnership and options to purchase 16,000 shares held by Mr. Smith that are exercisable within 60 days of March 31, 2003. Number of shares to be beneficially owned after offering consists of 108,430 shares held by the Barry and Julia Smith Family Trust, 1,406,650 shares held by B&J Smith Associates, Limited Partnership, and options to purchase 16,000 shares held by Mr. Smith that are exercisable within 60 days of March 31, 2003. Mr. Smith is a trustee of the Barry and Julia Smith Family Trust and he is the controlling stockholder of B&J Investments, Inc., the general partner of B&J Smith Associates, Limited Partnership.

Mr. Smith has shared voting and dispositive power over the shares held by the Barry and Julia Smith Family Trust and he has sole voting and dispositive power over the shares held by B&J Smith Associates, Limited Partnership. Mr. Smith disclaims beneficial ownership of the shares held by the Barry and Julia Smith Family Trust and B&J Smith Associates, Limited Partnership except to the extent of his pecuniary interest therein.

(5) The 58,096 shares beneficially owned prior to offering are shares of our Class B Common Stock, which may be converted into an equal number of shares of our common stock at any time. The 52,815 shares offered in this offering will be shares of our common stock issued upon conversion of an equal number of shares of our Class B Common Stock, which will occur upon the closing of this offering.

(6) Includes options to purchase 416,000 shares that are exercisable within 60 days of March 31, 2003.

(7) Represents options to purchase 22,000 shares that are exercisable within 60 days of March 31, 2003.

(8) Includes options to purchase 32,000 shares that are exercisable within 60 days of March 31, 2003.

(9) Represents options to purchase 8,000 shares that are exercisable within 60 days of March 31, 2003.

(10) Includes options to purchase 20,000 shares that are exercisable within 60 days of March 31, 2003.

(11) David A. Freeman serves on our board of directors. Mr. Freeman s beneficial ownership includes 3,826,479 shares held by FFC Partners I, L.P. and 158,308 shares held by FFC Executive Partners I, L.P. as previously described in note (3) above. Mr. Freeman is a member of Ferrer Freeman & Company, LLC, the general partner of both FFC Partners I, L.P. and FFC Executive Partners I, L.P. Mr. Freeman has shared voting and dispositive power over the shares held by the FFC funds. Mr. Freeman disclaims beneficial ownership of the shares held by the FFC funds except to the extent of his pecuniary interest therein. Mr. Freeman is not a selling stockholder in this offering.

(12) Includes options to purchase 20,000 shares that are exercisable within 60 days of March 31, 2003.

(13) Represents options to purchase 30,000 shares that are exercisable within 60 days of March 31, 2003.

(14) Includes options to purchase 614,000 shares that are exercisable within 60 days of March 31, 2003.

DESCRIPTION OF CAPITAL STOCK

Our authorized capital stock consists of 33,000,000 shares of common stock, $0.01 par value per share, 200,000 shares of Class B Common Stock and 2,000,000 shares of preferred stock, $0.01 par value per share. As of March 31, 2003, there were outstanding:

- 15,545,939 shares of common stock held by 70 stockholders of record;
- 58,096 shares of our Class B Common Stock (convertible at any time into an equal number of shares of our common stock) held by one stockholder of record;
- options to purchase an aggregate of 1,981,900 shares of common stock; and
- a warrant to purchase 20,000 shares of common stock.

The following summary of our capital stock and our certificate of incorporation and by-laws is qualified by reference to the provisions of applicable law and to our certificate of incorporation and by-laws included as exhibits to the registration statement of which this prospectus is a part. For more information, see the section of this prospectus entitled Where You Can Find More Information .

Common Stock

Holders of our common stock are entitled to one vote for each share held on all matters submitted to a vote of stockholders and do not have cumulative voting rights. Accordingly, holders of a majority of the shares of our common stock entitled to vote in any election of directors may elect all of the directors standing for election. Holders of our common stock are entitled to receive proportionately any dividends declared by our board of directors, subject to any preferential dividend rights of outstanding preferred stock. In addition, our credit facility restricts the payment of cash dividends. For more information, see the section of this prospectus entitled Dividend Policy . Upon the liquidation, dissolution or winding up of VistaCare, the holders of our common stock are entitled to receive ratably our net assets available after the payment of all debts and other liabilities and subject to the prior rights of any outstanding preferred stock. Holders of our common stock have no preemptive, subscription, redemption or conversion rights. The rights, preferences and privileges of holders of our common stock are subject to the rights of the holders of shares of any series of preferred stock which we may designate and issue in the future.

In addition to our common stock, our certificate of incorporation authorizes us to issue shares of Class B Common Stock. Our Class B Common Stock is similar in all respects to our common stock except holders of our Class B Common Stock are not entitled to any voting rights other than as prescribed by applicable law. Each share of our Class B Common Stock is convertible at any time at the option of the holder into one share of our common stock.

Preferred Stock

Under the terms of our certificate of incorporation, our board of directors is authorized to designate and issue shares of preferred stock in one or more series without stockholder approval. Our board of directors has discretion to determine the rights, preferences, privileges and restrictions, including voting rights, dividend rights, conversion rights, redemption privileges and liquidation preferences, of each series of preferred stock. It is not possible to state the actual effect of the issuance of any shares of preferred stock upon the rights of holders of the common stock until the board of directors determines the specific rights of the holders of the preferred stock. However, these effects might include:

- restricting dividends on the common stock;
- diluting the voting power of the common stock;
- impairing the liquidation rights of the common stock; and
- delaying or preventing a change in control of our company.

Table of Contents

The purpose of authorizing our board of directors to issue preferred stock and determine its rights and preferences is to eliminate delays associated with a stockholder vote on specific issuances. The issuance of preferred stock, while providing desirable flexibility in connection with possible acquisitions and other corporate purposes, could make it more difficult for a third-party to acquire, or could discourage a third-party from attempting to acquire, a majority of our outstanding voting stock. We have no present plans to issue any shares of preferred stock.

Delaware Anti-Takeover Law and Certain Charter and By-law Provisions

We are subject to the provisions of Section 203 of the General Corporation Law of Delaware. In general, the statute prohibits a publicly held Delaware corporation from engaging in a business combination with an interested stockholder for a period of three years after the date of the transaction in which the person became an interested stockholder, unless the business combination is approved by the corporation s board of directors and/or stockholders in a prescribed manner. The term business combination includes mergers, asset sales and other transactions resulting in a financial benefit to the interested stockholder. Subject to certain exceptions, an interested stockholder is a person who, together with affiliates and associates, owns, or within three years did own, 15% or more of the corporation s voting stock.

Our certificate of incorporation and by-laws provide for the division of our board of directors into three classes as nearly equal in size as possible with staggered three-year terms. Any vacancy on our board of directors, including a vacancy resulting from an enlargement of our board of directors, may be filled only by vote of a majority of the directors then in office. The classification of our board of directors and the limitation on filling of vacancies could make it more difficult for a third-party to acquire, or discourage a third-party from attempting to acquire, control of VistaCare.

Our by-laws also provide that any action required or permitted to be taken by our stockholders at an annual meeting or special meeting of stockholders may only be taken if it is properly brought before such meeting and may not be taken by written action in lieu of a meeting. Our by-laws further provide that special meetings of the stockholders may only be called by the Chairman of our board of directors, our President or our board of directors. In order for any matter to be considered properly brought before a meeting, a stockholder must comply with requirements regarding advance notice, and provide certain information to us. These provisions could have the effect of delaying until the next stockholders meeting stockholder actions which are favored by the holders of a majority of our outstanding voting securities. These provisions could also discourage a third-party from making a tender offer for our common stock, because even if it acquired a majority of our outstanding voting securities, it would be able to take action as a stockholder (such as electing new directors or approving a merger) only at a duly called stockholders meeting and not by written consent.

Transfer Agent and Registrar

The transfer agent and registrar for our common stock is EquiServe Trust Company, N.A.

SHARES ELIGIBLE FOR FUTURE SALE

Future sales of substantial amounts of common stock in the public market could adversely affect prevailing market prices of our common stock. Furthermore, since only a limited number of shares will be available for sale shortly after this offering because of contractual and legal restrictions on resale described below, sales of substantial amounts of our common stock in the public market after the restrictions lapse could adversely affect the prevailing market price and our ability to raise equity capital in the future.

Sales of Restricted Shares and Lock-up Agreements

All of the shares sold in this offering will be freely tradable without restriction under the Securities Act, except for any shares purchased by our affiliates as that term is defined in Rule 144 under the Securities Act. In addition, the shares sold by us and the selling stockholders in our initial public offering and any shares previously sold by our stockholders pursuant to Rule 144 are freely tradable under the Securities Act, unless they were purchased by our affiliates. Substantially all of the remaining shares of our common stock that will be outstanding after this offering are restricted shares as that term is defined in Rule 144 under the Securities Act. We issued and sold the restricted shares in private transactions in reliance upon exemptions from registration under the Securities Act. Restricted shares may be sold in the public market only if they are registered under the Securities Act or if they qualify for an exemption from registration, such as Rule 144 or 701 under the Securities Act, which are summarized below.

In connection with this offering, our directors, including Barry M. Smith, who is also a selling stockholder in this offering, together with our executive officers and some of our significant stock and option holders, have agreed to a 90-day lock-up with respect to the 1,725,800 shares of our common stock they will hold after this offering. In addition, the lock-up will apply to all shares of our common stock which such persons may acquire during this 90-day period upon exercise of options and warrants to acquire our capital stock. This generally means that they cannot sell these shares during the 90 days following the date of this offering. After the 90-day lock-up period ends, these shares may be sold only in accordance with an available exemption from registration, such as Rule 144 or 701, which are described below. In addition, some of our stockholders entered into a 180-day lock-up in December 2002 in connection with our initial public offering, but the selling stockholders, other than Barry M. Smith, and some of our other significant stockholders holding an aggregate of 1,295,000 shares of our common stock, did not enter into the 90-day lock-up referred to above in connection with this offering. This 180-day lock-up expires on June 16, 2003. After that date, those shares may be sold only in accordance with an available exemption from registration, such as Rule 144 or 701.

Barry M. Smith, the Chairman of our board of directors, previously entered into an agreement with us that prohibits him from selling, transferring or disposing of shares of our common stock until July 18, 2004, except under certain circumstances. Those prohibitions will lapse upon the completion of this offering.

We have filed a registration statement under the Securities Act covering shares of common stock issuable upon the exercise of options or reserved for issuance under our stock plans. The shares registered under this registration statement will, subject to Rule 144 provisions applicable to affiliates, be available for sale in the open market, except to the extent that the shares are subject to vesting restrictions or the lock-up agreements described above. For more information, see the section of this prospectus entitled Management Stock Plans .

