

ASSISTED LIVING CONCEPTS INC

Form 10-Q

May 20, 2002

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**UNITED STATES SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20459

**Form 10-Q**

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

For the quarterly period ended March 31, 2002

or

**Part II TRANSITION REPORT PURSUANT TO SECTION 12 OR 15(d) OF THE  
SECURITIES EXCHANGE ACT OF 1934**

For the Transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission file number 1-83938

**Assisted Living Concepts, Inc.**

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

**Nevada**

*(State or other jurisdiction of  
incorporation or organization)*

**93-1148702**

*(IRS Employer  
Identification No.)*

**11835 NE Glenn Widing Drive, Building E**

**Portland, Oregon 97220**

*(Address of principle executive offices)*

**(503) 252-6233**

*(Registrant's telephone number, including area code)*

Indicate by check mark whether Registrant (1) has filed all reports 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 Registrants was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  No

The Registrant had 6,431,759 shares of common stock, \$.01 par value, outstanding at May 13, 2002.

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**FORM 10-Q**

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**(in thousands, except share amounts)**

	Successor Company	
	December 31, 2001	March 31, 2002
		(Unaudited)
<b>ASSETS</b>		
Current Assets:		
Cash and cash equivalents	\$ 6,077	\$ 3,618
Cash restricted for resident security deposits	2,415	2,417
Accounts receivable, net of allowance for doubtful accounts of \$13 at 2002	2,328	2,415
Prepaid insurance	160	2,667
Prepaid expenses	823	637
Cash restricted for workers' compensation claims	2,825	4,519
Other current assets	3,862	3,617
	<u>18,490</u>	<u>19,890</u>
Total current assets	18,490	19,890
Restricted cash	5,349	5,372
Property and equipment, net	196,548	195,506
Other assets, net	1,866	1,956
	<u>\$ 222,253</u>	<u>\$ 222,724</u>
Total assets	\$ 222,253	\$ 222,724
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
Current liabilities:		
Accounts payable	\$ 1,450	\$ 1,196
Accrued real estate taxes	4,523	3,648
Accrued interest expense	666	1,095
Accrued interest expense payable to related parties		331
Accrued payroll expense	4,561	5,882
Other accrued expenses	7,163	6,270
Resident security deposits	2,471	2,433
Insurance premium obligation		1,224
Other current liabilities	652	261
Current portion of unfavorable lease adjustment	681	664
Current portion of long-term debt and capital lease obligation	2,622	2,583
	<u>24,789</u>	<u>25,587</u>
Total current liabilities	24,789	25,587
Other liabilities	89	168
Unfavorable lease adjustment	3,115	2,962
Long-term debt and capital lease obligation, net of current portion	161,461	162,658
	<u>161,461</u>	<u>162,658</u>

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Total liabilities	189,454	191,375
	<u>          </u>	<u>          </u>
Commitments and contingencies		
Shareholders' equity:		
Preferred stock, \$.01 par value; 3,250,000 shares authorized; none issued or outstanding		
Common Stock, \$.01 par value; 20,000,000 shares authorized; issued and outstanding 6,431,759 shares (68,241 shares to be issued upon settlement of pending claims)	65	65
Additional paid-in capital	32,734	32,734
Accumulated deficit		(1,450)
	<u>          </u>	<u>          </u>
Total shareholders' equity	32,799	31,349
	<u>          </u>	<u>          </u>
Total liabilities and shareholders' equity	\$222,253	\$222,724
	<u>          </u>	<u>          </u>

The accompanying notes are an integral part of these consolidated financial statements.

**Table of Contents****ASSISTED LIVING CONCEPTS, INC.****CONSOLIDATED STATEMENTS OF OPERATIONS**  
**(in thousands, except per share amounts)**  
**(unaudited)**

	<b>Predecessor Company</b>	<b>Successor Company</b>
	<b>Three Months Ended March 31, 2001</b>	<b>Three Months Ended March 31, 2002</b>
Revenue	\$36,877	\$37,889
Operating expenses:		
Residence operating expenses	25,558	26,335
Corporate general and administrative	4,268	4,316
Building rentals	1,958	982
Building rentals to related party	2,213	2,055
Depreciation and amortization	2,552	1,667
	<u>36,549</u>	<u>35,355</u>
Operating income	328	2,534
Other income (expense):		
Interest expense	(4,402)	(3,161)
Interest expense to related parties		(430)
Interest income	148	54
Other income, net	31	
	<u>(4,223)</u>	<u>(3,537)</u>
Loss before debt restructure and reorganization costs	(3,895)	(1,003)
Debt restructure and reorganization costs	303	447
Net loss	\$ (4,198)	\$ (1,450)
Basic and diluted net loss per common share	\$ (.25)	\$ (.22)
Basic and diluted weighted average common shares outstanding	<u>17,121</u>	<u>6,500</u>

The accompanying notes are an integral part of these consolidated financial statements.

**Table of Contents****ASSISTED LIVING CONCEPTS, INC.****CONSOLIDATED STATEMENTS OF CASH FLOWS****(in thousands)****(unaudited)**

	<b>Predecessor Company</b>	<b>Successor Company</b>
	<b>Three Months Ended March 31, 2001</b>	<b>Three Months Ended March 31, 2002</b>
<b>Operating Activities:</b>		
Net loss	\$(4,198)	\$(1,450)
Adjustment to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	2,552	1,667
Amortization of debt issuance costs		20
Amortization of fair value adjustment to building rentals		(170)
Amortization of fair market adjustment to long-term debt		107
Amortization of discount on long-term debt		106
Straight line adjustment to building rentals		86
Interest paid-in-kind		305
Provision for doubtful accounts	156	13
Changes in assets and liabilities:		
Accounts receivable	(166)	(100)
Prepaid expenses	282	(2,321)
Other current assets	378	245
Other assets	(17)	(31)
Accounts payable	(166)	(254)
Accrued expenses	(1,341)	313
Insurance premium obligation	2,507	1,224
Other current liabilities	(2,314)	(429)
Other liabilities	(106)	(7)
	<u>(2,433)</u>	<u>(676)</u>
<b>Investing Activities:</b>		
Increase in restricted cash	(2,081)	(1,719)
Purchases of property and equipment	(453)	(625)
	<u>(2,534)</u>	<u>(2,344)</u>
<b>Financing Activities:</b>		
Proceeds from long-term debt	1,300	1,000
Payments on long-term debt and capital lease obligation	(340)	(360)
Debt issuance costs	(1,809)	(79)
	<u>(849)</u>	<u>561</u>
Net decrease in cash and cash equivalents	(5,816)	(2,459)
Cash and cash equivalents, beginning of period	9,889	6,077
Cash and cash equivalents, end of period	<u>\$ 4,073</u>	<u>\$ 3,618</u>
<b>Supplemental disclosure of cash flow information:</b>		



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Cash payments for interest	\$ 1,730	\$ 2,705
Reclassification of other current and other liabilities to current and non-current long-term debt and capital lease obligation	\$ 550	\$

The accompanying notes are an integral part of these consolidated financial statements.

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**ASSISTED LIVING CONCEPTS, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
(Unaudited)**

**1. The Company**

Assisted Living Concepts, Inc., a Nevada Corporation, (the Company) owns, leases and operates assisted living residences which provide housing to older persons who need help with the activities of daily living such as bathing and dressing. The Company provides personal care and support services and makes available routine health care services, as permitted by applicable law, designed to meet the needs of its residents.

**2. Basis of Presentation**

The accompanying unaudited consolidated financial statements should be read in conjunction with the consolidated financial statements and the notes thereto included in the Company's annual report on Form 10-K for the fiscal year ended December 31, 2001.

The accompanying consolidated financial statements are unaudited and have been prepared in accordance with accounting principles generally accepted in the United States of America. In the opinion of management, the unaudited consolidated financial statements include all necessary adjustments consisting of normal recurring accruals. Certain prior year amounts have been reclassified to conform to the current year presentation.

**3. Reorganization and Fresh-Start Reporting**

***Reorganization***

On October 1, 2001, Assisted Living Concepts, Inc. (the Company), and its wholly owned subsidiary, Carriage House Assisted Living, Inc. (Carriage House), and together with the Company, the Debtors) each filed a voluntary petition under Chapter 11 of Title 11 of the United States Code (the Bankruptcy Code) in the United States Bankruptcy Court for the District of Delaware in Wilmington (the Court), case nos. 01-10674 and 01-10670, respectively, which are being jointly administered. The Court gave final approval to the first amended joint plan of reorganization (the Plan) on December 28, 2001.

On January 1, 2002 (the Effective Date) the Plan became effective. The Plan authorized the issuance as of the Effective Date (subject to the Reserve described below) of \$40.25 million aggregate principal amount of seven-year secured notes (the New Senior Secured Notes), bearing interest at 10% per annum, payable semi-annually in arrears, and \$15.25 million aggregate principal amount of ten-year secured notes (the New Junior Secured Notes) and collectively with the New Senior Secured Notes, the New Notes), bearing interest payable in additional New Junior Secured Notes for three years at 8% per annum and thereafter payable in cash at 12% per annum, payable semi-annually in arrears, and (c) 6,500,000 shares of new common stock, par value \$0.01 (the New Common Stock) of the reorganized Company, of which 4% was issued to shareholders of the Predecessor Company.

At the Effective Date, the new Board of Directors of the reorganized Company consisted of seven members as follows: W. Andrew Adams (Chairman), Leonard Tannenbaum, Andre Dimitriadis, Matthew Patrick, Mark Holliday, Richard Ladd and Wm. James Nicol, then the President and Chief Executive Officer of the Company. In February 2002, Steven L. Vick replaced Mr. Nicol as President, Chief Executive Officer and Director.

The Company held back from the initial issuance of New Common Stock and New Notes on the Effective Date, \$440,178 of New Senior Secured Notes, \$166,775 of New Junior Secured Notes and 68,241 shares of New Common Stock (collectively, the Reserve) to be issued to holders of general unsecured claims at a later date. The total amount of, and the identities of all of the holders of, the general unsecured claims were not known as of the Effective Date, either because they were disputed or they were not made by

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**ASSISTED LIVING CONCEPTS, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(Unaudited)**

their holders prior to December 19, 2001, the cutoff date for calculating the Reserve (the Cutoff Date). Once the total amount and the identities of the holders of those claims are determined, the shares of New Common Stock and the New Notes held in the Reserve will be distributed pro rata among the holders of those claims (the date of this distribution, the Subsequent Distribution Date).

