

BEVERLY ENTERPRISES INC

Form 10-K/A

June 14, 2004

Table of Contents

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, DC 20549

Form 10-K/ A

(Amendment No. 1)

(Mark One)

ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the fiscal year ended December 31, 2003

OR

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

Commission file number: 1-9550

BEVERLY ENTERPRISES, INC.

(Exact name of Registrant as specified in its charter)

Delaware
(State or other jurisdiction of
incorporation or organization)

62-1691861
(I.R.S. Employer
Identification No.)

One Thousand Beverly Way

Fort Smith, Arkansas 72919
(Address of principal executive offices)

Registrant's telephone number, including area code: **(479) 201-2000**

Registrant's website: **www.beverlycares.com**

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

| <u>Title of each class</u> | <u>Name of each exchange on which registered</u> |
|-------------------------------|---|
| Common Stock, \$.10 par value | New York Stock Exchange Pacific Stock Exchange |

Securities registered pursuant to Section 12(g) of the Act: **NONE**

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

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

Indicate by check mark if Registrant is an accelerated filer (as defined in Exchange Act Rule 12b-2). Yes No

The aggregate market value of the voting and non-voting common stock held by nonaffiliates of Registrant was \$368,035,217 as of June 30, 2003.

107,002,792

(Number of shares of common stock outstanding, net of treasury shares, as of May 31, 2004)

Part III is incorporated by reference from the Proxy Statement for the Annual Stockholders Meeting held on May 20, 2004.

TABLE OF CONTENTS

EXPLANATORY NOTE

FORWARD-LOOKING STATEMENTS

PART I

ITEM 1. BUSINESS.

ITEM 2. PROPERTIES.

ITEM 3. LEGAL PROCEEDINGS.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS.

PART II

ITEM 5. MARKET FOR THE COMPANY'S COMMON EQUITY AND RELATED STOCKHOLDER MATTERS.

ITEM 6. SELECTED FINANCIAL DATA.

ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS.

ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK.

ITEM 8. CONSOLIDATED FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA.

REPORT OF ERNST & YOUNG LLP, INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE.

ITEM 9A. CONTROLS AND PROCEDURES.

PART III

ITEM 10. DIRECTORS AND EXECUTIVE OFFICERS OF THE COMPANY.

ITEM 11. EXECUTIVE COMPENSATION.

ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS.

ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS.

ITEM 14. PRINCIPAL ACCOUNTANT FEES AND SERVICES.

PART IV

ITEM 15. EXHIBITS, FINANCIAL STATEMENT SCHEDULES AND REPORTS ON FORM 8-K.

SIGNATURES

Computation of Ratio of Earnings to Fixed Charges

Consent of Ernst & Young

CEO's Certification Pursuant to Section 302

CFO's Certification Pursuant to Section 302

CEO's Certification Pursuant to Section 906

CFO's Certification Pursuant to Section 906

Table of Contents

EXPLANATORY NOTE

We are filing this Amendment No. 1 to our Annual Report of Form 10-K/ A for the year ended December 31, 2003 (the Form 10-K/ A) to amend our Consolidated Financial Statements for the years ended December 31, 2003, 2002 and 2001, to reflect reclassifications to discontinued operations and to modify related disclosures. Where considered appropriate, we have updated other items and disclosures in this Form 10-K/ A. We disposed of certain nursing facilities and a home medical equipment business during the three months ended March 31, 2004, which have been reclassified to discontinued operations for all periods presented in accordance with generally accepted accounting principles and applicable Securities and Exchange Commission (SEC) reporting requirements. This document includes a Report of Ernst & Young LLP, Independent Registered Public Accounting Firm, on the amended Consolidated Financial Statements. The filing of this Form 10-K/ A shall not be deemed an admission that the original Form 10-K, when filed, knowingly included any untrue statement of a material fact or omitted to state a material fact necessary to make a statement not misleading.

In this report, when we use words such as today, recently, current or currently, or phrases such as as of the date hereof, or as of the date of this report, we are referring to June 14, 2004, the date we filed this report with the SEC.

FORWARD-LOOKING STATEMENTS

References throughout this document to the Company include Beverly Enterprises, Inc. and its wholly owned subsidiaries. In accordance with the SEC Plain English guidelines, this Annual Report on Form 10-K/ A has been written in the first person. In this document, the words we , our , ours and us refer only to Beverly Enterprises, Inc. and its wholly owned subsidiaries and not to any other person.