In general, under Rule 144 as currently in effect, beginning 90 days after the date of this prospectus, a person who has beneficially owned restricted shares for at least one year would be entitled to sell, within any three-month period, up to that number of restricted shares as is equal to the greater of one percent of the number of shares of common stock then outstanding (which will equal approximately 156,040 shares immediately after this offering) or the average weekly trading volume of our common stock on the Nasdaq National Market during the four calendar weeks preceding the filing of a notice on Form 144 with respect to such sale. Sales under Rule 144 are also subject to manner of sale provisions, notice requirements and the availability of current public information about us. Rule 144 also provides that our affiliates who are selling shares of common stock that are not restricted shares must nonetheless comply with the same restrictions applicable to restricted shares with the exception of the holding period requirement.

Under Rule 144(k), beginning on the date of this prospectus, a person who is not deemed to have been an affiliate of ours at any time during the 90 days preceding a sale, and who has beneficially owned the shares proposed to be sold for at least two years, is entitled to sell those shares without complying with the manner of sale, public information, volume limitation or notice provisions of Rule 144.

Rule 701 may be relied upon with respect to the resale of shares of common stock originally purchased from us by directors, employees or consultants prior to the date of this prospectus. Shares issued in reliance on Rule 701 are restricted shares and, subject to the lock-up agreements described above, may be sold beginning 90 days after the date of this prospectus by persons other than affiliates, subject only to the manner of sale provisions of Rule 144, and may be sold by affiliates under Rule 144 without compliance with its one-year holding period requirement.

Future Registrations of Shares

Following this offering, assuming that the underwriters do not exercise their over-allotment option, the holders of 1,278,566 shares of common stock will have the right, subject to certain exceptions and conditions, to require us to register their shares of common stock under the Securities Act, and the holders of 1,283,847 shares of common stock will have the right to participate in future registrations of securities by us. We may be required to effect up to two demand registrations on Form S-1 and an unlimited number of demand registrations on Form S-3. We are generally required to bear all of the expenses of all registrations except for underwriting discounts and selling commissions, which will be borne by the holders participating in the registrations. Registration of any of the shares of common stock would result in these shares becoming freely tradable without restriction under the Securities Act upon effectiveness of the registration statement.

UNDERWRITING

General

Under the underwriting agreement, which is filed as an exhibit to the registration statement relating to this prospectus, each of Lehman Brothers Inc., SG Cowen Securities Corporation, William Blair & Company, L.L.C. and Jefferies & Company, Inc. has severally agreed to purchase from the selling stockholders the respective number of shares of common stock shown opposite its name below:

Underwriters	Number of Shares
Lehman Brothers Inc.	2,200,000
SG Cowen Securities Corporation	2,200,000
William Blair & Company, L.L.C.	825,000
Jefferies & Company, Inc.	275,000
Total	5,500,000

The underwriting agreement provides that the underwriters obligations to purchase shares of common stock depend on the satisfaction of the conditions contained in the underwriting agreement, including:

the obligation to purchase all of the shares of common stock offered hereby if any of the shares are purchased;

the representations and warranties made by us and the selling stockholders to the underwriters are true;

there is no material change in the financial markets; and

we and the selling stockholders deliver customary closing documents to the underwriters.

Over-Allotment Option

The selling stockholders have granted to the underwriters an option to purchase up to an aggregate of 825,000 additional shares of common stock, exercisable to cover over-allotments at the public offering price less the underwriting discount shown on the cover page of this prospectus. The underwriters may exercise this option at any time, and from time to time, until 30 days after the date of the underwriting agreement. To the extent the underwriters exercise this option, each underwriter will be committed, so long as the conditions of the underwriting agreement are satisfied, to purchase a number of additional shares of common stock proportionate to that underwriter s initial commitment as indicated in the preceding table, and the selling stockholders will be obligated to sell the additional shares of common stock to the underwriters.

Commissions and Expenses

The following table summarizes the underwriting discount that selling stockholders will pay. These amounts are shown assuming both no exercise and full exercise of the underwriters option to purchase up to an additional 825,000 shares from the selling stockholders. The underwriting fee is the difference between the public offering price and the amount the underwriters pay to purchase the shares from the selling stockholders.

	No Exercise	Full Exercise
Per Share	$ 1.05	$ 1.05
Total	$5,775,000	$6,641,250

The underwriters have advised us that they propose to offer the shares of common stock directly to the public at the public offering price presented on the cover page of this prospectus, and to selected dealers, who may include the underwriters, at the public offering price less a selling concession not in excess of $0.63 per share. The underwriters may allow, and the selected dealers may reallow, a concession not in excess of $0.10 per share to brokers and dealers. After the offering, the underwriters may change the offering price and other selling terms.

We estimate that the total expenses of this offering, including registration, filing and listing fees, printing fees and legal and accounting expenses, but excluding underwriting discounts, will be approximately $0.5 million. We will pay all costs and expenses of this offering, other than the underwriting discount.

Lock-up Agreements

We have agreed that, without the prior written consent of Lehman Brothers Inc., we will not, directly or indirectly, offer, sell or dispose of any common stock or any securities which may be converted into or exchanged for any common stock for a period of 90 days from the date of this prospectus. Our directors, including Barry M. Smith, who is also a selling stockholder in this offering, together with our executive officers and some of our stock and option holders, holding in the aggregate 1,725,800 shares of our common stock, have agreed under lock-up agreements not to, without the prior written consent of Lehman Brothers Inc., directly or indirectly, offer, sell or otherwise dispose of any common stock or any securities which may be converted into or exchanged or exercised for any common stock for a period of 90 days from the date of this prospectus.

Quotation on the Nasdaq National Market

Our common stock is quoted on the Nasdaq National Market under the symbol VSTA .

Indemnification

We and the selling stockholders have agreed to indemnify the underwriters against liabilities relating to the offering, including liabilities under the Securities Act and liabilities arising from breaches of the representations and warranties contained in the underwriting agreement, and to contribute to payments that the underwriters may be required to make for these liabilities.

Stabilization, Short Positions and Penalty Bids

The underwriters may engage in over-allotment, stabilizing transactions, syndicate covering transactions, and penalty bids or purchases for the purpose of pegging, fixing or maintaining the price of our common stock, in accordance with Regulation M under the Exchange Act:

Over-allotment involves sales by the underwriters of shares in excess of the number of shares the underwriters are obligated to purchase, which creates a syndicate short position. The short position may be either a covered short position or a naked short position. In a covered short position, the number of shares over-allotted by the underwriters is not greater than the number of shares that they may purchase in the over-allotment option. In a naked short position, the number of shares involved is greater than the number of shares in the over-allotment option. The underwriters may close out any short position by either exercising their over-allotment option and/or purchasing shares in the open market.

Stabilizing transactions permit bids to purchase common stock so long as the stabilizing bids do not exceed a specified maximum.

Syndicate covering transactions involve purchases of common stock in the open market after the distribution has been completed in order to cover syndicate short positions. In determining the source of shares to close out the short position, the underwriters will consider, among other things, the price of shares available for purchase in the open market as compared to the price at which they may purchase shares through the over-allotment option. If the underwriters sell more shares than could be covered by the over-allotment option, a naked short position, the position can only be closed out by buying shares in the open market. A naked short position is more likely to be created if the underwriters are concerned that there could be downward pressure on the price of the shares in the open market after pricing that could adversely affect investors who purchase in the offering.

Table of Contents

Penalty bids permit the underwriters to reclaim a selling concession from a syndicate member when the common stock originally sold by the syndicate member is purchased in a stabilizing or syndicate covering transaction to cover syndicate short positions.

These stabilizing transactions, syndicate covering transactions and penalty bids may raise or maintain the market price of our common stock or prevent or slow a decline in the market price of our common stock. As a result, the price of our common stock may be higher than the price that might otherwise exist in the open market. These transactions may be effected on the Nasdaq National Market or otherwise and, if commenced, may be discontinued at any time.

Neither we nor any of the underwriters make any representation or prediction as to the direction or magnitude of any effect that the transactions described above may have on the price of our common stock. In addition, neither we nor the underwriters make any representation that the underwriters will engage in these stabilizing transactions or that any transaction, once commenced, will not be discontinued without notice.

Passive Market Making

In connection with this offering, underwriters and selling group members may engage in passive market making transactions in our common stock on the Nasdaq National Market in accordance with Rule 103 of Regulation M under the Exchange Act during the period before the commencement of offers or sales of common stock and extending through the completion of the distribution. A passive market maker must display its bids at a price not in excess of the highest independent bid of the security. However, if all independent bids are lowered below the passive market maker s bid, that bid must be lowered when specified purchase limits are exceeded.

Stamp Taxes

If you purchase shares of common stock offered in this prospectus, you may be required to pay stamp taxes and other charges under the laws and practices of the country of purchase, in addition to the offering price listed on the cover page of this prospectus.

Electronic Distribution

A prospectus in electronic format may be made available on Internet sites or through other online services maintained by one or more of the underwriters and/or selling group members participating in this offering, or by their affiliates. In those cases, prospective investors may view offering terms online and, depending upon the particular underwriter or selling group member, prospective investors may be allowed to place orders online. The underwriters may agree with us to allocate a specific number of shares for sale to online brokerage account holders. Any such allocation for online distributions will be made by the representatives on the same basis as other allocations.

Other than the prospectus in electronic format, information contained in any other web site maintained by an underwriter or selling group member is not part of this prospectus or the registration statement of which this prospectus forms a part, has not been approved and/or endorsed by us and should not be relied on by investors in deciding whether to purchase any shares of common stock. The underwriters and selling group members are not responsible for information contained in web sites that they do not maintain.

Other

The underwriters have performed and may in the future perform investment banking and advisory services for us from time to time for which they have received or may in the future receive customary fees and expenses. The underwriters may, from time to time, engage in transactions with or perform services for us in the ordinary course of their business.

Table of Contents

NOTICE TO CANADIAN RESIDENTS

Resale Restrictions

The distribution of our common stock, also referred to in this section as the securities, in Canada is being made only on a private placement basis exempt from the requirement that we prepare and file a prospectus with the securities regulatory authorities in each province where trades of the securities are made. Any resale of the securities in Canada must be made under applicable securities laws which will vary depending on the relevant jurisdiction, and which may require resales to be made under available statutory exemptions or under a discretionary exemption granted by the applicable Canadian securities regulatory authority. Purchasers are advised to seek legal advice prior to any resale of the securities.

Representations of Purchasers

By purchasing the securities in Canada and accepting a purchase confirmation a purchaser is representing to us and the dealer from whom the purchase confirmation is received that:

- the purchaser is entitled under applicable provincial securities laws to purchase the securities without the benefit of a prospectus qualified under those securities laws;
- where required by law, that the purchaser is purchasing as principal and not as agent; and
- the purchaser has reviewed the text above under Resale Restrictions.