If the Reserve is insufficient to cover the general unsecured claims allowed after the Cutoff Date, the Company and its subsidiaries will have no further liability with respect to those general unsecured claims and the holders of those claims will receive proportionately lower distributions of shares of New Common Stock and New Notes than the holders of general unsecured claims allowed prior to the Cutoff Date. If the Reserve exceeds the distributions necessary to cover the general unsecured claims allowed after the Cutoff Date, the additional securities remaining in the Reserve will be distributed among all holders of the general unsecured claims so as to ensure that each holder of a general unsecured claim receives, in the aggregate, its pro rata share of the New Common Stock and the New Notes. In this case, the holders of the general unsecured claims allowed prior to the Cutoff Date will receive distributions of securities both on the Effective Date and on the Subsequent Distribution Date.

***Fresh Start Reporting***

Upon emergence from Chapter 11 proceedings, the Company adopted fresh-start reporting in accordance with the American Institute of Certified Public Accountants Statement of Position 90-7, *Financial Reporting By Entities in Reorganization Under the Bankruptcy Code* (SOP 90-7). In connection with the adoption of fresh-start reporting, a new entity has been deemed created for financial reporting purposes. For financial reporting purposes, the Company adopted the provisions of fresh-start reporting effective December 31, 2001. Consequently, the consolidated balance sheet and related information at and subsequent to December 31, 2001 is labeled Successor Company, and reflects the Plan and the principles of fresh-start reporting. Periods presented prior to December 31, 2001 have been designated Predecessor Company.

In adopting the requirements of fresh-start reporting as of December 31, 2001, the Company was required to value its assets and liabilities at fair value and eliminate its accumulated deficit as of December 31, 2001. A \$32.8 million reorganization value was determined by the Company with the assistance of financial advisors in reliance upon various valuation methods, including discounted projected cash flow analysis and other applicable ratios and economic industry information relevant to the operation of the Company and through negotiations with various creditor parties in interest.

**4. Factors Affecting Comparability of Financial Information**

As a consequence of the implementation of fresh-start reporting effective December 31, 2001 the financial information presented in the unaudited consolidated statement of operations and the corresponding statements of cash flows for the three months ended March 31, 2001 are generally not comparable to the financial results for the three months ended March 31, 2002. Any financial information herein labeled Predecessor Company refers to periods prior to the adoption of fresh-start reporting, while those labeled Successor Company refer to periods following the Company's reorganization.

The lack of comparability in the accompanying unaudited consolidated financial statements relates primarily to the Company's capital costs (building rentals, interest, depreciation and amortization), as well as debt restructuring and reorganization costs.

**Table of Contents****ASSISTED LIVING CONCEPTS, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Unaudited)****5. Cash and Cash Equivalents**

The Company's cash and cash equivalents consist of the following (in thousands):

	<b>December 31, 2001</b>	<b>March 31, 2002</b>
Cash	\$ 5,022	\$ 3,461
Cash equivalents	1,055	157
<b>Total cash and cash equivalents</b>	<b>\$ 6,077</b>	<b>\$ 3,618</b>

**6. Long-Term Restricted Cash**

Long-term restricted cash consists of the following (in thousands):

	<b>December 31, 2001</b>	<b>March 31, 2002</b>
Cash held for loan agreements with U.S. Bank National Association ( U.S. Bank )	\$ 4,338	\$ 4,357
Cash held in accordance with lease agreements	970	974
State regulated restricted resident security deposits	41	41
<b>Total long-term restricted cash</b>	<b>\$ 5,349</b>	<b>\$ 5,372</b>

**7. Property and Equipment**

The Company's property and equipment consists of the following (in thousands):

	<b>December 31, 2001</b>	<b>March 31, 2002</b>
Land	\$ 22,177	22,177
Buildings and improvements	166,443	166,544
Equipment	3,937	4,380
Furniture	3,991	4,072
<b>Total property and equipment</b>	<b>196,548</b>	<b>197,173</b>
Less accumulated depreciation		1,667
<b>Property and equipment, net</b>	<b>\$ 196,548</b>	<b>\$ 195,506</b>

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Land, buildings and certain furniture and equipment relating to 129 owned residences serve as collateral for long-term debt.

Included in the 129 owned residences is one residence with a carrying value of \$870,000 which was closed in March 2002. This closed residence is one of 57 residences which secure our New Notes. Any proceeds received on disposal of this residence must be used to reduce such debt.

### **8. Insurance Premium Obligation**

During the three months ended March 31, 2002, the Company entered into several short-term agreements to finance its annual insurance premiums. These are nine-month agreements and bear interest at annual fixed rates of approximately 5.5% to 6.0%.

**Table of Contents****ASSISTED LIVING CONCEPTS, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Unaudited)****9. Long-Term Debt**

As of December 31, 2001 and March 31, 2002, long-term debt consists of the following (in thousands):

	December 31, 2001		March 31, 2002	
	Carrying Amount	Principal Amount	Carrying Amount	Principal Amount
Trust Deed Notes, payable to the State of Oregon Housing and Community Services Department (OHCS) due 2028.	\$ 9,849	\$ 9,741	\$ 9,809	\$ 9,703
Variable Rate Multifamily Revenue Bonds, payable to the Washington State Housing Finance Commission Department due 2028.	7,521	7,605	7,523	7,605
Variable Rate Demand Revenue Bonds, Series 1997, payable to the Idaho Housing and Finance Association due 2017.	6,542	6,615	6,543	6,615
Variable Rate Demand Revenue Bonds, Series A-1 and A-2 payable to the State of Ohio Housing Finance Agency due 2018.	11,888	12,020	11,900	12,020
Housing and Urban Development Insured Mortgages due 2035	7,374	7,457	7,363	7,446
New Senior Secured Notes due 2009.	40,250	40,250	40,250	40,250
New Junior Secured Notes due 2012.	12,628	12,628	13,038	13,038
Mortgages payable due 2008.	28,513	28,463	28,388	28,338
G.E. Capital (Previously Heller Healthcare Finance, Inc.) Credit Facility due 2005	39,222	40,458	40,252	41,386
Capital lease obligations due 2002.	296	301	175	188
<b>Total long-term debt</b>	<b>164,083</b>	<b>\$ 165,538</b>	<b>165,241</b>	<b>\$ 166,589</b>
Less current portion	2,622		2,583	
<b>Long-term debt</b>	<b>\$ 161,461</b>		<b>\$ 162,658</b>	

On January 1, 2002 the Company's Plan became effective. The Company's Plan of reorganization included the issuance of \$40.25 million aggregate principal amount of seven-year secured notes (the New Senior Secured Notes), bearing interest at 10% per annum, payable semi-annually in arrears, and \$15.25 million aggregate principal amount of ten-year secured notes (the New Junior Secured Notes and collectively with the New Senior Secured Notes, the New Notes), bearing interest payable in additional New Junior Secured Notes for three years at 8% per annum and thereafter payable in cash at 12% per annum, payable semi-annually in arrears. The New Junior Secured Notes were issued at a discount of \$2.6 million. The discount is being amortized over the life of the New Junior Secured Notes at an effective interest rate of 13.0%. The New Notes are secured by 57 properties. (See Notes 3 and 7).

Of the face amount of \$55.5 million and \$55.8 million outstanding of the New Notes at December 31, 2001 and March 31, 2002, \$18.2 million and \$18.3 million, respectively, were payable to related parties. (See Note 10).

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The Company's Washington, Idaho and Ohio Revenue Bonds are secured by a combination of cash, residences and letters of credit. The letters of credit have been issued by U.S. Bank and the underlying credit

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agreements between U.S. Bank and the Company contain restrictive covenants that include compliance with certain financial ratios.

In May 2002, the Company received a waiver from U.S. Bank regarding the Bank's right to declare an event of default for the Company's failure to meet the March 31, 2002 financial covenant requirements established for the Predecessor Company set forth in the amended U.S. Bank loan agreement. Furthermore, the Company amended its existing agreement with U.S. Bank, establishing new covenants, with which the Company was in compliance as of March 31, 2002.

As of March 31, 2001, the following annual principal payments are required (in thousands):

2002	\$ 2,583
2003	2,672
2004	2,891
2005	41,315
2006	2,258
Thereafter	114,870
	<hr/>
Total	\$ 166,589
	<hr/>

**10. Related Party Transactions*****LTC Properties, Inc. and CLC Healthcare, Inc.***

Andre Dimitriadis, who has been a member of the Company's Board of Directors and the Chair of its Audit Committee since January 2002, is the President, Chief Executive Officer and Chairman of the Board of LTC Properties, Inc. (LTC) and is the Chief Executive Officer and Chairman of the Board of CLC Healthcare, Inc. (previously LTC Healthcare, Inc.). LTC owned \$11.0 million of the Company's New Notes and CLC Healthcare, Inc. (CLC) owned 22.4% of the Company's common stock and \$1.9 million of the Company's New Notes at March 31, 2002.

The Company has incurred interest expense on LTC and CLC's New Notes in the amount of \$260,000 and \$45,000, respectively. Of this interest, \$200,000 and \$35,000 is payable in cash to LTC and CLC, respectively, at March 31, 2002. The remaining interest is payable-in-kind and increases LTC and CLC's ownership of the New Notes proportionately.

The Company currently leases 37 properties (1,426 units) from LTC. The Company incurred lease expense of \$2.2 million and \$2.1 million for the three months ended March 31, 2001 and 2002, respectively, pursuant to these leases.

***National Health Investors, Inc.***

W. Andrew Adams, who has been a member of the Company's Board of Directors and its Chair since January 2002, is the President, Chief Executive Officer and Chairman of the Board of Directors of National Health Investors, Inc. (NHI). NHI owned 557,214 shares of the Company's common stock and \$5.0 million of the Company's New Notes at March 31, 2002.

The Company has incurred interest expense on NHI's New Notes in the amount of \$117,000. Of this interest, \$90,000 is payable in cash to NHI at March 31, 2002. The remaining interest is payable-in-kind and increases NHI's ownership of the New Notes.



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**ASSISTED LIVING CONCEPTS, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(Unaudited)**

***Leonard Tannenbaum***

Leonard Tannenbaum is a current member of the Company's Board of Directors. Mr. Tannenbaum owned \$323,875 of the Company's New Notes at March 31, 2002.