This Annual Report on Form 10-K/ A, and other information we provide from time to time, contains certain statements that are not historical facts and may be forward-looking statements within the meaning of United States federal securities law. All statements regarding our expected future financial position, results of operations or cash flows, continued performance improvements, ability to service, refinance, replace and comply with our debt obligations, ability to finance growth opportunities, ability to control our patient care liability costs, ability to respond to changes in government regulations, ability to execute our three-year strategic plan, and similar statements including, without limitation, those containing words such as believes, anticipates, expects, intends, estimates, plans, and other similar expressions are forward-looking statements. These forward-looking statements reflect management's beliefs and assumptions and are based on information currently available to management. Forward-looking statements involve known and unknown risks, uncertainties and other factors that may cause our actual results, performance, achievements or industry results to be materially different from any future results, performance or achievements expressed or implied by us in those statements. These risks, uncertainties and other factors include, among others:

national and local economic conditions, including their effect on the availability and cost of labor, utilities and materials;

the effect of government regulations and changes in regulations governing the healthcare industry, including our compliance with such regulations;

changes in Medicare and Medicaid payment levels and methodologies and the application of such methodologies by the government and its fiscal intermediaries;

the effects of adopting new accounting standards;

the ability to integrate acquisitions and realize synergies and accretion;

liabilities and other claims asserted against us, including patient care liabilities, as well as the resolution of lawsuits brought about by the announcement or settlement of government investigations and the announcement of increases in reserves for patient care liabilities;

our ability to predict future reserve levels for patient care and workers' compensation liabilities;

Table of Contents

our ability to obtain adequate insurance coverage with financially viable insurance carriers, as well as the ability of our insurance carriers to fulfill their obligations;

our ability to execute strategic divestitures in a timely manner at fair values;

our ability to improve our fundamental business processes and reduce costs throughout the organization;

our ability to attract and retain qualified personnel;

the availability and terms of capital to fund acquisitions, capital improvements and ongoing operations;

our ability to repurchase our stock and changes in the stock price after any such repurchases;

the competitive environment in which we operate;

our ability to maintain and increase census (volume of residents) levels; and

demographic changes.

See Item 1. Business for a discussion of various governmental regulations and other operating factors relating to the healthcare industry and the related risk factors. You should carefully consider the risks described herein before making any investment decisions in the Company. These risks and uncertainties are not the only ones facing the Company. There may be additional risks that we do not presently know of or that we currently deem immaterial. If any of these risks actually occur, our business, financial condition, results of operations or cash flows could be materially and adversely affected. In that case, the trading price of our common stock could decline, and you may lose all or part of your investment. Given these risks and uncertainties, we can give no assurances that these forward-looking statements will, in fact, transpire and, therefore, we caution investors not to place undue reliance on them. We are not obligated to publicly update or revise any forward-looking statements, whether as a result of new information, future events or otherwise.

Table of Contents

PART I

ITEM 1. BUSINESS.

General

2003 was an important transition year for Beverly. Our improved financial and operating results validate the strategic plan that has guided the turnaround during the past three years. We strengthened our portfolio of nursing facilities and continued to concentrate these operations in strategic markets that provide attractive growth potential. We also continued the profitable growth of our eldercare service businesses, where margins are attractive and ongoing capital requirements are lower. We further strengthened our financial position by reducing on and off-balance sheet debt by a total of \$133.4 million. Our year-end cash position for 2003 was \$258.8 million, more than double the total at the end of 2002. We refinanced \$325.0 million of debt to achieve lower interest costs, extend maturities and provide increased financial flexibility.

A major issue facing the nursing facility industry is rising costs for patient care liabilities. We believe we made significant progress during 2003 to contain this issue. In late 2002, we identified facilities that represented a disproportionately high share of those projected costs collectively approximately 50 percent and we committed to a divestiture program during 2003 and 2004. During 2003, we divested or closed a total of 81 nursing facilities and seven assisted living centers that represented 36 percent of those projected costs. We used the net cash proceeds of these divestitures more than \$200 million to reduce debt and strengthen our liquidity position.

We believe we have the strategic framework, seasoned management team and financial resources to continue the profitable growth of the Company.

Operations and Services

Our business consists principally of providing healthcare services, primarily including the operation of nursing facilities, assisted living centers, hospice and home care centers, outpatient clinics and rehabilitation therapy services. We are one of the largest operators of nursing facilities in the United States. As of April 30, 2004, we operated 368 nursing facilities with a total of 38,874 licensed beds. Our nursing facilities are located in 23 states and the District of Columbia and range in capacity from 24 to 355 licensed beds. (See Item 2. Properties.) As of April 30, 2004, we also operated 19 assisted living centers containing 526 units, 25 hospice and home care centers and 10 outpatient clinics, and we provided rehabilitation therapy services in 35 states and the District of Columbia.