Rights of Action Ontario Purchasers

Under Ontario securities legislation, a purchaser who purchases a security offered by this prospectus during the period of distribution will have a statutory right of action for damages, or while still the owner of the shares, for rescission against us in the event that this prospectus contains a misrepresentation. A purchaser will be deemed to have relied on the misrepresentation. The right of action for damages is exercisable not later than the earlier of 180 days from the date the purchaser first had knowledge of the facts giving rise to the cause of action and three years from the date on which payment is made for the shares. The right of action for rescission is exercisable not later than 180 days from the date on which payment is made for the securities. If a purchaser elects to exercise the right of action for rescission, the purchaser will have no right of action for damages against us. In no case will the amount recoverable in any action exceed the price at which the securities were offered to the purchaser and if the purchaser is shown to have purchased the securities with knowledge of the misrepresentation, we will have no liability. In the case of an action for damages, we will not be liable for all or any portion of the damages that are proven to not represent the depreciation in value of the securities as a result of the misrepresentation relied upon. These rights are in addition to, and without derogation from, any other rights or remedies available at law to an Ontario purchaser. The foregoing is a summary of the rights available to an Ontario purchaser. Ontario purchasers should refer to the complete text of the relevant statutory provisions.

Enforcement of Legal Rights

All of our directors and officers as well as the experts named herein may be located outside of Canada and, as a result, it may not be possible for Canadian purchasers to effect service of process within Canada upon us or those persons. All or a substantial portion of our assets and the assets of those persons may be located outside of Canada and, as a result, it may not be possible to satisfy a judgment against us or those persons in Canada or to enforce a judgement obtained in Canadian courts against us or those persons outside of Canada.

Taxation and Eligibility for Investment

Canadian purchasers of the securities should consult their own legal and tax advisors with respect to the tax consequences of an investment in the securities in their particular circumstances and about the eligibility of the securities for investment by the purchaser under relevant Canadian legislation.

LEGAL MATTERS

The validity of the shares of common stock offered hereby will be passed upon for us by Choate, Hall & Stewart, Boston, Massachusetts. Certain legal matters will be passed upon for the underwriters by Clifford Chance US LLP, New York, New York.

EXPERTS

Ernst & Young LLP, independent auditors, have audited our consolidated balance sheets as of December 31, 2002 and 2001, and our related consolidated statements of operations, changes in preferred stock and stockholders (deficit) equity, and cash flows for each of the three years in the period ended December 31, 2002, as set forth in their report. We have included our consolidated financial statements in the prospectus and elsewhere in the registration statement in reliance on Ernst & Young LLP s report, given on their authority as experts in accounting and auditing.

WHERE YOU CAN FIND MORE INFORMATION

We have filed with the Securities and Exchange Commission a registration statement on Form S-1 under the Securities Act for the registration of the common stock in this offering. This prospectus, which is part of the registration statement, does not contain all the information included in the registration statement because we have omitted certain parts of the registration statement as permitted by Securities and Exchange Commission rules and regulations. For further information about us and our common stock, you should refer to the registration statement. Statements contained in this prospectus as to any contract, agreement or other document referred to are not necessarily complete. Where the contract or other document is an exhibit to the registration statement, each statement is qualified by the provisions of that exhibit.

We are required to file annual, quarterly and special reports, proxy statements and other information with the Securities and Exchange Commission. You can obtain our Securities and Exchange Commission filings, including the registration statement, over the Internet at the Securities and Exchange Commission s website at http://www.sec.gov. You may also read and copy any document we file with the Securities and Exchange Commission at its public reference facilities at 450 Fifth Street, N.W., Washington, D.C. 20549. You may also obtain copies of these documents at prescribed rates by writing to the Public Reference Room of the Securities and Exchange Commission at 450 Fifth Street, N.W., Washington, D.C. 20549. Please call the Securities and Exchange Commission at 1-800-SEC-0330 for further information on the operation of the public reference facilities.

Table of Contents

INDEX TO CONSOLIDATED FINANCIAL STATEMENTS

	Page
Report of Ernst & Young LLP, Independent Auditors	F-2
Consolidated Balance Sheets	F-3
Consolidated Statements of Operations	F-4
Consolidated Statements of Changes in Preferred Stock and Stockholders (Deficit) Equity	F-5
Consolidated Statements of Cash Flows	F-6
Notes to Consolidated Financial Statements	F-7

REPORT OF ERNST & YOUNG LLP, INDEPENDENT AUDITORS

Board of Directors and Stockholders

VistaCare, Inc.

We have audited the accompanying consolidated balance sheets of VistaCare, Inc. as of December 31, 2002 and 2001, and the related consolidated statements of operations, changes in preferred stock and stockholders (deficit) equity, and cash flows for each of the three years in the period ended December 31, 2002. These consolidated financial statements are the responsibility of the management of VistaCare, Inc. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

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

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of VistaCare, Inc. at December 31, 2002 and 2001, and the consolidated results of its operations and its cash flows for each of the three years in the period ended December 31, 2002, in conformity with accounting principles generally accepted in the United States.

/s/ ERNST & YOUNG LLP

Phoenix, Arizona
February 14, 2003

VISTACARE, INC.

CONSOLIDATED BALANCE SHEETS

(in thousands, except per share information)

	December 31, 2001	December 31, 2002	March 31, 2003
			(unaudited)
ASSETS			
Current assets:			
Cash and cash equivalents	$ 1,383	$ 39,104	$ 39,511
Patient accounts receivable	12,235	19,075	20,124
Patient accounts receivable room & board	4,323	7,613	9,125
Prepaid expenses and other current assets	134	1,312	2,321
Total current assets	18,075	67,104	71,081
Equipment, net	1,795	2,612	2,835
Goodwill, net of amortization	17,802	20,564	20,564
Other assets	3,325	4,663	5,255
Total assets	$ 40,997	$ 94,943	$ 99,735
LIABILITIES AND STOCKHOLDERS (DEFICIT) EQUITY			
Current liabilities:			
Accounts payable	$ 2,510	$ 2,288	$ 2,415
Accrued expenses	14,945	22,982	23,576
Current portion of long-term debt	1,806	250	250
Current portion of capital lease obligations	75	82	84
Total current liabilities	19,336	25,602	26,325
Long-term debt	8,325		
Capital lease obligations, less current portion	175	94	72
Redeemable Non-convertible Preferred Stock:			
Series A-2 redeemable non-convertible, $0.01 par value; 29,500 shares authorized, issued and outstanding at December 31, 2001 and no shares authorized or outstanding at December 31, 2002 and March 31, 2003	292		
Redeemable and Convertible Preferred Stock:			
Series A-1 convertible, $0.01 par value; 404,500 shares authorized and 375,000 shares issued and outstanding at December 31 2001 and no shares authorized or outstanding at December 31, 2002 and March 31, 2003	3,713		
Series B convertible, $0.01 par value; 485,000 shares authorized, issued and outstanding at December 31, 2001 and no shares authorized or outstanding at December 31, 2002 and March 31, 2003	35,383		
Series C convertible, $0.01 par value; 402,500 shares authorized, issued and outstanding at December 31, 2001 and no shares authorized or outstanding at December 31, 2002 and March 31, 2003	2,264		
Series D convertible, $0.01 par value; 65,000 shares authorized and 60,000 shares issued and outstanding at December 31, 2001 and no shares authorized or outstanding at December 31, 2002 and March 31, 2003	3,597		
Stockholders (deficit) equity:			

Class A Common Stock, $0.01 par value; authorized 33,000,000 shares; 3,781,832 shares issued and outstanding at December 31, 2001; 15,420,899 shares issued and outstanding at December 31, 2002; and 15,545,939 shares issued and outstanding at March 31, 2003	37	154	155
Class B Common Stock, $0.01 par value; authorized 200,000 shares; no shares outstanding at December 31, 2001 and 58,096 shares issued and outstanding at December 31, 2002 and March 31, 2003		1	1
Class C Common Stock, $0.01 par value; 1,320,000 shares authorized and 1,316,732 shares issued and outstanding at December 31, 2001 and no shares authorized or outstanding at December 31, 2002 and March 31, 2003	13		
Additional paid-in capital	1,279	101,161	101,216
Deferred compensation	(396)	(2,552)	(1,341)
Accumulated deficit	(33,021)	(29,517)	(26,693)
Total stockholders (deficit) equity	(32,088)	69,247	73,338
Total liabilities and stockholders (deficit) equity	$ 40,997	$ 94,943	$ 99,735

See accompanying notes.

Table of Contents

VISTACARE, INC.

CONSOLIDATED STATEMENTS OF OPERATIONS

(in thousands, except per share information)

	Year Ended December 31,			Three Months Ended March 31,	
	2000	**2001**	**2002**	**2002**	**2003**
				(unaudited)	
Net patient revenue	$81,595	$ 91,362	$132,947	$27,674	$42,001
Operating expenses:					
Patient care	55,256	63,950	79,752	17,269	24,085
General and administrative expenses, exclusive of stock-based compensation charges reported below	23,541	30,666	42,535	8,911	13,352
Depreciation and amortization	1,797	1,990	1,349	272	344
Stock-based compensation		50	427	50	1,047
Total operating expenses	80,594	96,656	124,063	26,502	38,828
Operating income (loss)	1,001	(5,294)	8,884	1,172	3,173
Non-operating income (expense):					
Interest income	202	52	25	2	101
Interest expense	(1,497)	(1,157)	(935)	(201)	(48)
Other expense	(8)	(163)	(137)	(28)	(16)
Total non-operating income (expense)	(1,303)	(1,268)	(1,047)	(227)	37
Net (loss) income before income taxes	(302)	(6,562)	7,837	945	3,210
Income tax expense	81	150	281	36	386
Net (loss) income	(383)	(6,712)	7,556	909	2,824
Accrued preferred stock dividends	3,482	3,839	4,052	1,032	
Net (loss) income to common stockholders	$ (3,865)	$(10,551)	$ 3,504	$ (123)	$ 2,824
Net (loss) income per common share:					
Basic net (loss) income per common share	$ (0.76)	$ (2.07)	$ 0.63	$ (0.02)	$ 0.18
Diluted net (loss) income per common share	$ (0.76)	$ (2.07)	$ 0.52	$ (0.02)	$ 0.17
Weighted average shares outstanding:					
Basic	5,098	5,098	5,580	5,100	15,500
Diluted	5,098	5,098	6,766	5,100	16,656

See accompanying notes.

Table of Contents

VISTACARE, INC.