The Company has incurred interest expense on Mr. Tannenbaum's New Notes in the amount of \$8,000. Of this interest, \$6,000 is payable in cash to Mr. Tannenbaum at March 31, 2002. The remaining interest is payable-in-kind and increases Mr. Tannenbaum's ownership of the New Notes.

**11. Income Taxes**

The Company has provided no benefit for income taxes as the Company recorded a full valuation allowance on its deferred tax asset. The Company believes it is more likely than not that some portion or all of the deferred tax assets will not be realized.

**12. Subsequent Event**

Effective May 16, 2002, Matthew Patrick replaced Drew Q. Miller as Senior Vice President, Chief Financial Officer and Treasurer. Mr. Patrick also serves as a Director of the Company.

**13. Subsidiary Guarantee of New Notes**

The New Notes, issued by the Company, are publicly traded and the repayment of these notes is guaranteed by two wholly-owned subsidiaries of the Company: ALC Indiana, Inc. and Home and Community Care, Inc. (HCI). HCI and Carriage House Assisted Living, Inc. (Carriage House), a wholly owned subsidiary of the Company, are also co-obligors of the New Notes. The following information is presented as required under the Securities and Exchange Commission Financial Reporting Release No. 55 in connection with the guarantee of the New Notes by the Company's wholly owned subsidiaries. The operating and

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investing activities of the separate legal entities included in the consolidated financial statements are fully interdependent and integrated with the Company and each other.

**Successor Company****Consolidating Balance Sheets  
March 31, 2002****Wholly-Owned Subsidiaries**

	<u>ALC, Inc.</u>	<u>ALC Indiana, Inc.</u>	<u>Carriage House</u>	<u>HCI</u>	<u>Non- Participating Subsidiaries</u>	<u>Consolidating Adjustments</u>	<u>Consolidated Total</u>
<b>ASSETS</b>							
Current Assets:							
Cash and cash equivalents	\$ 3,348	\$	\$	\$	\$ 270	\$	\$ 3,618
Receivable from subsidiaries/parent	1,586	5,357			4,949	(11,892)	
Cash restricted for resident security deposits	2,417						2,417
Accounts receivable, net	2,176			4	235		2,415
Prepaid insurance	2,667						2,667
Prepaid expenses	616				21		637
Cash restricted for workers compensation claims	4,519						4,519
Other current assets	1,704	9		23	1,881		3,617
<b>Total current assets</b>	<b>19,033</b>	<b>5,366</b>		<b>27</b>	<b>7,356</b>	<b>(11,892)</b>	<b>19,890</b>
Restricted cash	5,372						5,372
Property and equipment, net	92,074	12,818	3,586	6,568	80,460		195,506
Investment in subsidiaries	36,161					(36,161)	
Other assets, net	1,583				373		1,956
<b>Total assets</b>	<b>\$ 154,223</b>	<b>\$ 18,184</b>	<b>\$ 3,586</b>	<b>\$ 6,595</b>	<b>\$ 88,189</b>	<b>\$(48,053)</b>	<b>\$ 222,724</b>
<b>LIABILITIES AND SHAREHOLDERS EQUITY</b>							
Current liabilities:							
Accounts payable	\$ 1,174	\$	\$	\$ 1	\$ 21	\$	\$ 1,196
Payable to subsidiaries/ parent	4,949		211		1,586	(6,746)	3,648
Accrued real estate taxes	2,173	386	303	106	680		3,648
Accrued interest expense	1,049				46		1,095
Accrued interest expense payable to related parties	331						331
Accrued payroll expense	5,801			7	74		5,882
Other accrued expenses	6,204			4	62		6,270
Resident security deposits	2,155			19	259		2,433
Insurance premium obligation	1,224						1,224
Other current liabilities	259				2		261
	562		89		13		664

Current portion of unfavorable  
lease adjustment

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**Table of Contents****ASSISTED LIVING CONCEPTS, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Unaudited)****Wholly-Owned Subsidiaries**

	<b>ALC, Inc.</b>	<b>ALC Indiana, Inc.</b>	<b>Carriage House</b>	<b>HCI</b>	<b>Non- Participating Subsidiaries</b>	<b>Consolidating Adjustments</b>	<b>Consolidated Total</b>
Current portion of long-term debt and capital lease obligation	1,364				1,219		2,583
Total current liabilities	27,245	386	603	137	3,962	(6,746)	25,587
Other liabilities	160		8				168
Unfavorable lease adjustment	2,478		409		75		2,962
Long-term debt and capital lease obligation, net of current portion	87,874				74,784		162,658
Total liabilities	117,757	386	1,020	137	78,821	(6,746)	191,375
Shareholders' equity:							
Common stock	65						65
Additional paid-in capital	37,880	17,428	2,818	6,523	9,392	(41,307)	32,734
Retained earnings (accumulated deficit)	(1,479)	370	(252)	(65)	(24)		(1,450)
Total shareholders' equity	36,466	17,798	2,566	6,458	9,368	(41,307)	31,349
Total liabilities and shareholders' equity	\$ 154,223	\$ 18,184	\$ 3,586	\$ 6,595	\$ 88,189	\$ (48,053)	\$ 222,274

**Successor Company****Consolidating Balance Sheets  
December 31, 2001****Wholly-Owned Subsidiaries**

	<b>ALC, Inc.</b>	<b>ALC Indiana, Inc.</b>	<b>Carriage House</b>	<b>HCI</b>	<b>Non- Participating Subsidiaries</b>	<b>Consolidating Adjustments</b>	<b>Consolidated Total</b>
Current Assets:							
Cash and cash equivalents	\$ 6,077	\$	\$	\$	\$	\$	\$ 6,077
Receivable from subsidiaries/parent	674	4,906	1,074	1,177		(7,831)	
Cash restricted for resident security deposits	2,415						2,415

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Accounts receivable, net	2,086		15	227		2,328
Prepaid insurance	160					160
Prepaid expenses	780			43		823
Cash restricted for workers compensation claims	2,825					2,825
Other current assets	2,210		24	1,628		3,862
<b>Total current assets</b>	<b>17,227</b>	<b>4,906</b>	<b>1,074</b>	<b>1,216</b>	<b>1,898</b>	<b>18,490</b>
Restricted cash	5,349					5,349
Property and equipment, net	95,508	12,917	3,576	6,611	77,936	196,548
Investment in subsidiaries	23,171				(23,171)	
Other assets, net	1,511				355	1,866
<b>Total assets</b>	<b>\$ 142,766</b>	<b>\$ 17,823</b>	<b>\$ 4,650</b>	<b>\$ 7,827</b>	<b>\$ 80,189</b>	<b>\$(31,002)</b>

**Table of Contents****ASSISTED LIVING CONCEPTS, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Unaudited)****Wholly-Owned Subsidiaries**

	<u>ALC, Inc.</u>	<u>ALC Indiana, Inc.</u>	<u>Carriage House</u>	<u>HCI</u>	<u>Non- Participating Subsidiaries</u>	<u>Consolidating Adjustments</u>	<u>Consolidated Total</u>
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>							
Current liabilities:							
Accounts payable	935			6	509		1,450
Payable to subsidiaries/parent	7,157				674	(7,831)	
Accrued real estate taxes	2,451	315	240	90	1,427		4,523
Accrued interest expense	636	30					666
Accrued payroll expense	4,480			6	75		4,561
Other accrued expenses	7,097			11	55		7,163
Tenant security deposits	2,120			18	333		2,471
Other current liabilities	652						652
Current portion of unfavorable lease adjustment	589		92				681
Current portion of long-term debt and capital lease obligation	2,079				543		2,622
<b>Total current liabilities</b>	<b>28,196</b>	<b>345</b>	<b>332</b>	<b>131</b>	<b>3,616</b>	<b>(7,831)</b>	<b>24,789</b>
Other liabilities	11				78		89
Unfavorable lease adjustment	2,686		429				3,115
Long-term debt and capital lease obligation, net of current portion	90,858				70,603		161,461
<b>Total liabilities</b>	<b>121,751</b>	<b>345</b>	<b>761</b>	<b>131</b>	<b>74,297</b>	<b>(7,831)</b>	<b>189,454</b>
Shareholders' equity:							
Common stock	65						65
Additional paid-in capital	20,950	17,478	3,889	7,696	5,892	(23,171)	32,734
Accumulated deficit							
<b>Total shareholders' equity</b>	<b>21,015</b>	<b>17,478</b>	<b>3,889</b>	<b>7,696</b>	<b>5,892</b>	<b>(23,171)</b>	<b>32,799</b>
<b>Total liabilities and shareholders' equity</b>	<b>\$ 142,766</b>	<b>\$ 17,823</b>	<b>\$ 4,650</b>	<b>\$ 7,827</b>	<b>\$ 80,189</b>	<b>\$(31,002)</b>	<b>\$ 222,253</b>

**Table of Contents****ASSISTED LIVING CONCEPTS, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Unaudited)****Successor Company****Consolidating Statements of Operations****Three months ended March 31, 2002**

	<u>Wholly-Owned Subsidiaries</u>					<u>Consolidated Total</u>
	<u>ALC, Inc.</u>	<u>ALC Indiana, Inc.</u>	<u>Carriage House</u>	<u>HCI</u>	<u>Non- Participating Subsidiaries</u>	
Revenue	\$33,828	\$	\$	\$287	\$ 3,774	\$37,889
Operating expenses:						
Residence operating expenses	23,039	71	62	287	2,876	26,335
Corporate general and administrative	4,316					4,316
Building rentals	982					982
Building rentals to related party	1,822		233			2,055
Depreciation and amortization	845	99	32	51	640	1,667
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
Total operating expenses	31,004	170	327	338	3,516	35,355
Operating income (loss)	<u>2,824</u>	<u>(170)</u>	<u>(327)</u>	<u>(51)</u>	<u>258</u>	<u>2,534</u>
Other income (expense):						
Interest expense	(1,633)				(1,528)	(3,161)
Interest expense to related parties	(430)					(430)
Interest income	54					54
Management fee income (expense)	(78)		75	(14)	17	
Lease income (expense)	(1,769)	540			1,229	
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
Total other income (expense), net	(3,856)	540	75	(14)	(282)	(3,537)
Income (loss) before debt restructure and reorganization costs	<u>(1,032)</u>	<u>370</u>	<u>(252)</u>	<u>(65)</u>	<u>(24)</u>	<u>(1,003)</u>
Debt restructure and reorganization costs	447					447
Net income (loss)	<u>\$ (1,479)</u>	<u>\$ 370</u>	<u>\$ (252)</u>	<u>\$ (65)</u>	<u>\$ (24)</u>	<u>\$ (1,450)</u>