Our operations are currently organized into three primary operating segments: Nursing Facilities, Aegis Therapies and Home Care.

Nursing Facilities. Our Nursing Facilities operations provide long-term healthcare and rehabilitation services through the operation of skilled nursing facilities and assisted living centers and accounted for approximately 92% of our revenues for the three months ended March 31, 2004 and approximately 94% for the year ended December 31, 2003. Our facilities provide residents with routine long-term care services, including daily nursing, dietary, social and recreational services and a full range of pharmacy services and medical supplies. Our skilled nursing staff also provides complex and intensive medical services to residents with higher acuity needs outside the traditional acute-care hospital setting. We have designed our assisted living centers to provide residents with a greater degree of independence while still offering routine services and, if required, limited medical care.

Aegis Therapies. Our Aegis operations provide rehabilitation therapy services under contract to our nursing facilities, as well as 547 third-party customers as of March 31, 2004, and accounted for approximately 5% of our revenues for the three months ended March 31, 2004 and approximately 4% as of December 31, 2003. Aegis offers occupational, physical and speech therapy services designed to maximize function and independence, assist in recovery from medical conditions and compensate for remaining disabilities.

Table of Contents

Home Care. Our Home Care operations primarily provide hospice services within our nursing facilities, in facilities operated by other healthcare providers and in patients' homes and accounted for approximately 2% of our revenues for the three months ended March 31, 2004 and the year ended December 31, 2003. Our hospice services include palliative care for terminally ill patients, as well as pastoral, counseling and bereavement services for the families of hospice patients.

In addition, we derived approximately 1% of our revenues for the three months ended March 31, 2004 from certain new business ventures, including pharmacy consulting services, and the sale of procurement-related services.

Revenue Sources**Overview**

We receive payments for services provided to patients from:

each of the states in which our facilities are located under the applicable Medicaid program;

the federal government under the Medicare program and the Department of Veterans Affairs; and

private and other payors, including commercial insurers and managed care payors.

The following table sets forth for the periods indicated:

nursing facility patient days derived from the indicated sources of payment as a percentage of total nursing facility patient days; and

revenues derived from the indicated sources of payment as a percentage of total revenues.

| | Medicaid | | Medicare | | Private and Other | |
|---------------------|--------------|----------|--------------|----------|-------------------|----------|
| | Patient Days | Revenues | Patient Days | Revenues | Patient Days | Revenues |
| Three Months Ended: | | | | | | |
| March 31, 2004 | 71% | 51% | 12% | 28% | 17% | 21% |
| March 31, 2003 | 71% | 52% | 12% | 27% | 17% | 21% |
| Years Ended: | | | | | | |
| December 31, 2003 | 71% | 53% | 12% | 26% | 17% | 21% |
| December 31, 2002 | 71% | 53% | 11% | 27% | 18% | 20% |
| December 31, 2001 | 72% | 55% | 10% | 26% | 18% | 19% |

Changes in the mix of our patient population among the Medicare, Medicaid and private categories can significantly impact our revenues and profitability. In most states, private patient care is the most profitable, and Medicaid patient care is the least profitable. We receive revenues by providing room and board, occupational, physical, speech, respiratory and intravenous therapy, as well as sales of pharmaceuticals and other services.

Reimbursement by Medicaid Programs

Medicaid programs currently exist in all of the 23 states, and the District of Columbia, in which we operate nursing facilities. These programs differ in certain respects from state to state, but they are all subject to federally imposed requirements. At least 50% of the funds available under these programs is provided by the federal government under a matching program.

Currently, most state Medicaid programs use a cost-based reimbursement system. This means that a facility is reimbursed for the reasonable direct and indirect allowable costs it incurs in providing routine patient care services (as defined by the programs). These reasonable costs normally include certain allowances for administrative and general costs, as well as the costs of property and equipment (e.g., depreciation and

Table of Contents

interest, fair rental allowance or rental expense). In addition, certain states provide for efficiency incentives, subject to certain cost ceilings.