CONSOLIDATED STATEMENTS OF CHANGES IN PREFERRED STOCK AND STOCKHOLDERS (DEFICIT) EQUITY

(in thousands)

	Redeemable Non-convertible Preferred Stock		Convertible and Redeemable Preferred Stock							
	Series A-2		Series A-1		Series B		Series C		Series D	
	Shares	Amount	Shares	Amount	Shares	Amount	Shares	Amount	Shares	Amount
Balance, January 1, 2000	29	$ 292	375	$ 3,713	485	$ 29,110	402	$ 1,863	65	$ 3,250
Accrued preferred stock dividends						2,983		191		308
Redemption of warrants										
Net loss										
Balance, December 31, 2000	29	292	375	3,713	485	32,093	402	2,054	65	3,558
Accrued preferred stock dividends						3,290		210		339
Repurchase of stock									(5)	(300)
Deferred compensation related to stock options										
Amortization of deferred compensation										
Net loss										
Balance, December 31, 2001	29	292	375	3,713	485	35,383	402	2,264	60	3,597
Accrued preferred stock dividends						3,472		222		358
Exercise of stock options										
Exercise of warrants										
Deferred compensation related to stock options										
Deferred compensation related to cancelled stock options										
Amortization of deferred compensation										
Conversion of Series A-1 preferred stock in connection with initial public offering			(375)	(3,713)						

Redemption of Series A-2 preferred stock in connection with initial public offering	(29)	(292)								
Issuance of common shares in connection with initial public offering										
Conversion of series B, C and D preferred shares in connection with initial public offering					(485)	(38,855)	(402)	(2,486)	(60)	(3,955)
Net income										
Balance, December 31, 2002		$		$		$		$		$
Exercise of stock options (unaudited)										
Deferred compensation related to cancelled stock options (unaudited)										
Amortization of deferred compensation (unaudited)										
Net income (unaudited)										
Balance, March 31, 2003 (unaudited)		$		$		$		$		$

[Additional columns below]

[Continued from above table, first column(s) repeated]

	Stockholders (Deficit) Equity					
	Common Stock		Additional Paid-In Capital	Deferred Compensation	Accumulated Deficit	Total
	Shares	Amount				
Balance, January 1, 2000	5,099	$ 50	$ 1,340		$ (18,605)	$ (17,215)
Accrued preferred stock dividends					(3,482)	(3,482)
Redemption of warrants			(507)			(507)
Net loss					(383)	(383)
Balance, December 31, 2000	5,099	50	833		(22,470)	(21,587)
Accrued preferred stock dividends					(3,839)	(3,839)
Repurchase of stock						
			446	(446)		

Deferred compensation related to stock options						
Amortization of deferred compensation				50		50
Net loss					(6,712)	(6,712)
Balance, December 31, 2001	5,099	50	1,279	(396)	(33,021)	(32,088)
Accrued preferred stock dividends					(4,052)	(4,052)
Exercise of stock options	77	2	243			245
Exercise of warrants	200	2	3			5
Deferred compensation related to stock options			2,748	(2,748)		
Deferred compensation related to cancelled stock options			(165)	165		
Amortization of deferred compensation				427		427
Conversion of Series A-1 preferred stock in connection with initial public offering	309	3	3,710			3,713
Redemption of Series A-2 preferred stock in connection with initial public offering						
Issuance of common shares in connection with initial public offering	4,500	45	48,100			48,145
Conversion of series B, C and D preferred shares in connection with initial public offering	5,294	53	45,243			45,296
Net income					7,556	7,556
Balance, December 31, 2002	15,479	$155	$101,161	$(2,552)	$(29,517)	$ 69,247
Exercise of stock options (unaudited)	125	1	219			220
Deferred compensation related to cancelled stock options (unaudited)			(164)	164		
Amortization of deferred compensation (unaudited)				1,047		1,047
Net income (unaudited)					2,824	2,824
Balance, March 31, 2003 (unaudited)	$15,604	$156	$101,216	$(1,341)	$(26,693)	$ 73,338

See accompanying notes.

Table of Contents

VISTACARE, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS

(in thousands)

	Year Ended December 31,			Three Months Ended March 31,	
	2000	2001	2002	2002	2003
				(unaudited)	
Operating activities					
Net (loss) income	$ (383)	$ (6,712)	$ 7,556	$ 909	$ 2,824
Adjustments to reconcile net (loss) income to net cash provided by (used in) operating activities:					
Depreciation and amortization	1,797	1,990	1,349	272	344
Warrant amortization	151	151	303	38	
Site closure settlement	(526)				
Loss on disposal of assets	60				
Deferred compensation related to stock options		50	427	50	1,047
Changes in operating assets and liabilities:					
Patient accounts receivable	1,394	2,764	(10,130)	(4,605)	(2,560)
Prepaid expenses and other	(215)	359	(1,178)	(390)	(1,008)
Accounts payable and accrued expenses	(198)	4,562	7,815	336	700
Net cash provided by (used in) operating activities	2,080	3,164	6,142	(3,390)	1,347
Investing activities					
Site acquisition			(2,512)		
Purchases of equipment	(447)	(331)	(1,469)	(71)	(425)
Increase in other assets	(1,819)	(1,720)	(2,027)	(243)	(735)
Net cash used in investing activities	(2,266)	(2,051)	(6,008)	(314)	(1,160)
Financing activities					
Net (payments) proceeds on long-term debt	(2,190)	(1,977)	(10,516)	3,194	
Proceeds from issuance of common stock from exercise of stock options			245		220
Net proceeds from initial public offering			48,145		
Redemption of Series A-2 preferred stock			(292)		
Conversion of warrants			5		
Repurchase of preferred stock		(300)			
Net cash (used in) provided by financing activities	(2,190)	(2,277)	37,587	3,194	220
Net (decrease) increase in cash and cash equivalents	(2,376)	(1,164)	37,721	(510)	407
Cash and cash equivalents, beginning of period	4,923	2,547	1,383	1,384	39,104
Cash and cash equivalents, end of period	$ 2,547	$ 1,383	$ 39,104	$ 874	$ 39,511
Supplemental cash flow data					
Interest paid	$ 1,442	$ 1,188	$ 980	$ 201	$ 48

Non-cash activity					
Redemption of warrants	$ (507)	$	$	$	$
Capital lease obligations	$	$ 251	$	$	$
Accrued preferred stock dividends	$ 3,482	$ 3,839	$ 4,052	$ 50	$
Acquisition note payable	$	$	$ 250	$	$
Preferred stock conversion	$	$	$ 49,009	$	$

See accompanying notes.

VISTACARE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Information for the three-month periods ended March 31, 2002 and 2003 is unaudited)

Description of Business

VistaCare, Inc. (VistaCare), is a Delaware corporation providing medical care designed to address the physical, emotional, and spiritual needs of patients with a terminal illness and to support their family members. Hospice services are provided predominately in the patient s home; however, certain patients require inpatient services. These inpatient services are provided by VistaCare at its stand-alone inpatient facility in Cincinnati, Ohio, at its hospital-based inpatient facility in Albuquerque, New Mexico or through leased beds at unrelated hospitals and skilled nursing facilities on a per diem basis. VistaCare provides services in Alabama, Arizona, Colorado, Georgia, Indiana, Massachusetts, New Mexico, Nevada, Ohio, Oklahoma, Pennsylvania, South Carolina, Texas and Utah.

1. Significant Accounting Policies

Basis of Presentation

The accompanying consolidated financial statements include accounts of VistaCare and its wholly-owned subsidiaries: VistaCare USA, Inc., Vista Hospice Care, Inc., and FHI Health Services, Inc. (including its wholly-owned subsidiaries). Intercompany transactions and balances have been eliminated in consolidation.

Cash and Cash Equivalents

Cash and cash equivalents include highly liquid investments with a maturity of three months or less. Cash equivalents are carried at cost which approximates fair value.

Patient Accounts Receivable

VistaCare receives payment for services provided to patients from third-party payors including federal and state governments under the Medicare and Medicaid programs and private insurance companies. Approximately 86%, 90%, 89% and 88% of VistaCare s accounts receivable were from Medicare and Medicaid as of December 31, 2001 and 2002 and March 31, 2002 and 2003, respectively. VistaCare also receives reimbursements from state Medicaid programs for room and board services provided at contracted nursing homes (see Nursing Home Costs , below).

Equipment

Equipment is recorded at cost. Equipment acquired with the acquisitions of FHI Health Services, Inc., Vencor Hospice, Inc. (VistaCare USA, Inc.) and Palliative Care Concepts, Inc. was recorded at estimated fair value on the date of acquisition. Depreciation is calculated on the straight-line method over the estimated useful lives of depreciable assets, typically five years.

Capitalized Software Development Costs

VistaCare capitalizes certain internal salaries related to the development of computer software used in its operations. Such capitalized software development costs are being amortized over three years. Capitalized software development costs, net of amortization, included in other assets, amounted to $2,197,000, $3,965,000, $2,562,000 and $4,273,000 as of December 31, 2001 and 2002 and March 31, 2002 and 2003, respectively. Costs incurred during the preliminary project stage and post implementation/operations stage are expensed as incurred.

Table of Contents

VISTACARE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Information for the three-month periods ended March 31, 2002 and 2003 is unaudited)

Goodwill

During 1998, VistaCare completed the acquisitions of FHI Health Services, Inc. and Vencor Hospice, Inc. (VistaCare USA, Inc.). During 2002, VistaCare completed the acquisition of Palliative Care Concepts, Inc. The difference between the purchase prices and the fair value of assets acquired and liabilities assumed was recorded as goodwill. Prior to January 1, 2002, VistaCare amortized goodwill over a period of 30 years. Amortization related to goodwill totalled $2,408,000 on January 1, 2003. No amortization was recognized in the three months ended March 31, 2003.

In June 2001, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 141, *Business Combinations,* and SFAS No. 142, *Goodwill and Other Intangible Assets,* which became effective for VistaCare in the first quarter of 2002. Under these new rules, goodwill and intangible assets deemed to have indefinite lives are no longer amortized but are subject to impairment tests that must be conducted at least annually, or more often if events or circumstances arise that indicate that the carrying value of the goodwill associated with VistaCare s acquired businesses exceeds its fair market value. VistaCare determined that no impairment of goodwill existed as of December 31, 2002 and for the three months ended March 31, 2003.

The following is provided to present VistaCare s net (loss) income as if the provisions of SFAS 142 had been adopted for each of the following periods (in thousands):

	Year Ended December 31,			Three Months Ended March 31,	
	2000	**2001**	**2002**	**2002**	**2003**
Net (loss) income to common stockholders as reported	$(3,865)	$(10,551)	$3,504	$ (123)	$2,820
Goodwill amortization expense included in net (loss) income	676	665			
Adjusted net (loss) income	$(3,189)	$ (9,886)	$3,504	$ (123)	$2,820
Basic earnings per share:					
Reported net (loss) income	$ (0.76)	$ (2.07)	$ 0.63	$(0.02)	$ 0.18
Goodwill amortization	0.13	0.13			
Adjusted net (loss) income	$ (0.63)	$ (1.94)	$ 0.63	$(0.02)	$ 0.18
Diluted earnings per share:					
Reported net (loss) income	$ (0.76)	$ (2.07)	$ 0.52	$(0.02)	$ 0.17
Goodwill amortization	0.13	0.13			
Adjusted net (loss) income	$ (0.63)	$ (1.94)	$ 0.52	$(0.02)	$ 0.17

Acquisition

In August 2002, VistaCare completed the acquisition of Palliative Care Concepts, Inc., a hospice program in Albuquerque, New Mexico. VistaCare paid $2,500,000 in cash and issued a $250,000 unsecured promissory note to the seller in connection with the acquisition. The purchase price was allocated primarily to goodwill.