**Table of Contents****ASSISTED LIVING CONCEPTS, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Unaudited)****Successor Company****Consolidating Statements of Cash Flows  
Three months ended March 31, 2002**

	Wholly-Owned Subsidiaries				Non- Participating Subsidiaries	Consolidated Total
	ALC, Inc.	ALC Indiana, Inc.	Carriage House	HCI		
<b>Operating Activities:</b>						
Net income (loss)	\$(1,479)	\$ 370	\$(252)	\$(65)	\$ (24)	\$(1,450)
Adjustment to reconcile net income (loss) to net cash provided by (used in) operating activities:						
Depreciation and amortization	845	99	32	51	640	1,667
Amortization of debt issuance costs	20					20
Amortization of fair value adjustment to building rentals	(144)		(23)		(3)	(170)
Amortization of fair market adjustment to long-term debt	4				103	107
Amortization of discount on long-term debt	106					106
Straight line adjustment to building rentals	86					86
Interest paid-in-kind	305					305
Provision (recoveries) for doubtful accounts	26				(13)	13
<b>Changes in assets and liabilities:</b>						
Receivable from subsidiaries/ parent	3,251	(531)	211	4	(2,935)	
Accounts receivable	(116)			11	5	(100)
Prepaid expenses	(2,343)				22	(2,321)
Other current assets	206	(9)	3		45	245
Other assets	(12)				(19)	(31)
Accounts payable	(213)			(4)	(37)	(254)
Payable to subsidiaries/ parent	(1,135)				1,135	
Accrued expenses	1,147	71	62	11	(978)	313
Insurance premium obligation	1,224					1,224
Other current liabilities	(370)				(59)	(429)
Other liabilities	(15)		8			(7)
Net cash provided by (used in) operating activities	<u>1,393</u>	<u>      </u>	<u>41</u>	<u>8</u>	<u>(2,118)</u>	<u>(676)</u>
<b>Investing Activities:</b>						
Increase in restricted cash	(1,719)					(1,719)
Purchases of property and equipment	(355)		(41)	(8)	(221)	(625)
Net cash used in investing activities	<u>(2,074)</u>	<u>      </u>	<u>(41)</u>	<u>(8)</u>	<u>(221)</u>	<u>(2,344)</u>
<b>Financing Activities:</b>						



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Proceeds from long-term debt	(791)				1,791	1,000
Payments on long-term debt and capital lease obligation	(360)					(360)
Debt issuance costs	(79)					(79)
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
Net cash provided by (used in) financing activities	(1,230)				1,791	561
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
Net decrease in cash and cash equivalents	(1,911)				(548)	(2,459)
Cash and cash equivalents, beginning of period	5,259				818	6,077
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
Cash and cash equivalents, end of period	\$ 3,348	\$	\$	\$	\$ 270	\$ 3,618
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>

**Table of Contents****ASSISTED LIVING CONCEPTS, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Unaudited)****Predecessor Company****Consolidating Statements of Operations  
Three months ended March 31, 2001**

	Wholly-Owned Subsidiaries					Consolidated Total
	ALC, Inc.	ALC Indiana, Inc.	Carriage House	HCI	Non- Participating Subsidiaries	
Revenue	\$27,963	\$1,710	\$	\$287	\$6,917	\$36,877
Operating expenses:						
Residence operating expenses	19,527	1,037	84	233	4,677	25,558
Corporate general and administrative	4,268					4,268
Building rentals	761		248		949	1,958
Building rentals to related party	2,213					2,213
Depreciation and amortization	1,665	155	54	112	566	2,552
Total operating expenses	<u>28,434</u>	<u>1,192</u>	<u>386</u>	<u>345</u>	<u>6,192</u>	<u>36,549</u>
Operating income (loss)	<u>(471)</u>	<u>518</u>	<u>(386)</u>	<u>(58)</u>	<u>725</u>	<u>328</u>
Other income (expense):						
Interest expense	(3,637)				(765)	(4,402)
Interest expense to related parties						
Interest income	148					148
Gain/loss on disposal of assets	1	(1)				
Management fee income (expense)	180	(87)	67	(14)	(146)	
Lease income (expense)	(1,229)				1,229	
Other income, net	31					31
Total other income (expense), net	<u>(4,506)</u>	<u>(88)</u>	<u>67</u>	<u>(14)</u>	<u>318</u>	<u>(4,223)</u>
Income (loss) before debt restructure and reorganization costs	(4,977)	430	(319)	(72)	1,043	(3,895)
Debt restructure and reorganization costs	303					303
Net income (loss)	<u>\$ (5,280)</u>	<u>\$ 430</u>	<u>\$ (319)</u>	<u>\$ (72)</u>	<u>\$ 1,043</u>	<u>\$ (4,198)</u>

**Table of Contents****ASSISTED LIVING CONCEPTS, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Unaudited)****Predecessor Company****Consolidating Statements of Cash Flows  
Three months ended March 31, 2001**

	Wholly-Owned Subsidiaries				Consolidated Total	
	ALC, Inc.	ALC Indiana, Inc.	Carriage House	HCI		Non- Participating Subsidiaries
<b>Operating Activities:</b>						
Net income (loss)	\$(5,280)	\$ 430	\$(319)	\$ (72)	\$ 1,043	\$(4,198)
Adjustment to reconcile net income (loss) to net case provided by (used in) operating activities:						
Depreciation and amortization	1,665	155	54	112	566	2,552
Amortization of debt issuance costs						
Amortization of fair value adjustment to building rentals						
Amortization of fair market adjustment to long-term debt						
Amortization of discount on long-term debt						
Straight line adjustment to building rentals						
Interest paid-in-kind						
Provision for doubtful accounts	156					156
<b>Changes in assets and liabilities:</b>						
Receivable from subsidiaries/parent	604	(604)				
Accounts receivable	(188)	(24)		(4)	50	(166)
Prepaid expenses	255			1	26	282
Other current assets	88	1		(1)	290	378
Other assets	(40)	(12)			35	(17)
Accounts payable	(1,801)	(6)		6	1,635	(166)
Payable to subsidiaries/parent	3,636		189	15	(3,840)	
Accrued expenses	(701)	67	83	(29)	(761)	(1,341)
Insurance premium obligation	2,507					2,507
Other current liabilities	(2,343)	(6)		2	33	(2,314)
Other liabilities	(60)		(1)		(45)	(106)
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
Net cash provided by (used in) operating activities	<u>(1,502)</u>	<u>1</u>	<u>6</u>	<u>30</u>	<u>(968)</u>	<u>(2,433)</u>
<b>Investing Activities:</b>						
Increase in restricted cash	(2,081)					(2,081)
Purchases of property and equipment	(329)	(1)	(6)	(30)	(87)	(453)
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
Net cash used in investing activities	<u>(2,410)</u>	<u>(1)</u>	<u>(6)</u>	<u>(30)</u>	<u>(87)</u>	<u>(2,534)</u>
<b>Financing Activities:</b>						
Proceeds from long-term debt	245				1,055	1,300

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Payments on long-term debt and capital lease obligation	(340)					(340)
Debt issuance costs	(1,809)					(1,809)
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
Net cash provided by (used in) financing activities	(1,904)				1,055	(849)
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
Net decrease in cash and cash equivalents	(5,816)					(5,816)
Cash and cash equivalents, beginning of period	9,889					9,889
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
Cash and cash equivalents, end of period	\$ 4,073	\$	\$	\$	\$	\$ 4,073
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>

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

References in this section to ALC, the Company, us or we refer to Assisted Living Concepts, Inc. and its wholly-owned subsidiaries.

#### **General**

We operate, own and lease free-standing assisted living residences in 16 states. These residences are primarily located in small middle-market rural and suburban communities with a population typically ranging from 10,000 to 40,000. We provide personal care and support services, and make available routine nursing services (as permitted by applicable law) designed to meet the personal and health care needs of our residents.

As of March 31, 2002, we operated 183 residences (7,076 units), of which we owned 128 residences (5,010 units) and leased 55 residences (2,105 units).

We derive our revenues primarily from resident fees for room, board and care. Resident fees typically are paid monthly by residents, their families, state Medicaid agencies or other third parties. Resident fees include revenue derived from a multi-tiered rate structure, which varies based on the level of care provided. Resident fees are recognized as revenues when services are provided. Our operating expenses include:

residence operating expenses, such as staff payroll, food, property taxes, utilities, insurance and other direct residence operating expenses;

general and administrative expenses consisting of regional management and corporate support functions such as legal, accounting and other administrative expenses;

building rentals;

depreciation and amortization; and

debt and lease restructure costs.

We anticipate that the majority of our revenues will continue to come from private pay sources. However, we believe that by having located some of our residences in states with favorable regulatory and reimbursement climates, we should have a stable source of residents eligible for Medicaid reimbursement to the extent that private pay residents are not available and, in addition, provide our private pay residents with alternative sources of income when their private funds are depleted and they become Medicaid eligible.

Although we manage the mix of private paying residents and Medicaid paying residents residing in our facilities, any significant increase in our Medicaid population could have an adverse effect on our financial position, results of operations or cash flows, particularly if states operating these programs continue to limit, or more aggressively seek limits on, reimbursement rates. See Risk Factors We Depend on Reimbursement by Third-Party Payors.

#### **Certain Transactions and Events**

##### ***Reorganization***

On October 1, 2001, Assisted Living Concepts, Inc. (the Company), and its wholly owned subsidiary, Carriage House Assisted Living, Inc. voluntarily filed for bankruptcy protection under Chapter 11 of the United States Bankruptcy Code, as amended (the Bankruptcy Code). The bankruptcy court gave final approval to the first amended joint plan of reorganization (the Plan) on December 28, 2001, and the plan became effective on January 1, 2002 (the Effective Date).

Under the Plan, on the Effective Date, the Company issued general unsecured creditors their pro rata shares, subject to the reserve described below (the Reserve), of the following securities:

\$40.25 million principal amount of 10% senior secured notes, due January 1, 2009 (the Senior Secured Notes);



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\$15.25 million principal amount of junior secured notes, due January 1, 2012 (the Junior Secured Notes ); and

6.24 million shares of new common stock (representing 96% of the new common stock).