State Medicaid reimbursement programs vary as to the level of allowable costs that are reimbursed to operators. In some states, cost-based reimbursement is subject to retrospective adjustment through cost report settlement. In other states, reimbursements made to a facility that are subsequently determined to be less than or in excess of allowable costs may be adjusted through future reimbursements to the facility and to other facilities owned by the same operator. Still other states reimburse facilities based upon costs from a prior base year, adjusted for inflation. More than 50% of the states we currently operate in have enacted reimbursement programs that are based on patient acuity versus traditional cost-based methodologies. Many other states are actively developing reimbursement systems based on patient acuity or that follow a methodology similar to Medicare's prospective payment system (PPS). We are unable to estimate the ultimate impact of any changes in state reimbursement programs on our future consolidated financial position, results of operations or cash flows.

While federal regulations do not provide states with grounds to curtail funding of their Medicaid cost reimbursement programs due to state budget deficiencies, states have done so in the past. No assurance can be given that states will not do so in the future or that the future funding of Medicaid programs will remain at levels comparable to the present levels.

The Balanced Budget Act of 1997 (the Budget Act) broadened the states' authority to develop their own standards for setting payment rates. The law requires each state to use a public process for establishing proposed rates whereby the methodologies and justifications used for setting such rates are available for public review and comment. This requires facilities to become more involved in the rate setting process since failure to do so may interfere with a facility's ability to challenge rates later. Currently, several states in which we have substantial operations are experiencing deficits in their fiscal operating budgets. There can be no assurance that these states, as well as other states in which we operate, will not reduce payment rates.

Reimbursement by Medicare

Healthcare system reform and concerns over rising Medicare costs have been priorities for both the federal and state governments. The Budget Act included numerous program changes directed at balancing the federal budget. In addition to the Medicaid changes described above, the legislation changed Medicare policy in a number of ways, including the phase-in of PPS for skilled nursing facilities. PPS reimburses a skilled nursing facility based upon the acuity level of Medicare patients. Acuity level is determined by classifying a patient into one of 44 Resource Utilization Grouping (RUG) categories, based on the nature of the patient's condition and services needed.

In 1999 and 2000, refinements were made to the Budget Act. These refinements restored substantial Medicare funding to skilled nursing facilities and other healthcare providers originally eliminated by the Budget Act. A number of the refinements made in 1999 and 2000 remain in place today, including, among other things:

a 20% add-on for 12 high acuity non-therapy RUG categories; and

a 6.7% add-on for all rehabilitation RUG categories.

These add-ons are scheduled to expire when the Centers for Medicare and Medicaid Services (CMS) release their refinements to the current RUG payment system. It is expected that these refinements will not be implemented until at least October 1, 2005. We currently generate approximately \$35.6 million in annual revenues related to these add-ons. We cannot predict when CMS will release its refinements nor can we predict what their ultimate impact will be on our operating results or cash flows, if any.

In addition, the 1999 and 2000 refinements to the Budget Act included a three-year moratorium on two \$1,500 Part B therapy caps, which expired on December 31, 2002. After several delays in implementation during 2003, the annual caps of \$1,590 for physical and speech therapy services combined and \$1,590 for occupational therapy services, which were adjusted for inflation, were applied to services provided during the

Table of Contents

period from September 1, 2003 through December 8, 2003. On December 8, 2003, the Medicare Prescription Drug, Improvement, and Modernization Act of 2003 (the Prescription Drug Bill) was signed into law and included an additional two-year moratorium on the Part B therapy caps until December 31, 2005.

The Prescription Drug Bill also requires payments to skilled nursing facilities to be increased by 128% for residents with AIDS, added a pilot program in certain states for national and state criminal background checks for workers who provide direct patient care in skilled nursing facilities, and mandated that hospitals include new information about the availability of skilled nursing facility care in notices of discharge given to patients.

CMS implemented two increases in nursing facility Medicare rates effective October 1, 2003. The first increase of 3.26% was a cumulative correction for understated market basket increases that CMS had relied on since 1998. The second increase of 3.0%, which is applied to the Medicare rates subsequent to being adjusted for the 3.26% increase above, was an annual market basket increase for the federal fiscal year beginning October 1, 2003. Based on our volume and mix of Medicare patients during 2003, we estimate that these increases will result in approximately \$27.5 million of additional annual revenues, including approximately \$13.5 million for the cumulative correction for understated market basket increases and approximately \$14.0 million for the annual market basket increase.

On February 10, 2003, CMS published a proposed rule to reduce by 30 percent the amount that Medicare reimburses skilled nursing facilities and other non-hospital providers for bad debts arising from uncollectible Medicare coinsurance and deductibles. The proposal is to phase in the reduction over a three-year period at 10 percent per year. Based on our current volume of Medicare bad debts, this proposed rule would reduce our revenues by \$1.9 million, \$3.8 million and \$5.7 million for the first, second and third year, respectively. We cannot currently determine if and when this rule will be implemented.