VISTACARE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Information for the three-month periods ended March 31, 2002 and 2003 is unaudited)

Net Patient Revenue

Net patient revenue is the amount VistaCare believes it is entitled to collect for its services, adjusted as described below. The amount VistaCare believes it is entitled to collect for its services varies depending on the level of care provided, the payor and the geographic area where services are rendered. Net patient revenue includes adjustments for charity care and estimated payment denials (which VistaCare experiences from time to time for reasons such as its failure to submit complete and accurate claim documentation, its failure to provide timely written physician certifications as to patient eligibility, or the payor deems the patient ineligible for insurance coverage), contractual adjustments, amounts VistaCare estimates it could be required to repay to Medicare, such as payments that VistaCare would be required to make in the event that any of its programs exceed the annual per-beneficiary cap, and subsequent changes to initial level of care determinations. VistaCare adjusts its estimates from time to time based on its billing and collection experience. VistaCare believes that it can reasonably estimate such adjustments to net patient revenue because it has significant historical experience and because it has a centralized billing and collection department that continually monitors the factors that could potentially result in a change in estimate. There were no material changes in estimates to net patient revenue for the years ended December 31, 2000, 2001 and 2002 or for the three-month periods ended March 31, 2002 and 2003. Vistacare recognizes net patient revenue once the patient s hospice eligibility has been certified, the patient s coverage from a payment source has been verified and services have been provided to that patient.

Approximately 92%, 99%, 97%, 97% and 96% of VistaCare s net patient revenue was derived from the Medicare and Medicaid programs for the years ended December 31, 2000, 2001 and 2002 and March 31, 2002 and 2003, respectively. VistaCare operates under arrangements with Medicare, Medicaid and other third-party payors pursuant to which these payors reimburse VistaCare for services it provides to hospice-eligible patients these payors cover, subject only to VistaCare s submission of adequate and timely claim documentation. VistaCare has a patient intake process that screens patients for hospice eligibility and identifies whether their care will be covered by Medicare, Medicaid, private insurance, managed care or self-pay. Whether Medicare or Medicaid continue to provide reimbursement for hospice care is dependent upon governmental policies.

Provision for Doubtful Accounts

VistaCare records a provision for doubtful accounts as a general and administrative expense. The provision for doubtful accounts primarily represents VistaCare s estimate of uncollectible amounts from self-pay patients and from those patients who are responsible for, but do not pay, private insurance co-payments.

Medicare and Medicaid Regulation

VistaCare is subject to certain limitations on Medicare payments for services. Specifically, if the number of inpatient care days of care any hospice program provides to Medicare beneficiaries exceeds 20% of the total days of hospice care such program provides to all patients for an annual period beginning September 28, the days in excess of the 20% figure may be reimbursed only at the routine home care rate. None of VistaCare s hospice programs exceeded the payment limits on inpatient services in 2000, 2001 or 2002 or in the three-month periods ended March 31, 2002 and 2003.

VistaCare is also subject to a Medicare annual per-beneficiary cap. Compliance with the Medicare per-beneficiary cap is measured by comparing the cost of services provided to each Medicare beneficiary by each hospice program during the Medicare fiscal year ending October 31 to the per-beneficiary cap amount for each Medicare beneficiary in such program who elects to receive the Medicare hospice benefit for the first time during such fiscal year. VistaCare recorded reductions to net patient revenue of approximately $1,048,000, $1,061,000, $863,000 and $399,000 for the years ended December 31, 2000, 2001 and 2002 and

VISTACARE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Information for the three-month periods ended March 31, 2002 and 2003 is unaudited)

the three months ended March 31, 2002, respectively, as estimates for exceeding the Medicare per-beneficiary cap. VistaCare did not record any reduction to net patient revenue for the three months ended March 31, 2002 as an estimate to exceeding the per-beneficiary cap in that period. As of March 31, 2003, VistaCare had not been assessed any amount for exceeding the per-beneficiary cap for the assessment periods that began on November 1, 2001 and November 1, 2002. VistaCare management believes that as of March 31, 2003 adequate reserves have been established for this potential liability.

VistaCare monitors each of its programs to determine whether such programs are likely to exceed the foregoing limitations and estimates the extent to which it could be required to repay Medicare. At the time that management estimates the potential impact of having exceeded the Medicare limitations, the estimated assessment is deducted from net patient revenue and accrued as an accrued expense until such time as an actual payment is assessed by Medicare.

Laws and regulations governing the Medicare and Medicaid program are complex and subject to interpretation. VistaCare believes that it is in compliance with all applicable laws and regulations and is not aware of any pending or threatened investigations involving allegations of potential wrongdoing which would have a material impact on VistaCare s consolidated financial condition or results of operations. Compliance with such laws and regulations can be subject to future government review and interpretation as well as significant regulatory action including fines, penalties, and exclusion from the Medicare and Medicaid programs.

Charity Care

VistaCare provides care at no cost to patients who are not eligible for insurance coverage and meet certain financial need criteria established by VistaCare. Charity care totaled approximately $1,677,000, $2,367,000, $1,568,000, $513,000 and $666,000 for the years ended December 31, 2000, 2001 and 2002 and the three-month periods ended March 31, 2002 and 2003, respectively. Because VistaCare does not pursue collection of amounts determined to qualify as charity care, these amounts are not recorded in net patient revenue. Costs VistaCare incurs in providing charity care are recorded as patient care expenses.

Patient Care Expenses

Patient care expenses consist primarily of salaries, benefits, payroll taxes and travel costs associated with hospice care providers. Patient care expenses also include the cost of pharmaceuticals, durable medical equipment, medical supplies, inpatient arrangements, net nursing home costs, and purchased services such as ambulance, infusion and radiology.

Nursing Home Costs

For patients receiving nursing home care under state Medicaid programs who elect hospice care under Medicare or Medicaid, VistaCare contracts with nursing homes for the nursing homes provision to patients of room and board services. In most states, the applicable Medicaid program must pay VistaCare, in addition to the applicable Medicare or Medicaid hospice daily or hourly rate, an amount equal to at least 95% of the Medicaid daily nursing home rate for room and board furnished to the patient by the nursing home. In some states, the Medicaid program pays the nursing home directly for these costs or has created a Medicare managed care program that either reduces or eliminates this room and board payment. Under VistaCare s standard nursing home contracts, VistaCare pays the nursing home for these room and board services at predetermined contract rates. Nursing home costs are offset by nursing home revenue and the net amount is included in patient care expenses.

Table of Contents

VISTACARE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Information for the three-month periods ended March 31, 2002 and 2003 is unaudited)

Nursing home costs totaled approximately $14,500,000, $17,400,000, $24,500,000 $3,700,000 and $7,500,000 for the years ended December 31, 2000, 2001 and 2002 and the three months ended March 31, 2002 and 2003, respectively. Nursing home revenue totaled approximately $13,900,000, $16,400,000, $23,200,000, $3,500,000 and $7,100,000 for the years ended December 31, 2000, 2001 and 2002 and the three-month periods ended March 31, 2002 and 2003, respectively.

Advertising Costs

VistaCare expenses all advertising costs as incurred, which expenses totaled approximately $1,100,000, $1,030,000, and $1,180,000 for the years ended December 31, 2000, 2001 and 2002, respectively.

Income Taxes

VistaCare accounts for income taxes under the liability method as required by SFAS No. 109, *Accounting for Income Taxes.* Under the liability method, deferred taxes are determined based on temporary differences between financial statement and tax bases of assets and liabilities existing at each balance sheet date using enacted tax rates for years in which the related taxes are expected to be paid or recovered. Valuation allowances are established against the deferred tax assets due to the uncertainty of VistaCare s ability to use net operating tax loss carryforwards in the future.

Medical Malpractice

VistaCare is covered by claims-made general and professional liability insurance coverage with limits of $1,000,000 per claim and $3,000,000 in the aggregate. VistaCare has not experienced any uninsured medical malpractice losses.

Health Benefit Costs

In 2001 and 2002, VistaCare provided health benefit coverage to its employees through a self-funded program and dental benefit coverage through a fully-funded program. VistaCare will provide the same coverage in 2003. Benefit costs are determined based on the historical benefit cost per employee. VistaCare has recorded a liability for its estimated exposure relating to reported and incurred but not reported claims.

Auto Insurance

In 2002, VistaCare became self-insured for auto claims relating to employee motor vehicle use incurred by employees while working within the scope of employment. VistaCare management believes that adequate reserves have been established for auto claims in the year ended December 31, 2002 and the three months ended March 31, 2003.

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates.

Fair Value of Financial Instruments

VistaCare s cash and cash equivalents, patient accounts receivable, and long-term debt represent financial instruments as defined by Statement of Financial Accounting Standards No. 107, *Disclosures About Fair Value of Financial Instruments*. The carrying value of these financial instruments is a reasonable approximation of fair value.

Table of Contents

VISTACARE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Information for the three-month periods ended March 31, 2002 and 2003 is unaudited)

Stock-Based Compensation

VistaCare has elected to follow Accounting Principles Board Opinion No. 25 (APB No. 25), *Accounting for Stock Issued to Employees* and related interpretations, in accounting for its employee stock options rather than the alternative fair value accounting allowed by SFAS No. 123 (SFAS 123), *Accounting for Stock-Based Compensation*. Under APB No. 25, if the exercise price of VistaCare s stock options equals or exceeds the estimated fair value of the underlying stock on the dates of grant, no compensation expense is recognized. However, if the exercise prices of VistaCare s stock options are less than the estimated fair value, on the date of grant, then compensation expense will be recognized for the difference over the related vesting periods.

If compensation for options granted under VistaCare s stock option plan had been determined based on the deemed fair value at the grant date consistent with the method provided under SFAS 123, then VistaCare s net (loss) income would have been as indicated in the pro forma table below (in thousands, except per share information) (See Note 8 for further discussion of VistaCare s stock based employee compensation).