The Senior Secured Notes and the Junior Secured Notes (collectively the New Notes ) are secured by 57 of our properties.

The remaining 4% of the new common stock, subject to the Reserve, was issued on the Effective Date to the Company s shareholders immediately prior to the Effective Date.

Under the Plan, 1.1% of the senior notes, junior notes and new common stock that would otherwise have been issued on the Effective Date were held back as a reserve (the Reserve ) to cover general unsecured claims that had not been either made or settled by the December 19, 2001 cutoff date established under the Plan. The reserved securities will be issued once all these outstanding general unsecured claims have been settled. If the Reserve is insufficient to cover these outstanding general unsecured claims, we will have no further liability with respect to these claims. If the Reserve exceeds the amount of these outstanding general unsecured claims, the excess securities in the Reserve will be distributed pro rata among the holders of all general unsecured claims, including those settled prior to the cutoff date.

On the Effective Date, a new Board of Directors of the reorganized Company consisting of seven members was established as follows: W. Andrew Adams (Chairman), Andre Dimitriadis, Mark Holliday, Richard Ladd, Matthew Patrick, Leonard Tannenbaum, and Wm. James Nicol, then the President and Chief Executive Officer of the Company. Subsequent to the Effective Date, Steven L. Vick replaced Mr. Nicol as President, Chief Executive Officer and Director.

We adopted fresh-start reporting, as of December 31, 2001, in accordance with the American Institute of Certified Public Accountants Statement of Position 90-7, *Financial Reporting By Entities in Reorganization Under the Bankruptcy Code* (SOP 90-7). Under fresh-starting reporting, a new entity has been deemed created for financial reporting purposes.

***Fresh-Start Reporting***

Upon the Effective Date of our Plan of reorganization, we adopted fresh-start reporting in accordance with the American Institute of Certified Public Accountants Statement of Position 90-7, *Financial Reporting By Entities in Reorganization Under the Bankruptcy Code* (SOP 90-7). In connection with the adoption of fresh-start reporting, a new entity has been deemed created for financial reporting purposes. For financial reporting purposes, we adopted the provisions of fresh-start reporting effective December 31, 2001. Consequently, the consolidated balance sheet and related information at December 31, 2001 is labeled Successor Company, and reflects the Plan and the principles of fresh-start reporting. Periods presented prior to December 31, 2001 have been designated Predecessor Company. For purposes of this Item 2, references to operating results and cash flows for periods ended prior to December 31, 2001 refer to the operating results and cash flows of the Predecessor Company, and references to working capital and other balance sheet data, liquidity and prospective information regarding future periods refer to the Successor Company.

In adopting the requirements of fresh-start reporting as of December 31, 2001, we were required to value our assets and liabilities at their estimated fair value and eliminate our accumulated deficit at December 31, 2001. With the assistance of financial advisors who relied upon various valuation methods including discounted projected cash flows and other applicable ratios and economic industry information relevant to our operations, and through negotiations with the various creditor parties in interest, we determined our reorganization value to be \$32.8 million.

The adjustments to reflect the adoption of fresh-start reporting, including the adjustments to record property, plant and equipment, at their fair values, have been reflected in the consolidated balance sheet as of December 31, 2001. In addition, the Successor Company s balance sheet was further adjusted to eliminate existing liabilities subject to compromise, associated deferred financing costs and deferred gains, goodwill, and the historical consolidated shareholders equity.

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### ***Factors Affecting Comparability of Financial Information***

As a consequence of the implementation of fresh-start reporting effective December 31, 2001 (see Note 3 to the consolidated financial statements included elsewhere herein), the financial information presented in the unaudited consolidated statement of operations and the corresponding statements of cash flows for the three months ended March 31, 2001 are generally not comparable to the financial results for the three months ended March 31, 2002.

The lack of comparability in the accompanying unaudited consolidated financial statements is most apparent in the Company's capital costs (building rentals, interest, depreciation and amortization), as well as with debt restructuring and reorganization costs.

### ***Management Changes***

In February 2002, Steven L. Vick replaced Wm. James Nicol as President and Chief Executive Officer. Effective May 16, 2002, Matthew Patrick replaced Drew Q. Miller as Senior Vice President, Chief Financial Officer and Treasurer. Mr. Vick and Mr. Patrick also serve as Directors of the Company.

### ***Sale of Existing Residences***

We closed one residence in Indiana in March 2002. This residence is currently being listed for sale. This residence serves as collateral for our New Notes and, therefore, any net proceeds received from the sale of this residence must be used to reduce the outstanding principal amount of the New Notes.

In addition, we are currently negotiating the sale of four of our residences in Florida and one residence in Georgia. These five residences serve as collateral for our New Notes and any potential proceeds from the sale will be used to reduce the outstanding principal amount of the New Notes.

### **Critical Accounting Policies and Estimates**

The discussion and analysis of our financial condition and results of operations are based upon our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses and related disclosure of contingent assets and liabilities. On an on-going basis, we evaluate these estimates, including those related to bad debts, income taxes, financing operations, contingencies and litigation. We base our estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions.

We believe the following critical accounting policies require significant judgment and estimates used in the preparation of our consolidated financial statements:

*Fresh-Start Reporting.* Upon the Effective Date of our Plan of reorganization we adopted fresh-start reporting in accordance with SOP 90-7. For financial reporting purposes, we were required to value our assets and liabilities at their current fair value. With assistance of financial advisors in reliance upon various valuation methods, including discounted projected cash flow analysis and other applicable ratios and economic industry information relevant to our operations and through negotiations with various creditor parties in interest, we determined a reorganization value of \$32.8 million. The reorganization value was allocated to our assets and liabilities based upon their fair value.

The determination of fair value of assets and liabilities required significant estimates and judgments made by management, particularly as it related to the fair market value of our debt, operating leases and property, plant and equipment. The fair value of our debt at December 31, 2001 was determined based upon the then current effective interest rates for similar debt instruments. The fair value of our leases and property, plant and



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equipment were based on the then current market rentals and building values. Results may differ under different assumptions or conditions.

*Income Taxes.* Historically, we have not recorded a provision for income taxes as we had generated a loss for both financial reporting and tax purposes. We have recorded a 100% valuation allowance for our net deferred tax assets as we believe it is more likely than not that the benefit will not be realized. Pursuant to SOP 90-7, the income tax benefit, if any, of any future realization of the remaining NOL carryforwards and other deductible temporary differences existing as of the Effective Date will be applied as a reduction to additional paid-in capital.

**Results of Operations**

The following table sets forth, for the periods presented, operating expenses as a percentage of revenue, the number of total residences and units operated, average occupancy and rental rates and the sources of our revenue. The portion of revenues received from state Medicaid agencies are labeled as Medicaid state paid portion while the portion of our revenues that a Medicaid-eligible resident must pay out of his or her own resources is labeled Medicaid resident paid portion.

	Three Months Ended March 31,	
	Predecessor Company	Successor Company
	2001	2002
Revenue	100.0%	100.0%
Operating expenses:		
Residence operating expenses	69.3	69.5
Corporate general and administrative	11.6	11.4
Building rentals	11.3	8.0
Depreciation and amortization	6.9	4.4
	<u>99.1</u>	<u>93.3</u>
Operating income	0.9	6.7
Other income (expense):		
Interest expense	(11.9)	(9.5)
Interest income	0.4	0.1
Other income, net	0.1	
	<u>(11.4)</u>	<u>(9.4)</u>
Loss before debt restructure and reorganization costs	(10.5)	(2.7)
Debt restructure and reorganization costs	0.8	1.2
	<u>(11.3)%</u>	<u>(3.9)%</u>
Other Data:		
Residences operated (end of period)	185	183
Units operated (end of period)	7,149	7,076
Average occupancy rate (based on occupied units)	83.4%	83.1%
End of period occupancy rate (based on occupied units)	83.3%	82.8%
Average monthly rental rate	\$2,041	\$2,117
Sources of revenue:		
Medicaid state paid portion	12.1%	12.5%
Medicaid resident paid portion	7.2%	6.8%
Private resident paid portion	80.7%	80.7%

Total	<u>100.0%</u>	<u>100.0%</u>
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The following table sets forth, for the periods presented, the results of operations for the three months ended March 31, 2001 compared to March 31, 2002 (in millions, except percentages):

	2001	2002	Consolidated Three Months Ended March 31,	
	Predecessor Company	Successor Company	Increase/(Decrease	
Revenue	\$36.9	\$37.9	\$ 1.0	2.7%
Operating expenses:				
Residence operating expenses	25.6	26.3	0.7	2.7
Corporate general and administrative	4.3	4.3		
Building rentals	4.2	3.1	(1.1)	(26.2)
Depreciation and amortization	2.5	1.7	(0.8)	(32.0)
Total operating expenses	36.6	35.4	(1.2)	(3.3)
Operating income	0.3	2.5	2.2	733.3
Other income (expense):				
Interest expense	(4.4)	(3.6)	0.8	18.2
Interest income	0.2		(0.2)	(100.0)
Total other expense	(4.2)	(3.6)	0.6	14.3
Loss before debt restructure and reorganization costs	(3.9)	(1.1)	2.8	71.8%
Debt restructure and reorganization costs	0.3	0.4	0.1	33.3
Net loss	\$ (4.2)	\$ (1.5)	\$ 2.7	64.3%

**Three months ended March 31, 2002 compared to three months ended March 31, 2001:**

We incurred a net loss of \$1.5 million, or \$0.22 per basic and diluted common share, on revenue of \$37.9 million for the three months ended March 31, 2002 (the March 2002 Quarter) as compared to a net loss of \$4.2 million or \$0.25 per basic and diluted common share, on revenues of \$36.9 million for the three months ended March 31, 2001 (the March 2001 Quarter).

**Revenues.** Revenues were \$37.9 million for the March 2002 Quarter as compared to \$36.9 million for the March 2001 Quarter, a net increase of \$1.0 million. The increase in revenue was attributable to an increase in the average monthly rental rate to \$2,117 for the March 2002 Quarter as compared to an average monthly rental rate of \$2,041 for March 2001 Quarter. The increase in revenue due to increase in average monthly rental rates was offset by a decline in average occupancy from 83.4% in the March 2001 Quarter to 83.1% in the March 2002 Quarter. Additionally, revenue for the March 2001 Quarter included \$149,000 of revenue for one residence which is no longer being operated by us due to the termination of our lease agreement, effective December 1, 2001.