Government Regulation

Survey, Certification and Licensure

Our nursing facilities, assisted living centers, home health agencies and hospices are subject to state licensure and certification requirements under the Medicare, Medicaid and Veterans Administration programs. While regulations and licensing requirements vary based upon provider type and from state to state, they typically address, among other things, administration and supervision, personnel qualifications, physical plant specifications, nursing, rehabilitative therapy and medical services and resident rights and responsibilities. If we fail to comply with applicable licensing or certification requirements, we may be subject to civil money penalties, loss of licensure or termination of our participation in the Medicare, Medicaid or Veterans Administration programs. Changes in the laws or new interpretations of existing laws as applied to our nursing facilities, assisted living centers or other components of our healthcare businesses may have a significant impact on our operations and costs of doing business.

In 1989, CMS published new survey and certification regulations to implement the Medicare and Medicaid provisions of the Omnibus Budget Reconciliation Act of 1987 (OBRA 1987). OBRA 1987 mandated enhanced quality of care requirements for participation by skilled nursing facilities under Medicare and nursing facilities under Medicaid. After additional changes in the law, survey and certification regulations became effective in October 1990. Final nursing facility enforcement regulations were published in November 1994 and were revised significantly in March 1999. Among the provisions that CMS has adopted are requirements that:

surveys focus on residents' outcomes;

all deviations from the participation requirements will be considered deficiencies, but all deficiencies will not constitute noncompliance; and

penalties will result for certain types of deficiencies.

Table of Contents

The regulations also identify remedies, as alternatives to termination from participation, and specify the categories of deficiencies for which these remedies will be applied. These remedies include:

installation of temporary management;

denial of payment for new admissions;

denial of payment for all patients;

civil money penalties of \$50 to \$3,000 per day or per instance for deficiencies that do not put a resident in immediate jeopardy and \$3,050 to \$10,000 per day for deficiencies that have caused or are likely to cause serious injury or death;

closure of facility and/or transfer of patients in emergencies;

directed plans of correction; and

directed in-service training.

In the ordinary course of our business, and like other providers in the healthcare industry, we receive requests for information from government agencies in connection with their regulatory or investigational authority and notices of deficiencies for failure to comply with various regulatory requirements. We review such requests and notices and we believe that we take appropriate corrective action. In most cases, with respect to the notices, the facility or other provider and the reviewing agency will agree upon the steps to be taken to bring the facility into compliance with regulatory requirements. In some cases or upon repeat violations, the reviewing agency may take a number of adverse actions against a provider. These adverse actions include:

the imposition of fines;

temporary suspension of admission of new patients to the facility;

decertification from participation in the Medicare or Medicaid programs; or

in extreme circumstances, revocation of a facility's license.

We have been subject to certain of these adverse actions in the past and could be subject to adverse actions in the future, which could result in significant penalties, as well as adverse publicity. The results of current or future enforcements or actions could have an adverse effect on our operations or financial position.

In February 2000, as part of the settlement of an investigation by the federal government into our allocation of certain costs to the Medicare program, we entered into a Corporate Integrity Agreement with the United States Department of Justice and the Office of Inspector General (the OIG). This agreement requires that we monitor our compliance with the requirements of the federal healthcare programs and addresses our obligations to ensure that we comply. It includes our functional and training obligations, audit and review requirements, recordkeeping and reporting requirements, as well as penalties for breach or noncompliance of the agreement. In April 2004, revisions were made to our Corporate Integrity Agreement to extend the services of a quality monitor to all of our nursing facilities and to reflect a modification of the requirements under the agreement with respect to training and education. We believe that we are generally in compliance with the requirements of the Corporate Integrity Agreement and file annual reports with the OIG documenting our compliance. Failure to comply with the Corporate Integrity Agreement may result in penalties or exclusion from the Medicare and Medicaid programs.

Nursing Facility Quality Initiative

In November 2002, CMS implemented Nursing Home Compare, a national initiative to publicly report quality measures to improve the quality of care of each Medicare and Medicaid certified nursing facility. In January 2004, CMS upgraded this program to include enhanced quality measures. This report uses a set of quality indicators calculated from the minimum data set assessments prepared by the nursing facilities on each resident. The quality measures are intended to assist consumers in evaluating nursing facilities, and to assist

Table of Contents

CMS in working with the nursing facility industry to develop quality improvement programs where needed. We have implemented an internal software program allowing each facility access to their real-time CMS enhanced quality measures. This enables the facility to compare their performance to local, state and national averages along with the ability to analyze which residents are included in each quality measure. Many of our facilities were selected to participate in their individual state Quality Improvement Organizations in a three-year nursing home collaboration to improve these quality measures.