	Year Ended December 31,			Three Months Ended March 31,	
	2000	2001	2002	2002	2003
Net (loss) income to common stockholders:					
As reported	$(3,865)	$(10,551)	$3,504	$ (123)	$ 2,824
Add: Stock-based employee compensation expenses included in reported net income, net of related tax effects		50	427	50	1,047
Deduct: Total stock-based compensation expense determined under fair value method for all awards	(91)	(73)	(929)	(75)	(787)
Pro forma net (loss) income to common stockholders	$(3,956)	$(10,574)	$3,002	$ (148)	$ 3,084
Basic net (loss) per common share:					
As reported	$ (0.76)	$ (2.07)	$ 0.54	$ (0.02)	$ 0.18
Pro forma	(0.78)	(2.07)	0.60	$ (0.03)	$ 0.20
Diluted net (loss) per common share:					
As reported	$ (0.76)	$ (2.07)	$ 0.52	$ (0.02)	$ 0.17
Pro forma	(0.78)	(2.07)	0.44	$ (0.03)	$ 0.19
Weighted average shares used in computation:					
Basic	5,090	5,098	5,580	5,100	15,500
Diluted	5,090	5,098	6,766	5,100	15,656

Initial Public Offering

On December 23, 2002, VistaCare completed its initial public offering of common stock (IPO) at $12.00 per share. VistaCare sold 4,500,000 shares and received $48,145,000 in net proceeds from the IPO. Of the net proceeds VistaCare received in the IPO, $4,200,000 was used for working capital, $11,000,000 was used to repay outstanding indebtedness under VistaCare s credit facility (see Note 5), and $292,000 was used to redeem all of the outstanding shares of VistaCare s Series A-2 Preferred Stock. The remaining proceeds will be used to finance potential acquisitions of hospices and for other corporate purposes. Upon the closing of the IPO, all of VistaCare s redeemable and convertible preferred stock was converted into 5,603,111 shares of VistaCare s Class A common stock. The accumulated dividends on VistaCare s Series B, C and D preferred stock of $16,486,000, which were not payable in the event of a mandatory conversion, were reclassified as additional paid-in capital and no additional dividends will be accrued or recorded subsequent to the IPO.

Table of Contents

VISTACARE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Information for the three-month periods ended March 31, 2002 and 2003 is unaudited)

Earnings Per Share

Basic net (loss) income per common share is computed by dividing net (loss) income by the weighted average number of common shares outstanding during the period. Diluted net income per common share is computed by dividing net income by the weighted average number of shares outstanding during the period plus the effect of dilutive securities, including outstanding warrants, employee stock options (using the treasury stock method) and shares of Series A-1 Preferred Stock (using the if-converted method).

Recent Accounting Pronouncements

In April 2002, the FASB issued SFAS No. 145, *Rescission of FASB Statements No. 4, 44 and 64, Amendment of FASB Statement No. 13 and Technical Corrections.* SFAS No. 145 is effective for fiscal years beginning after May 15, 2002. This statement eliminates accounting treatment for reporting gains or losses on debt extinguishments and amends certain other existing accounting pronouncements. The adoption of this standard is not expected to have a material effect on VistaCare s consolidated financial position or results of operations.

In June 2002, the FASB issued SFAS No. 146, *Accounting for Costs Associated with Exit or Disposal Activities.* SFAS No. 146 nullifies the guidance in EITF Issue No. 94-3, *Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity.* Under EITF No. 94-3, an entity recognizes a liability for an exit cost on the date that the entity committed itself to an exit plan. In SFAS No. 146, the FASB acknowledges that an entity s commitment to a plan does not, by itself, create a present obligation to the other parties that meets the definition of a liability and requires that a liability for a cost that is associated with an exit or disposal activity be recognized when the liability is incurred. It also establishes that fair value is the objective for the initial measurement of the liability. SFAS No. 146 will be effective for exit or disposal activities that are initiated after December 31, 2002. The adoption of this standard is not expected to have a material effect on VistaCare s financial position or results of operations.

In November 2002, the FASB issued Interpretation No. 45, *Guarantor s Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others.* FIN No. 45 requires certain guarantees to be recorded at fair value. FIN No. 45 also requires a guarantor to make certain disclosures about guarantees even when the likelihood of making any payments under the guarantee is remote. FIN No. 45 is effective for financial statements of interim or annual periods ending after December 15, 2002. The adoption of this interpretation did not have a material effect on VistaCare s consolidated financial position or results of operations.

In December 2002, the FASB issued SFAS No. 148, *Accounting for Stock-Based Compensation Transition and Disclosure.* SFAS No. 148 amends SFAS No. 123, *Accounting for Stock-Based Compensation* and provides alternative methods of transition for a voluntarily change to the fair value based method of accounting for stock-based employee compensation. SFAS No. 148 also amends the disclosure requirements of SFAS No. 123 to require prominent disclosures in both annual and interim financial statements about the method of accounting for stock-based compensation and the effect of the method used on reported results. SFAS No. 148 is effective for fiscal years ending after December 15, 2002. While SFAS No. 148 does not amend SFAS No. 123 to require companies to account for employee stock options using the fair value method, the disclosure provisions of SFAS No. 148 are applicable to all companies with stock-based employee compensation, regardless of whether they account for that compensation using the fair value method of SFAS No. 123 or the intrinsic method of APB Opinion No. 25. As allowed by SFAS No. 123, VistaCare has elected to continue to utilize the accounting method prescribed by APB Opinion No. 25 and has adopted the disclosure requirements of SFAS No. 123 as of December 1, 2002.

VISTACARE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Information for the three-month periods ended March 31, 2002 and 2003 is unaudited)

In January 2003, the FASB issued Interpretation No. 46, *Consolidation of Variable Interest Entities.* FIN No. 46 addresses the consolidation and financial reporting of variable interest entities. FIN No. 46 is effective for financial statements of interim or annual periods beginning after June 15, 2002 for variable interest entities created before February 1, 2003, or immediately for variable interest entities created after February 1, 2003. The adoption of this interpretation is not expected to have a material effect on VistaCare s consolidated financial position or results of operations.

2. Equipment

A summary of equipment follows (in thousands):

	December 31,		March 31,
	2001	2002	2003
Equipment	$ 3,407	$ 4,572	$ 4,959
Furniture and fixtures	1,218	1,319	1,335
Leasehold improvements	185	388	410
	4,810	6,279	6,704
Accumulated depreciation	(3,015)	(3,667)	(3,869)
	$ 1,795	$ 2,612	$ 2,835

3. Accrued Expenses

A summary of accrued expenses follows (in thousands):

	December 31,		March 31,
	2001	2002	2003
Treatment costs	$ 6,758	$10,758	$10,530
Self-insured health costs	1,251	1,994	2,508
Salaries and payroll taxes	3,066	5,119	4,808
Medicare cap accrual	1,528	1,263	1,662
Other	2,342	3,848	4,068
	$14,945	$22,982	$23,576

4. Income Taxes

The components of income tax expense follows (in thousands):

	Year Ended December 31, 2000	2001	2002	Three Months Ended March 31, 2003
Current taxes:				
Federal	$	$	$	$116
State	81	150	281	270
Income tax expense	$ 81	$150	$281	$386

The provisions for income taxes for the three-month periods ended March 31, 2002 and 2003 reflects VistaCare s estimate of the effective tax rate expected to be applicable for the full year. This estimate is reevaluated by VistaCare each quarter based upon forecasts of income before taxes for the year. VistaCare s

Table of Contents

VISTACARE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Information for the three-month periods ended March 31, 2002 and 2003 is unaudited)

effective tax rate in these periods was lower then the federal statutory rates primarily due to its use of tax credits and net operating loss carryforwards.

The reconciliation of income tax expense computed at the federal statutory tax rate to income tax expense recorded is as follows (in thousands):

	Year Ended December 31,						Three Months Ended March 31,	
	2000		2001		2002		2003	
	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percent
Tax benefit at statutory rate	$(103)	34%	$(2,214)	34%	$ 2,810	34%	$1,124	35%
State taxes, net of federal benefit	(18)	6	(391)	6	496	6	241	8
Effect of permanent items	270	(89)	220	(3)	60	1	66	2
AMT Credits							(11)	(1)
Change in valuation allowance	(119)	39	1,821	(28)	(2,584)	(31)	(812)	(25)
Other	51	(17)	714	(11)	(501)	(6)	(222)	(7)
	$ 81	(27)%	$ 150	(2)%	$ 281	4%	$ 386	12%

Deferred income taxes reflect the tax effect of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes at enacted rates. Temporary differences are primarily attributable to net operating tax loss carryforwards, recognition of certain accruals and the allowance for doubtful accounts. A summary of deferred tax assets and liabilities follows (in thousands):

	December 31,		March 31,
	2001	2002	2003
Deferred tax assets:			
Net operating losses	$ 4,731	$ 2,390	$ 1,793
Allowance for doubtful accounts	1,796	1,745	2,078
Accrued expenses	341	768	928
Bonuses	549	837	419
Charitable contributions	112	294	220
Alternative minimum tax credits	44	44	33
	7,573	6,078	5,471
Valuation allowance	(6,475)	(3,891)	(3,079)
	1,098	2,187	2,392
Deferred tax liabilities:			

Depreciation and amortization	168	601	682
Software development costs	930	1,586	1,710
	1,098	2,187	2,392
Net deferred assets	$	$	$

A valuation allowance has been established against the deferred tax assets due to the uncertainty of VistaCare s ability to use net operating losses to offset future taxable income. The net operating loss

F-15

VISTACARE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Information for the three-month periods ended March 31, 2002 and 2003 is unaudited)

carryforwards of approximately $5,900,000 for federal income tax purposes and $6,300,000 for state income tax purposes at December 31, 2002, begin to expire in the year 2011 for federal income tax purposes and began to expire in 2002 for state income tax purposes. Future utilization of the available net operating loss carryforwards may be limited under Internal Revenue Code Section 382 based upon changes in ownership that have occurred or may occur in the future. The recognition of deferred tax assets in the future may result in approximately $1,500,000 being netted against goodwill as certain of VistaCare s net operating loss carryforwards were related to the 1998 acquisitions.

5. Long-Term Debt

In April 2001, VistaCare entered into a $30,000,000 revolving line of credit and a $3,000,000 term loan (credit facility). The credit facility is collateralized by substantially all of VistaCare s assets including cash, accounts receivable and equipment. Loans under the revolving line of credit bear interest at an annual rate equal to, at VistaCare s option, either the prime rate in effect from time to time, as reported in the Money Rates section of the *Wall Street Journal*, plus 1.5%, or the one-month London Interbank Borrowing Rate in effect from time to time, plus 3.0%. Accrued interest under the revolving line of credit is due (i) weekly, if VistaCare opts to pay interest at the prime rate, or (ii) on the last business day of the month, if VistaCare opts to pay interest at the London Interbank Borrowing Rate based rate.

Under the revolving line of credit, VistaCare may borrow, repay and reborrow an amount equal to the lesser of: (i) $30,000,000 or (ii) 85% of the estimated net value of eligible accounts receivable. As of March 31, 2003, approximately $19,002,000 was available for borrowing under the revolving line of credit. The maturity date of the revolving line of credit is April 30, 2005. As of March 31, 2003, there was no balance outstanding on the revolving line of credit.

The term loan was paid in full and terminated on December 27, 2002 with proceeds from VistaCare s initial public offering. While in existence, interest on the term loan accrued at the one-month London Interbank Offering Rate in effect from time to time, plus 3.5% per annum. While in existence accrued interest on the term loan was due and payable on the last business day of the month in addition to monthly principal payments of $83,333.