**Residence Operating Expenses.** Residence operating expenses were \$26.3 million for the March 2002 Quarter as compared to \$25.6 million for the March 2001 Quarter, a net increase of \$777,000.

The principal elements of the increase in these expenses include:

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\$1.0 million related to an increase in payroll costs as a result of increases in wages and benefits; and

\$432,000 related to increases in professional and property liability insurance premiums.

These increases were offset by:

\$135,000 of operating expenses included in the March 2001 Quarter results which related to one residence which is no longer being operated by us due to the termination of our lease agreement, effective December 1, 2001;

\$283,000 related to decreases in utility costs; and

\$237,000 in other expenses.

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*Corporate, General and Administrative.* Corporate, general and administrative expenses remained consistent for the March 2002 Quarter as compared to the March 2001 Quarter at \$4.3 million.

*Building Rentals.* Building rentals were \$3.0 million for the March 2002 Quarter as compared to \$4.2 million for the March 2001 Quarter, a decrease of \$1.2 million.

The decrease in building rentals include:

\$949,000 of building rental expense is excluded from the March 2002 Quarter due to the October 2001 repurchase of 16 properties previously leased;

\$65,000 of building rental expense is included in March 2001 Quarter related to an operating lease terminated on December 1, 2001; and

\$219,000 due to rental concessions received from one lessor as a result of the bankruptcy process.

*Depreciation and Amortization.* Depreciation and amortization expense was \$1.7 million in the March 2002 Quarter as compared to \$2.6 million in the March 2001 Quarter. The decrease is primarily due to impact of fresh-start reporting on the carrying value of property and equipment, which were adjusted to their estimated fair value as of December 31, 2001.

*Interest Expense.* Interest expense was \$3.6 million for the March 2002 Quarter compared to \$4.4 million for the March 2001 Quarter, a decrease of \$811,000. The decrease is due to the overall reduction of indebtedness following the Company's Plan of reorganization which became effective on January 1, 2002.

*Interest Income.* Interest income was \$54,000 for the March 2002 Quarter compared to \$148,000 for the March 2001 Quarter, a decrease of \$94,000. This decrease is the result of decreased balances in cash and cash equivalents.

*Debt Restructure and Reorganization Costs.* Debt restructure and reorganization costs were \$447,000 for the March 2002 Quarter as compared to \$303,000 for the March 2001 Quarter. These are professional fees, including legal and investment advisory fees, related to the Company's Plan of reorganization which became effective January 1, 2002. We will continue to incur costs related to the reorganization until all general and unsecured claims are settled which is expected to occur within the next six months.

*Income Taxes.* We have provided no benefit for income taxes as we have recorded a full valuation allowance on our deferred tax assets. Management believes it is more likely than not that some portion or all of the deferred tax assets will not be realized.

*Net Loss.* As a result of the above, we incurred a net loss of \$1.5 million or \$0.22 per basic and diluted common share for the March 2002 Quarter, compared to a net loss of \$4.2 million, or \$0.25 per basic and diluted common share, for the March 2001 Quarter.

## **Liquidity and Capital Resources**

At March 31, 2002, we had a working capital deficit of \$5.7 million and unrestricted cash and cash equivalents of \$3.6 million.

Net cash used in operating activities was \$676,000 during the three months ended March 31, 2002. The primary uses included the payment of \$3.4 million related to our 2002 property and professional liability insurance. These reductions were partially offset by an increase in insurance premium obligations of \$1.2 million. During the three months ended March 31, 2002, we entered into several short-term agreements to finance our annual insurance premiums. These agreements mature in September 2002 and bear interest at annual fixed rates of approximately 5.5% to 6.0%.

Net cash used in investing activities was \$2.3 million during the three months ended March 31, 2002. The primary use was an increase of \$1.7 million in restricted cash related to workers' compensation deposits required by our insurance carrier. Funds will be withdrawn from this account as workers' compensation claims are incurred and paid.

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Net cash provided by financing activities was \$561,000 during the three months ended March 31, 2002. Proceeds of \$1.0 million were received on a draw of our \$44.0 million line of credit with G.E. Capital. Principal payments on long-term debt and capital lease obligations were \$360,000 for the three months ended March 31, 2002.

As of March 31, 2002, approximately \$26.2 million of our indebtedness was secured by letters of credit issued by U.S. Bank, which in some cases, have termination dates prior to the maturity of the underlying debt. As such letters of credit expire, beginning in 2003, we will need to obtain replacement letters of credit, post cash collateral or refinance the underlying debt. There can be no assurance that we will be able to procure replacement letters of credit from the same or other lending institutions on terms that are acceptable to us. In the event that we are unable to obtain a replacement letter of credit or provide alternate collateral prior to the expiration of any of these letters of credit, we would be in default on the underlying debt.

Our credit agreements with U.S. Bank contain restrictive covenants, including certain financial ratios. The agreements also require us to deposit \$500,000 in cash collateral with U.S. Bank in the event certain regulatory actions are commenced with respect to the properties securing our obligations to U.S. Bank. U.S. Bank is required to release such deposits upon satisfactory resolution of the regulatory action. As of the date of this filing, no such additional deposits have been required.

In May 2002, we received a waiver from U.S. Bank regarding the Bank's right to declare an event of default for our failure to meet the March 31, 2002 financial covenant requirements established for the Predecessor Company set forth in the amended U.S. Bank loan agreement. Furthermore, we amended our existing agreement with U.S. Bank, establishing new covenants, with which we were in compliance as of March 31, 2002.

Failure to comply with any covenant constitutes an event of default, which will allow U.S. Bank (at its discretion) to declare any amounts outstanding under the loan documents to be due and payable. Certain of our leases and loan agreements contain covenants and cross-default provisions such that a default on one of those agreements could cause us to be in default on one or more other agreements which would have a material adverse effect on the Company.

We have future minimum annual lease payments over the next five years of \$13.1 million, \$13.1 million, \$13.3 million, \$12.8 million and \$12.9 million, respectively. At March 31, 2002, we had \$166.6 million of long-term indebtedness, of which annual principal payments due over the next five years are \$2.6 million, \$2.7 million, \$2.9 million, \$41.3 million and \$2.3 million, respectively.

Our ability to make payments on and to refinance any of our indebtedness, to satisfy our lease obligations and to fund planned capital expenditures will depend on our ability to generate cash in the future. This, to a certain extent, is subject to general economic, financial, competitive, legislative, regulatory and other factors that are beyond our control. In addition, our ability to draw additional amounts under our G.E. Capital facility may depend on us satisfying certain conditions to draw additional amounts under the facility.

Based upon our current level of operations, we believe that our current cash on hand, available credit under our G.E. Capital facility and cash flow from operations are sufficient to meet our liquidity needs for at least the next twelve months.

There can be no assurance, however, that our business will generate sufficient cash flow from operations, that currently anticipated cost savings and operating improvements will be realized on schedule or that we will satisfy the conditions to draw additional amounts under the G.E. Capital facility, all of which may be necessary to enable us to pay our indebtedness, to satisfy our lease obligations and to fund our other liquidity needs. As a result, we may need to refinance all or a portion of our indebtedness, on or before maturity. There can be no assurance that we will be able to refinance any of our indebtedness, on commercially reasonable terms or at all.

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**Risk Factors**

Set forth below are various risks that we believe are material. This report on Form 10-Q, including the risks discussed below, contain statements including, without limitation, statements containing the words will, believes, anticipates, estimates, intends, expects, should, and words of similar import, constitute forward looking statements and are made pursuant to the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. These forward-looking statements may be affected by risks and uncertainties, including without limitation (i) our ability to control costs and improve operating margins, (ii) the possibility that we will experience a decrease in occupancy in our residences, which would adversely affect residence revenues and operating margins, (iii) our ability to operate our residences in compliance with evolving regulatory requirements, and (iv) the degree to which our future operating results and financial condition may be affected by a reduction in Medicaid reimbursement rates. In light of such risks and uncertainties, our actual results could differ materially from such forward-looking statements. Readers are cautioned not to place undue reliance on forward-looking statements, which speak only as of this date of this Form 10-Q. Except as may be required by law, we do not undertake any obligation to publicly release any revisions to any forward-looking statements contained herein to reflect events and circumstances occurring after the date hereof or to reflect the occurrence of unanticipated events.

***We are highly leveraged; our loan and lease agreements contain financial covenants.***

We are highly leveraged. We had total indebtedness, including short-term portion, of \$166.6 million and shareholders' equity of \$31.3 million as of March 31, 2002. We obtained some relief through the implementation of our Plan but will continue to be highly leveraged (see Notes 3 and 9 of the consolidated financial statements included elsewhere herein). The degree to which we are leveraged could have important consequences, including:

making it difficult to satisfy our debt or lease obligations;

increasing our vulnerability to general adverse economic and industry conditions;

limiting our ability to obtain additional financing;

requiring dedication of a substantial portion of our cash flow from operations to the payment of principal and interest on our debt and leases, thereby reducing the availability of such cash flow to fund working capital, capital expenditures or other general corporate purposes;

limiting our flexibility in planning for, or reacting to, changes in our business or industry; and

placing us at a competitive disadvantage to less leveraged competitors.

On March 31, 2002 we did not meet the financial requirements established for the Predecessor Company as set forth in the amended U.S. Bank loan agreement. In May 2002, we received a waiver from U.S. Bank regarding the Bank's right to declare an event of default for our failure to meet the March 31, 2002 financial requirements set forth in the amended U.S. Bank loan agreement. Furthermore, we amended our existing agreement with U.S. Bank, establishing new covenants, with which we were in compliance as of March 31, 2002.

Failure to comply with any covenant constitutes an event of default, which will allow U.S. Bank (at its discretion) to declare any amounts outstanding under the loan documents to be due and payable. We cannot provide assurance that we will comply in the future with the modified financial covenants included in the agreement, or with the financial covenants set forth in our other debt agreements and leases. If we fail to comply with one or more of the U.S. Bank covenants or any other debt or lease covenants (after giving effect to any applicable cure period), the lender or lessor may declare us in default of the underlying obligation and exercise any available remedies, which may include:

in the case of debt, declaring the entire amount of the debt immediately due and payable;

foreclosing on any residences or other collateral securing the obligation; and

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in the case of a lease, terminating the lease and suing for damages.

Many of our debt instruments and leases contain cross-default provisions pursuant to which a default under one obligation can cause a default under one or more other obligations. Accordingly, if enforced, we could experience a material adverse effect on our financial condition.

***If an active trading market does not develop for our securities, holders may not be able to resell those securities.***

Our common stock currently trades on the over-the-counter bulletin board ( OTC.BB ) under the symbol ASLC . At this time there can be no assurances that our securities will ever be listed on any exchange, or that there will be an active trading market for our common stock.

***We are involved in a dispute with our corporate liability insurance carrier.***

In September 2000, we reached an agreement to settle the class action litigation relating to the restatement of our consolidated financial statements for the years ended December 31, 1996 and 1997 and the first three fiscal quarters of 1998. This agreement received final court approval on November 30, 2000 and we were dismissed from the litigation with prejudice. On September 28, 2001, we made our final installment of \$1.0 million on our promissory note for the class action litigation settlement. Although we were dismissed from the litigation with prejudice, a dispute which arose with our corporate liability insurance carriers remains unresolved. At the time we settled the class action litigation, the Company and the insurance carriers agreed to resolve this dispute through binding arbitration, and we filed a complaint for a declaratory judgment that we are not liable to the carriers as claimed. The carriers counter-claimed to recover an amount capped at \$4.0 million.

After filing for bankruptcy on October 1, 2001, we made a motion for dismissal of our complaint for declaratory relief in the arbitration based upon having filed for bankruptcy protection. An objection was filed to our motion, and one of our insurance carriers filed a proof of claim in the amount of \$4.0 million in the bankruptcy proceeding. We dispute that claim. We offered (and the offer currently remains outstanding) to settle the dispute for \$75,000 to be paid out as an Allowed Class 4 Claim in the bankruptcy process. See Note 3 to the consolidated financial statements included elsewhere herein.

***We are party to other legal proceedings.***

Participants in the senior living and long-term care industry, including us, are routinely subject to lawsuits and claims. Many of the persons who bring these lawsuits and claims seek significant monetary damages, and these lawsuits and claims often result in significant defense costs. As a result, the defense and ultimate outcome of lawsuits and claims against us may result in higher operating expenses. Those higher operating expenses could have a material adverse effect on our business, financial condition, results of operations, cash flow or liquidity.

***Certain of our leases may be terminated as result of increase in concentrated ownership in our common stock and upon occurrence of other events.***

Certain of our leases with LTC Properties, Inc. ( LTC ) provide LTC with the option to exercise certain remedies, including the termination of many of our leases with LTC, upon a change of control under which at least 30% ownership of our common stock is held by a party or combination of parties directly or indirectly. LTC has the same option if the stockholders approve a plan of liquidation or the stockholders approve of a merger or consolidation that meets certain conditions.

***We may be liable for losses not covered by or in excess of our insurance.***

In order to protect ourselves against the lawsuits and claims made against us, we currently maintain insurance policies in amounts and covering risks that are consistent with industry practice. However, as a result of poor loss experience, a number of insurance carriers have stopped providing insurance coverage to the



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long-term care industry, and those remaining have increased premiums and deductibles substantially. While nursing homes have been primarily affected, assisted living companies, including us, have experienced premium and deductible increases. We currently have a retention level of \$250,000 per incident, except in Florida and Texas where the retention level is \$500,000 per incident. Our professional liability insurance is on a claims-made basis. In certain states, particularly Florida and Texas, many long-term care providers are facing very difficult renewals. There can be no assurance that we will be able to obtain liability insurance in the future on commercially reasonable terms or at all. A claim against us, covered by, or in excess of, our insurance, could have a material adverse affect on our operations and cash flows.

***We are subject to significant government regulation.***

The operation of assisted living facilities and the provision of health care services are subject to state and federal laws, and state and local licensure, certification and inspection laws that regulate, among other matters:

- the number of licensed residences and units per residence;
- the provision of services;
- equipment;
- staffing, including professional licensing and criminal background checks;
- operating policies and procedures;
- fire prevention measures;
- environmental matters;
- resident characteristics;
- physical design and compliance with building and safety codes;
- confidentiality of medical information;
- safe working conditions;
- family leave; and
- disposal of medical waste.

The cost of compliance with these regulations is significant. In addition, it could adversely affect our financial condition or results of operations if a court or regulatory tribunal were to determine we have failed to comply with any of these laws or regulations. Because these laws and regulations are amended from time to time, we cannot predict when and to what extent liability may arise. See We must comply with laws and regulations regarding the confidentiality of medical information, We must comply with restrictions imposed by laws benefiting disabled persons , We may incur significant costs and liability as a result of medical waste and We may incur significant costs related to environmental remediation or compliance.

In the ordinary course of business, we receive and have received notices of deficiencies for failure to comply with various regulatory requirements. We review such notices and, in most cases, will agree with the regulator upon the steps to be taken to bring the facility into compliance with regulatory requirements. From time to time, we may dispute the matter and sometimes will seek a hearing if we do not agree with the regulator. In some cases or upon repeat violations, the regulator may take one or more adverse actions against a facility, such as:

- the imposition of fines the Company paid \$15,000 and \$1,200, respectively, in the aggregate for the year ended December 31, 2001 and the quarter ended March 31, 2002;

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temporary stop placement of admission of new residents, or imposition of other conditions to admission of new residents to a facility;

termination of a facility's Medicaid contract;

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conversion of a facility's license to provisional status; and

suspension or revocation of a facility's license, which in 2001 included one residence in Washington against which the state has commenced license revocation procedures. This matter is still pending as of the date of this filing.

The operation of our residences is subject to state and federal laws prohibiting fraud by health care providers, including criminal provisions, which prohibit filing false claims or making false statements to receive payment or certification under Medicaid, or failing to refund overpayments or improper payments. Violation of these criminal provisions is a felony punishable by imprisonment and/or fines. We may be subject to fines and treble damage claims if we violate the civil provisions which prohibit the knowing filing of a false claim or the knowing use of false statements to obtain payment.

State and federal governments are devoting increasing attention and resources to anti-fraud initiatives against health care providers. The Health Insurance Portability and Accountability Act of 1996 (HIPAA) and the Balanced Budget Act of 1997 expanded the penalties for health care fraud, including broader provisions for the exclusion of providers from the Medicaid program. We have established policies and procedures that we believe are sufficient to ensure that our facilities will operate in substantial compliance with these anti-fraud and abuse requirements. While we believe that our business practices are consistent with Medicaid criteria, those criteria are often vague and subject to change and interpretation. Aggressive anti-fraud actions, however, could have an adverse effect on our financial position, results of operations or cash flows.

We are subject to regulation by the Securities and Exchange Commission (SEC). In April, 1999, we received a preliminary inquiry from the SEC regarding the restatement of our financial statements for the years ended December 31, 1996 and 1997 and the first three quarters of 1998 and related matters. We provided the SEC with information and documents in response to the inquiry, and have received no correspondence from the SEC regarding the inquiry since March 2000. The SEC has never alleged any violation of law in connection with the inquiry. There can be no assurance that the SEC will not resume its inquiry.

***We must comply with laws and regulations regarding the confidentiality of medical information.***

In 1996, the HIPAA law created comprehensive new requirements regarding the confidentiality of medical information that is or has been electronically transmitted or maintained. The Department of Health and Human Services has enacted regulations implementing the law, and we may have to significantly change the way we maintain and transmit healthcare information for our residents to comply with these regulations.

Although HIPAA was intended ultimately to reduce administrative expenses and burdens faced within the health care industry, we believe the law could initially bring about significant and, in some cases, costly changes. HHS has released two rules to date mandating the use of new standards with respect to certain health care transactions and health information. The first rule requires the use of uniform standards for 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.

Second, HHS has released new standards relating to the privacy of individually identifiable health information. These standards not only require our operators' compliance with rules governing the use and disclosure of protected health information, but they also require entities to impose those rules, by contract, on any business associate to whom such information is disclosed. Rules governing the security of health information have been proposed but have not yet been issued in final form.

HHS finalized the new transaction standards on August 17, 2000, and covered entities will be required to comply with them by October 16, 2002. Congress passed legislation in December 2001 that delays for one year (to October 16, 2003) the compliance date, but only for entities that submit a compliance plan to HHS by the original implementation deadline. The privacy standards were issued on December 28, 2000, and, after certain delays, became effective April 14, 2001, with a compliance date of April 14, 2003. The Bush Administration

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and Congress are taking a careful look at the existing regulations, but it is uncertain whether there will be additional changes to the privacy standards or their compliance date. With respect to the security regulation, once they are issued in final form, affected parties will have approximately two years to be fully compliant. Sanctions for failing to comply with HIPAA include criminal penalties and civil sanctions.

***We must comply with restrictions imposed by laws benefiting disabled persons.***

Under the Americans with Disabilities Act of 1990, all places of public accommodation are required to meet certain federal requirements related to access and use by disabled persons. A number of additional federal, state and local laws exist that also may require us to modify existing residences to allow disabled persons to access the residences. We believe that their residences are either substantially in compliance with present requirements or are exempt from them. However, if required changes cost more than anticipated, or must be made sooner than anticipated, we would incur additional costs. Further legislation may impose additional burdens or restrictions related to access by disabled persons, and the costs of compliance could be substantial.

***We may incur significant costs and liability as a result of medical waste.***

Our facilities generate potentially infectious waste due to the illness or physical condition of the residents, including blood-soaked bandages, swabs and other medical waste products and incontinence products of those residents diagnosed with infectious diseases. The management of potentially infectious medical waste, including handling, storage, transportation, treatment and disposal, is subject to regulation under federal and state laws. These laws and regulations set forth requirements for managing medical waste, as well as permit, record keeping, notice and reporting obligations. Any finding that we are not in compliance with these laws and regulations could adversely affect our business operations and financial condition. Because these laws and regulations are amended from time to time, we cannot predict when and to what extent liability may arise. In addition, because these environmental laws vary from state to state, expansion of our operations to states where they do not currently operate may subject us to additional restrictions on the manner in which they operate their facilities.

We may be liable under some laws and regulations as an owner, operator or an entity that arranges for the disposal of hazardous or toxic substances at a disposal site. In that event, we may be liable for the costs of any required remediation or removal of the hazardous or toxic substances at the disposal site. In connection with the ownership or operation of our properties, we could be liable for these costs, as well as some other costs, including governmental fines and injuries to persons or properties. As a result, any hazardous or toxic substances which are present, with or without our knowledge, at any property held or operated by us could have an adverse effect on our business, financial condition or results of operations.