The credit facility contains certain customary covenants including those that restrict the ability of VistaCare to incur additional indebtedness, pay dividends under certain circumstances, permit liens on property or assets, make capital expenditures, make certain investments, and prepay or redeem debt or amend certain agreements relating to outstanding indebtedness. VistaCare was not in compliance with certain financial covenants as of December 31, 2001. In July 2002, VistaCare and the lender entered into an agreement pursuant to which the lender agreed to waive VistaCare s past failure to comply with such covenants and to amend certain of the financial covenants for future periods. As of March 31, 2003, VistaCare was in compliance with the terms of such amended covenants.

During 1999, VistaCare issued warrants to purchase 336,000 shares of its Class B Common Stock (subsequently reduced to 200,000 shares) to an institutional lender in connection with a credit facility that was repaid in full in April 2001 with proceeds of VistaCare s current credit facility. On the date of issuance, the value of the warrants was estimated at $1,263,000, based on the estimated fair value of VistaCare s Class B Common Stock. The value of the warrants was recorded as a reduction to long-term debt, and is being amortized using the straight-line method. As of December 31, 2001, the unamortized value of the warrant was $303,000. In September 2002, the warrants were exercised in full.

In connection with its acquisition of Palliative Care Concepts, Inc., VistaCare issued a $250,000 unsecured promissory note. The promissory note bears interest at a rate of 4.0% per annum and is payable in full in August 2003.

VISTACARE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Information for the three-month periods ended March 31, 2002 and 2003 is unaudited)

6. Redeemable and Convertible Preferred Stock

Prior to VistaCare s initial public offering of common stock (IPO), the Series A-1, Series B, Series C and Series D Convertible Preferred Stock were convertible, at the option of the holder, into Class A Common Stock at any time, subject to certain conditions. In addition, the Series A-1, Series B, Series C and Series D Convertible Preferred Stock were also subject to mandatory conversion into Class A Common Stock upon certain conditions, including the issuance of Class A Common Stock in an initial public offering.

Upon the closing of the IPO, the Convertible Preferred stock was mandatorily converted to an aggregate of 5,603,111 shares of VistaCare s Class A Common Stock. Pursuant to the terms of VistaCare s certificate of incorporation, accumulated dividends on the Series B, Series C and Series D Preferred Stock of $16,486,000 were not payable in the event of a mandatory conversion. Accordingly, the accumulated dividends were reclassified as Additional Paid-in-Capital and no additional dividends have been accrued or recorded subsequent to the IPO.

7. Stockholders Equity

Common Stock

Pursuant to VistaCare s amended and restated certificate of incorporation, VistaCare is authorized to issue 33,000,000 shares of voting Class A Common Stock, $0.01 par value per share, and 200,000 shares of non-voting Class B Common Stock, $0.01 par value per share.

The Class B Common Stock is convertible into shares of Class A Common Stock at the holder s option. At the closing of the IPO 141,904 shares of the Class B Common and each share of the Class C Common Stock were converted into shares of Class A Common Stock.

Common Stock Warrants

In June 1999, VistaCare issued warrants to an institutional lender to purchase 336,000 shares of Class B Common Stock at an exercise price of $0.025 per share. The number of shares subject to the warrants was reduced to 200,000 in March 2000. In September 2002, the warrants were exercised in full.

In December 1999, VistaCare issued warrants to a stockholder to purchase 20,000 shares of Class A Common Stock at an exercise price of $0.025 per share. The warrants may be exercised at any time through July 26, 2009.

8. Stock Plans

1998 Stock Option Plan

In 1998, VistaCare established a qualified and nonqualified stock option plan (the 1998 Plan) whereby options to purchase shares of VistaCare s common stock are granted at a price equal to the estimated fair value of the stock at the date of the grant as determined by the Board of Directors. A total of 3,200,000 shares of common stock are reserved for issuance under the 1998 Plan. The options granted under the 1998 Plan typically vest over a three, five or seven-year period.

Table of Contents

VISTACARE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Information for the three-month periods ended March 31, 2002 and 2003 is unaudited)

Summary information related to the 1998 Plan is as follows:

	Number of Shares Under Option	Weighted-Average Exercise Prices
Options outstanding at January 1, 2000	722,000	$ 3.23
Granted	285,412	3.80
Canceled	(70,000)	2.88
Options outstanding at December 31, 2000	937,412	3.35
Granted	924,400	3.75
Canceled	(355,412)	3.75
Options outstanding at December 31, 2001	1,506,400	3.50
Granted	872,840	9.81
Exercised	(77,320)	3.16
Canceled	(251,200)	3.43
Options outstanding at December 31, 2002	2,050,720	6.19
Granted	58,460	15.17
Exercised	(125,040)	1.76
Canceled	(2,240)	4.02
Options outstanding at March 31, 2003	1,981,900	6.62

For the years ended December 31, 2000, 2001 and 2002 and the three months ended March 31, 2003, the weighted average grant date fair value of the options approximated $3.80, $3.75, $9.81 and $15.17, respectively.

In accordance with Accounting Principles Board Opinion No. 25 and its related interpretations, certain options were deemed to be subject to compensation charges. VistaCare recorded deferred compensation in connection with the grant of stock options to employees for the year ended December 31, 2001 and 2002 as follows:

For options granted in November 2001, February 2002, May 2002, and August 2002, the fair value on the grant dates, as determined by VistaCare s board of directors, was approximately $3.75, $3.75, $6.25, and $12.50, respectively. In connection with VistaCare s IPO, VistaCare determined that the estimated deemed fair value of its common stock for accounting purposes to be $5.35, $7.75, $10.33, and $13.75 as of November 2001, February 2002, May 2002 and August 2002, respectively. The compensation charge for these options results from the differential between the exercise price and deemed fair market value at the time of grant.

In November 2002, 320,000 stock options were granted to VistaCare s Chief Executive Officer with an exercise price of $12.50 per share. The shares subject to the option vest on September 30, 2012. However, if the average closing price of VistaCare s common stock during specified periods exceeds specified thresholds (which increase over time), the vesting of the option will be accelerated with respect to a portion of the shares covered by the option. These options are subject to a variable accounting charge until all options vest and as a result of this determination, the Compensation Committee of VistaCare s Board of Directors has subsequently modified the vesting period of unvested options so as to accelerate the vesting period to February 24, 2003.

These stock option grants resulted in deferred compensation expense of $446,000 and $2,748,000 in 2001 and 2002, respectively. Approximately $953,000 of this deferred charge was expensed in February 2003

VISTACARE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Information for the three-month periods ended March 31, 2002 and 2003 is unaudited)

due to the accelerated vesting of the options issued to VistaCare s Chief Executive Officer. The remaining deferred compensation will be amortized ratably over the respective vesting periods of the options.

The following table summarizes the stock options outstanding exercisable as of December 31, 2002:

Exercise Price	Number Outstanding	Weighted Average Remaining Contractual Life (Years)	Number Vested and Exercisable	Number Unvested and Not Exercisable
$ 1.68	122,000	1	122,000	0
2.50	2,000	1	2,000	0
3.75	1,129,320	4	338,920	790,400
4.13	40,000	4	16,000	24,000
6.25	221,060	5		221,060
12.50	536,340	4	100,000	436,340

Total stock options vested and exercisable as of December 31, 2001 and 2002 was 308,000 and 579,000, respectively.

Pro forma information regarding net (loss) income is required by SFAS No. 123, *Accounting for Stock-Based Compensation*, which requires that the information be determined as if VistaCare had accounted for its employee stock options granted during the fiscal periods ended December 31, 2000, 2001, 2002 and for three months ended March 31, 2003 under the fair value method of SFAS 123 as disclosed in note 1. The deemed fair value for options granted prior to the IPO was estimated at the date of grant using the minimum value option valuation model, which assumes the stock price has no volatility since the common stock was not publicly traded at the time of grant. The deemed fair value for options granted after the IPO was estimated at the date of grant using the Black-Scholes model, which considers stock volatility. The following assumptions were used to calculate the deemed fair value of the option awards at the date of grant: no dividend payout expected, expected volatility of 0.23, expected option life of 5 years and a risk-free interest rate averaging 6.0% for the years ended December 31, 2000, 2001 and 2002.

The minimum value option valuation model and the Black-Scholes model were developed for use in estimating the fair value of traded options that have no vesting restrictions and are fully transferable. In addition, option valuation models require the input of highly subjective assumptions, including the expected life of the option. Because, among other things, changes in the subjective input assumptions can materially affect the fair value estimate, in management s opinion, the existing models do not necessarily provide a reliable single measure of the fair value of its stock options. For purposes of pro forma disclosures, the deemed fair value of the options is amortized to expense over the vesting periods.

2002 Non-Employee Director Stock Option Plan

In 2002, VistaCare established a Non-Employee Director Stock Option Plan, or the director plan, which authorizes the grant of options to purchase up to 300,000 shares of common stock to non-employee directors. Under the director plan, each future non-employee director will be granted a stock option to purchase 20,000 shares of common stock on the date he or she is first elected to VistaCare s board of directors. On November 11 of each year effective 2003 each non-employee director will be granted an option to purchase 10,000 shares of VistaCare common stock, provided that he or she attended at least 75% of the meetings of the board of directors in the preceding year or any board committee on which he or she served. The exercise price for all options granted under the director plan will be equal to the fair market value of the common stock on the date of grant. Each option granted under the director plan will be immediately exercisable in full. Each option will expire on the earlier of ten years from the date of grant or on the first anniversary of the date on which the optionee ceases to be a director.

VISTACARE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Information for the three-month periods ended March 31, 2002 and 2003 is unaudited)

2002 Employee Stock Purchase Plan

In 2002, VistaCare established a Employee Stock Purchase Plan, or the purchase plan, provides for the issuance of up to 200,000 shares of VistaCare common stock to participating employees.

All VistaCare employees, including directors who are employees, and all employees of any participating subsidiaries, whose customary employment is more than 20 hours per week for more than five months in a calendar year are eligible to participate in the purchase plan. Employees who would immediately after the grant own five percent or more of the total combined voting the shares in each offering period will be 85% of the closing price per share of the common stock on either the first or last day of the offering period, whichever is lower, power or value of our stock or any subsidiary are not eligible to participate.

The purchase plan will be implemented through a series of offerings, the dates of which shall be established from time to time by VistaCare s board of directors. Participating employees may purchase shares under the purchase plan through periodic payroll deductions, lump sum payments, or both. The purchase price of the shares in each offering period will be 85% of the closing price per share of the common stock on either the first or last day of the offering period, whichever is lower. To date there have been no offerings under the purchase plan.

9. 401(k) Plans

VistaCare maintains two plans qualified under Section 401(k) of the Internal Revenue Code. Under the 401(k) plans, a participant may contribute a maximum of 10% or 15%, depending on the plan under which he or she participates, of his or her pre-tax salary, commissions and bonuses through payroll deductions, up to the statutorily prescribed annual limit. The percentage elected by more highly compensated participants may be required to be lower. In addition, at the discretion of the VistaCare board of directors, VistaCare may make discretionary matching and/or profit-sharing contributions into the 401(k) plans for eligible employees. For the years ended December 31, 2000, 2001 and 2002 VistaCare elected a discretionary match of approximately $26,000, $18,000 and $14,000, respectively. For the three months ended March 31, 2003, the discretionary match was approximately $4,000.

10. Minimum Lease Payments

VistaCare conducts a major part of its operations from leased facilities which include several extended care centers and office space. The leases, which have varying terms, the latest of which expires in 2006, are classified as operating leases.

Future minimum rental payments under noncancelable leases with terms in excess of one year as of December 31, 2002, follows (in thousands):

2003	$2,974
2004	2,485
2005	1,822
2006	1,019
	$8,300

Total rental expense was $2,143,000, $2,466,000, $3,015,000, $621,000 and $902,000 for the years ended December 31, 2000, 2001 and 2002 and the three months ended March 31, 2002 and 2003, respectively.

Table of Contents

VISTACARE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Information for the three-month periods ended March 31, 2002 and 2003 is unaudited)

11. Related Party Transactions

In March 1996, VistaCare extended a loan to a former Chief Financial Officer in the original principal amount of $66,000 and bearing interest at 7.5% per annum. The loan was collateralized by a pledge of the shares of common stock issuable upon exercise of a stock option held by the executive. Such stock option, which was exercisable for 48,000 shares of common stock at $1.68 per share, was fully vested when the executive s employment terminated in June 1999. In September 2002, VistaCare entered into a settlement agreement and mutual release with the executive pursuant to which VistaCare agreed to repurchase the stock option for $105,839, reduced by the outstanding principal and accrued interest on the loan as of June 30, 1999 in the amount of $72,979, and deem such loan fully paid.

In February 1999 and March 2000, VistaCare paid aggregate consideration of $71,934 to a former Chief Operating Officer for the repurchase of vested options to purchase 34,667 shares of common stock following the executive s termination of employment.

In July 1999, VistaCare borrowed $1 million from an existing stockholder pursuant to an unsecured promissory note bearing interest at 8.0% per annum. As consideration for the note, VistaCare issued to the stockholder a warrant to purchase 20,000 shares of common stock at $0.025 per share. The expiration date of the warrant is July 26, 2009. In December 1999, VistaCare paid all accrued interest due under the promissory note and the entire principal balance on the note was applied to the purchase of Class C Common Stock.

In December 1999, VistaCare issued and sold an aggregate of 1,316,732 of Class C Common Stock at $0.025 per share and an aggregate of 65,000 shares of Series D Preferred Stock at $50 per share to certain existing stockholders and VistaCare s former Chief Financial Officer. The Class C Common Stock issuance price represented a substantial discount from the estimated fair value of VistaCare s Class C Common Stock. The purchasers of the Class C Common Stock, except for VistaCare s former Chief Financial Officer, had previously purchased shares of VistaCare s Series B Preferred Stock. The Class C Common Stock was issued as a means of adjusting the conversion price of certain shares of Series B Preferred Stock previously sold to those purchasers in exchange for a limited release from those purchasers of claims they had related to the accuracy of certain representations and warranties made in connection with the previous sale of the Series B Preferred Stock. There was no beneficial conversion feature to this transaction as the effective adjusted conversion price of these shares of Series B Preferred Stock exceeded the estimated fair value of the Class A Common Stock at the time of this transaction.

In November 2000, VistaCare entered into a severance agreement and full release of claims with a former Vice President in connection with the executive s termination of employment. Under this agreement, VistaCare made severance payments totaling $102,000, and agreed to continue the executive s health benefits for a period of six months following the date of the executive s termination of employment. In exchange for the severance payments, the executive waived all claims against VistaCare arising from the executive s employment, agreed to maintain the confidentiality of information relating to VistaCare s business and not to compete with VistaCare s business or solicit VistaCare s employees for six months following the executive s termination of employment.

In October 2001, VistaCare entered into a full and final release of claims with a former Chief Operating Officer in connection with the termination of the executive s employment. At that time, VistaCare made a severance payment to the executive totaling $250,000. In exchange for the severance payment, the executive waived all claims against VistaCare arising from the executive s employment, agreed to maintain the confidentiality of information relating to VistaCare s business, and agreed not to compete with VistaCare s business prior to December 31, 2001 or to solicit VistaCare s employees for six months following the executive s termination of employment.

Table of Contents

VISTACARE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Information for the three-month periods ended March 31, 2002 and 2003 is unaudited)

In February 2002, VistaCare entered into a settlement agreement, buy-sell agreement and mutual release with a former Chief Financial Officer in connection with the executive s termination of employment. Pursuant to that agreement, VistaCare made a severance payment of $247,500 to the executive. VistaCare also paid the executive $502,500 to repurchase 5,000 shares of its Series D Preferred Stock and to settle all claims arising prior to the date of the agreement, including claims arising from the executive s employment.

In October 2002, VistaCare entered into a severance agreement and mutual release of claims with a former Executive Vice President in connection with the executive s termination of employment. Pursuant to that agreement, VistaCare agreed to make aggregate severance payments of $194,000. In addition, VistaCare agreed to provide continuing health insurance benefits for a period of six months following termination. In exchange for these benefits, the executive waived all claims against VistaCare arising from the executive s employment, and agreed to maintain the confidentiality of information relating to VistaCare s business and not to compete with VistaCare for a period of one year following the executive s termination of employment.

For the year ended December 31, 2002, VistaCare donated $455,000 to the VistaCare Foundation (the Foundation). The donation is reported in general and administrative expenses. The Foundation is a non-profit corporation that was established by VistaCare s Chairman of the Board for the purpose of soliciting, investing and distributing funds for hospice related care. Although one of VistaCare s directors and one of VistaCare s executives serve on the Foundation s board of directors, VistaCare does not presently have an ownership or controlling interest in the Foundation. For 2002, the Foundation contributed to VistaCare approximately $159,000 for patient care to patients who lack means to pay for such care, which was recorded as net patient revenue.

12. Litigation

VistaCare and one of its former employees are currently defendants in an action initiated on February 5, 2003 in the United States District Court in the District of Nevada. The action, Bradeen et al. v. Vista Hospice Care, Inc. and Edward Raymond Lowe, relates to a fatal motor vehicle accident involving a VistaCare former employee. The plaintiffs in the action allege that the former employee, while acting within the scope of his employment by VistaCare, negligently and recklessly caused a motor vehicle collision that resulted in the death of two people. The plaintiffs seek pecuniary and punitive damages in an unspecified amount. The court is considering VistaCare s motion to dismiss the action. VistaCare maintained aggregate liability insurance of $4.0 million at the time of the accident. VistaCare has determined, without considering any possible insurance recovery, that a loss in connection with this matter is possible, but not probable and estimable. Accordingly, VistaCare has not recorded any liability relating to this matter.

VistaCare is involved in various other litigation and administrative proceedings arising in the normal course of business. In the opinion of management, any liabilities that may result from pending litigation and administrative proceedings will not, individually or in the aggregate, have a material adverse effect on VistaCare s financial position, results of operations, or cash flows.

Table of Contents

VISTACARE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Information for the three-month periods ended March 31, 2002 and 2003 is unaudited)

13. Dilutive Securities

The following table presents the calculation of basic and diluted net (loss) income per common share (in thousands, except per share information):

	Year Ended December 31,			Three Months Ended March 31,	
	2000	**2001**	**2002**	**2002**	**2003**
Numerator					
Net (loss) income	$ (383)	$ (6,712)	$ 7,556	$ 909	$ 2,824
Series B, C and D Preferred Stock Dividends	(3,482)	(3,839)	(4,052)	(1,032)	
Numerator for basic and diluted earnings per share (loss) income available to common stockholders	$ (3,865)	$ (10,551)	$ 3,504	$ (123)	$ 2,824
Denominator					
Denominator for basic net (loss) income per share weighted average shares	5,098	5,098	5,580	5,100	15,500
Effect of dilutive securities					
Employee stock options			729		1,078
Series A-1 Preferred Stock			298		
Common stock warrants			159		20
Class B Common					58
Denominator for diluted net (loss) income per share adjusted weighted average shares and assumed conversion	5,098	5,098	6,766	5,100	16,656
Net (loss) income per common share:					
Basic net (loss) income to common stockholders	$ (0.76)	$ (2.07)	$ .63	$ (0.02)	$ 0.18
Diluted net (loss) income to common stockholders	$ (0.76)	$ (2.07)	$ .52	$ (0.02)	$ 0.17

The effect of dilutive securities amounting to 5,934,000, 6,056,000, 5,090,000 and 6,672,000 was not included in the diluted earnings per share calculation for the years ended December 31, 2000, 2001 and 2002 and the three months ended March 31, 2002, respectively, because inclusion of the securities would be anti-dilutive.

14. Allowance for Denials

The allowance for denials for patient accounts receivable is as follows (in thousands):

	Balance at Beginning of Period	Provision for Denials	Write-Offs, Net of Recoveries	Balance at End of Period
Year ended December 31, 2000	$3,680	$3,313	$(3,616)	$3,377
Year ended December 31, 2001	3,377	6,199	(5,086)	4,490
Year ended December 31, 2002	4,490	2,748	(2,876)	4,362
Three Months Ended March 31, 2003	4,362	861	(29)	5,194

Table of Contents

VISTACARE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Information for the three-month periods ended March 31, 2002 and 2003 is unaudited)

15. Quarterly Financial Data (Unaudited)

The following table sets forth certain unaudited quarterly financial information for the fiscal years ended December 31, 2001 and 2002.

	First Quarter	Second Quarter	Third Quarter	Fourth Quarter	Total
Fiscal year ended December 31, 2001					
Net patient revenues	$20,425	$22,923	$22,983	$25,031	$ 91,362
Gross Profit	5,312	7,181	6,403	8,516	27,412
Net Income	(3,050)	(2,125)	(2,717)	(2,659)	(10,551)
Earnings per Share					
Basic	$ (0.60)	$ (0.42)	$ (0.53)	$ (0.52)	$ (2.07)
Diluted	$ (0.60)	$ (0.42)	$ (0.53)	$ (0.52)	$ (2.07)
Fiscal year ended December 31, 2002					
Net patient revenues	$27,674	$31,000	$35,079	$39,194	$132,947
Gross Profit	10,517	12,414	14,411	16,523	53,865
Net Income	(123)	481	638	2,508	3,504
Earnings per Share					
Basic	$ (0.02)	$ 0.09	$ 0.12	$ 0.36	$ 0.55
Diluted	$ (0.02)	$ 0.08	$ 0.10	$ 0.27	$ 0.43

Table of Contents

Table of Contents

5,500,000 Shares

Class A Common Stock

PROSPECTUS

May 13, 2003

LEHMAN BROTHERS

SG COWEN

WILLIAM BLAIR & COMPANY

JEFFERIES & COMPANY, INC.