***We could incur significant costs related to environmental remediation or compliance.***

We are subject to various federal, state and local environmental laws, ordinances and regulations. Some of these laws, ordinances and regulations hold a current or previous owner, lessee or operator of real property liable for the cost of removal or remediation of some hazardous or toxic substances that could be located on, in or under such property. These laws and regulations often impose liability whether or not we knew of, or were responsible for, the presence of the hazardous or toxic substances. The costs of any required remediation or removal of these substances could be substantial. Furthermore, there is no limit to our liability under such laws and regulations. As a result, our liability could exceed their property's value and aggregate assets. The presence of these substances or failure to remediate these substances properly may also adversely affect our ability to sell our property, or to borrow using the property as collateral.

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***Many assisted living markets have been overbuilt.***

Many assisted living markets have been overbuilt, including certain markets in which we currently operate. In addition, the barriers to entry into the assisted living industry are not substantial. The effects of overbuilding include:

- it takes significantly longer for our residences and our subsidiaries' residences to fill up,
- newly opened facilities may attract residents from some or all of our current facilities,
- there is pressure to lower or not increase rates paid by residents in our residences,
- there is increased competition for workers in already tight labor markets, and
- our profit margins are lower until vacant units in our residences are filled.

If we are unable to compete effectively in markets as a result of overbuilding, we will suffer lower revenue and may suffer a loss of market share.

Due to market conditions facing one location in Indiana, we closed the facility, effective March 15, 2002.

***We may not be able to attract and retain qualified employees and control labor costs.***

We compete with other providers of long-term care with respect to attracting and retaining qualified personnel. A shortage of qualified personnel may require us to enhance our wage and benefits packages in order to compete. Some of the states in which we operate impose licensing requirements on individuals serving as administrators at assisted living residences, and others may adopt similar requirements. We also depend upon the available labor pool of lower-wage employees. We cannot guarantee that our labor costs will not increase, or that, if they do increase, they can be matched by corresponding increases in revenues.

***Our business relies heavily on certain markets and an economic downturn or changes in the laws affecting our business in those markets could have a material adverse effect on our results.***

Our business depends significantly on our properties located in Texas, Indiana, Oregon, Ohio and Washington. As of March 31, 2002, 21.9% of our residences were located in Texas, 10.9% in Indiana, 9.8% in Oregon, 9.8% in Ohio and 8.7% in Washington. An economic downturn, or changes in the laws affecting our business, in these markets could have a material adverse effect on our operating results.

***We depend on reimbursement by governmental payors and other third parties for a significant portion of our revenues.***

Although revenues at a majority of our residences come primarily from private payors, we derive a substantial portion of our revenues from reimbursements by third-party governmental payors, including state Medicaid waiver programs. We expect that state Medicaid waiver programs will continue to constitute a significant source of our revenues in the future, and it is possible that the proportionate percentage of revenue received by us from Medicaid waiver programs will increase. There are continuing efforts by governmental payors and by non-governmental payors, such as commercial insurance companies and health maintenance organizations, to contain or reduce the costs of health care by lowering reimbursement rates, increasing case management review of services and negotiating reduced contract pricing. Also, there have been, and we expect that there will continue to be, additional proposals to reduce the federal and some state budget deficits by limiting Medicaid reimbursement in general. If any of these proposals are adopted at either the federal or the state level, it could have a material adverse effect on our business, financial condition, results of operations and prospects. The state of Washington recently approved legislation which would limit future increase in rental reimbursements and may actually reduce current reimbursement rates. Additionally, the state of New Jersey currently has limited additional beds for eligible Medicaid residences. This may limit our ability to move new Medicaid residents into our New Jersey facilities or to retain residents who reach Medicaid eligibility while living in our New Jersey facilities.

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The following table sets forth the sources of our revenue for states where we participate in Medicaid programs. The portion of revenues received from state Medicaid agencies are labeled as **Medicaid State Paid Portion** while the portion of our revenues that a Medicaid-eligible resident must pay out of his or her own resources is labeled **Medicaid Resident Paid Portion**.

	Three Months Ended March 31, 2001			Three Months Ended March 31, 2002		
	Medicaid		Private	Medicaid		Private
	State Paid Portion	Resident Paid Portion	Resident Paid Portion	State Paid Portion	Resident Paid Portion	Resident Paid Portion
Oregon	29.4%	17.8%	52.8%	25.3%	14.6%	60.1%
Washington	29.8%	17.8%	52.4%	29.9%	17.2%	52.9%
Idaho	13.3%	10.6%	76.1%	14.0%	10.9%	75.1%
Arizona	13.7%	10.7%	75.6%	17.4%	15.2%	67.4%
New Jersey	16.7%	9.3%	74.0%	27.1%	4.7%	68.2%
Texas	15.5%	8.2%	76.3%	15.6%	8.0%	76.4%
Nebraska	8.5%	5.5%	86.0%	10.3%	6.4%	83.3%

In addition, although we manage the mix of private paying residents and Medicaid paying residents residing in our facilities, any significant increase in our Medicaid population could have a material adverse effect on our financial position, results of operations or cash flows, particularly if the states operating these programs continue to limit, or more aggressively seek limits on, reimbursement rates.

**Item 3. Quantitative and Qualitative Disclosure About Market Risk**

Market risk represents the risk of changes in value of a financial instrument, derivative or non-derivative, caused by fluctuations in interest rates, foreign exchange rates and equity prices. Changes in these factors could cause fluctuations in our results of operations and cash flows.

For fixed rate debt, changes in interest rates generally affect the fair market value of the debt instrument, but not our results of operations or cash flows. We do not have an obligation to prepay any of our fixed rate debt prior to maturity, and therefore, interest rate risk and changes in the fair market value of our fixed rate debt will not have an impact on our results of operations or cash flows until we decide, or are required, to refinance such debt.

For variable rate debt, changes in interest rates generally do not impact the fair market value of the debt instrument, but do affect our future results of operations and cash flows. We had variable rate debt of \$67.6 million outstanding at March 31, 2002 with a weighted average interest rate of 5.5%, of which \$41.4 million has an interest rate floor of 8.0%. Assuming that our balance of variable rate debt, excluding \$41.4 million which has an interest rate floor of 8.0%, remains constant at \$26.2 million, each one-percent increase in interest rates would result in an annual increase in interest expense, and a corresponding decrease in cash flows, of \$262,000. Conversely, each one-percent decrease in interest rates would result in an annual decrease in interest expense, and a corresponding increase in cash flows, of \$262,000. For our \$41.4 million of variable rate debt which has a interest rate floor of 8.0%, each one-percent increase in interest rates in excess of 8.0% would result in an annual increase in interest expense, and a corresponding decrease in cash flows, of \$414,000. Conversely, each one-percent decrease at interest rates of 9.0% or greater would result in an annual decrease in interest expense, and a corresponding increase in cash flows, of \$414,000.

We are also exposed to market risks from fluctuations in interest rates and the effects of those fluctuations on market values of our cash equivalents and short-term investments. These investments generally consist of overnight investments that are not significantly exposed to interest rate risk, except to the extent that changes in interest rates will ultimately affect the amount of interest income earned and cash flow from these investments.

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We do not have any derivative financial instruments in place to manage interest costs, but that does not mean we will not use them as a means to manage interest rate risk in the future.

We do not use foreign currency exchange forward contracts or commodity contracts and do not have foreign currency exposure.

**PART II OTHER INFORMATION**

**Item 1. Legal Proceedings**

***Insurance Coverage Dispute***

In September, 2000, the Company reached an agreement to settle the class action litigation relating to the restatement of its consolidated financial statements for the years ended December 31, 1996 and 1997 and the first three fiscal quarters of 1998. This agreement received final court approval on November 30, 2000 and the Company was dismissed from the litigation with prejudice. On September 28, 2001, the Company made its final installment of \$1.0 million on its promissory note for the class action litigation settlement. Although the Company was dismissed from the litigation with prejudice, a dispute which arose with its corporate liability insurance carriers remains unresolved. At the time the Company settled the class action litigation, the Company and the insurance carriers agreed to resolve this dispute through binding arbitration, and the Company filed a complaint for a declaratory judgment that it was not liable to the carriers as claimed. The carriers counter-claimed to recover an amount capped at \$4.0 million.

After filing for bankruptcy on October 1, 2001, the Company made a motion for dismissal of its complaint for declaratory relief in the arbitration based upon having filed for bankruptcy protection. An objection was filed to its motion, and one of its insurance carriers filed a proof of claim in the amount of \$4.0 million in the bankruptcy proceeding. The Company disputes that claim. The Company offered (and the offer currently remains outstanding) to settle the dispute for \$75,000 to be paid out as a general unsecured claim in the bankruptcy process. (See Note 3 to the consolidated financial statements included elsewhere herein).

In addition to the matter referred to in the immediately preceding paragraphs, the Company is involved in various lawsuits and claims arising in the normal course of business. In the aggregate, such other suits and claims should not have a material adverse effect on the Company's financial condition, results of operations, cash flow and liquidity.

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

The Company's annual shareholder meeting was held on May 8, 2002. At this meeting the shareholders elected the seven current directors and approved the 2002 Incentive Award Plan ( Stock Option Plan ). The Company has reserved 650,000 shares of common stock for issuance under the Stock Option Plan.

**Item 6. Exhibits and Reports on Form 8-K**

(a) The following documents are filed as part of this report:

<b>Exhibit Number</b>	
12	Ratio of Earnings to Fixed Charges

(b) Reports on Form 8-K.

We filed a report on Form 8-K on January 24, 2002 pursuant to Item 5 of Form 8-K announcing the appointment of Steven L. Vick as President and Chief Executive Officer.





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**SIGNATURES**

Pursuant to the requirements of Sections 13 or 15(d) the Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

ASSISTED LIVING CONCEPTS, INC.  
Registrant

By: /s/ MATTHEW PATRICK

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Name: Matthew Patrick  
Title: *Senior Vice President,  
Chief Financial Officer and Treasurer*

May 20, 2002

By: /s/ M. CATHERINE MALONEY

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Name: M. Catherine Maloney  
Title: *Vice President and  
Chief Accounting Officer*

May 20, 2002

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**EXHIBIT INDEX**

<b>Exhibit Number</b>	
<hr/> 12	Ratio of Earnings to Fixed Charges

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