We developed and utilize a program called the *Beverly Quality System* to help ensure quality care is provided in all of our facilities. The program is comprised of four elements: facility-based Quality Assurance and Assessment Committees; Quality Councils; facility performance assessments; and a performance improvement model. All elements of the *Beverly Quality System* are addressed by a multi-disciplinary team that includes regional and district level business leaders and clinical consultants. Additional consultative support is provided by designated Quality Management Directors within the organization.

We have analyzed the revised CMS regulations with respect to our programs and facilities, as well as compliance data for the past year. Results of CMS surveys for the past year determined that a significant majority of our nursing facilities surveyed were in substantial compliance with CMS, and specific state, requirements for participation. Our analysis shows that our nursing facilities have improved their survey performance year over year. Although we could be adversely affected if a substantial portion of our programs or facilities were eventually determined not to be in compliance with CMS regulations, we believe our programs and facilities are generally in compliance.

Regulations Governing Healthcare Fraud and Abuse

The Social Security Act and regulations of the Department of Health and Human Services (HHS) state that any entities or individuals who have been convicted of a criminal offense related to the delivery of an item or service under the Medicare or Medicaid programs or who have been convicted, under state or federal law, of a criminal offense relating to neglect or abuse of residents in connection with the delivery of a healthcare item or service cannot participate in the Medicare or Medicaid programs. Furthermore, any entities or individuals who have been convicted of fraud, who have had their licenses revoked or suspended, or who have failed to provide services of adequate quality may be excluded from the Medicare and Medicaid programs.

There are *fraud and abuse* anti-kickback provisions of the Social Security Act (the *Antifraud Amendments*) that make it a criminal felony offense to knowingly and willfully offer, pay, solicit or receive payment or any other remuneration in order to induce, or in return for the receipt of, business for which reimbursement is provided under government health programs, including Medicare and Medicaid. In addition, violators can be subject to civil penalties, as well as exclusion from government health programs. The *Antifraud Amendments* have been broadly interpreted to make payment of any kind, including many types of business and financial arrangements among providers, and between providers and beneficiaries, potentially illegal if any purpose of the payment or financial arrangement is to induce a referral. Accordingly, joint ventures, space and equipment rentals, management and personal services contracts, and certain investment arrangements among providers may be subject to increased regulatory scrutiny.

From time to time, HHS puts into effect regulations describing or clarifying certain arrangements that are not subject to enforcement action under the Social Security Act (the *Safe Harbors*). The *Safe Harbors* described in the regulations are narrow, leaving a wide range of economic relationships, which many hospitals, physicians and other healthcare providers consider to be legitimate business arrangements, possibly subject to enforcement action under the *Antifraud Amendments*. The *Safe Harbor* regulations do not intend to comprehensively describe all lawful relationships between healthcare providers and referral sources. The *Safe Harbor* regulations state that just because an arrangement does not qualify for *Safe Harbor* protection does not mean it violates the *Antifraud Amendments*. However, a failure to meet all the elements of a potentially applicable *Safe Harbor* may subject a particular arrangement or relationship to increased regulatory scrutiny.

In addition to the *Antifraud Amendments*, Section 1877 of the Social Security Act, known as the *Stark Law*, imposes restrictions on referrals between physicians and certain entities with which the physicians have

Table of Contents

financial relationships. The Stark Law provides that if a physician (or an immediate family member of a physician) has a financial relationship with an entity that provides certain designated health services, the physician may not refer a Medicare or Medicaid patient to the entity for those designated services, unless an exception applies. In addition, the entity may not bill for services provided by that physician unless an exception to the financial relationship exists. Designated health services include certain services, such as physical therapy, occupational therapy, outpatient prescription drugs and home health. The types of financial relationships that can trigger the referral and billing prohibitions include ownership or investment interests, as well as compensation arrangements. Penalties for violating the law are severe, and include:

denial of payment for services provided;

civil money penalties of \$15,000 for each item or service claimed;

refunds of any amounts collected;

assessments of up to twice the amount claimed for each service;

civil money penalties up to \$100,000 for each arrangement or scheme designed to circumvent the Stark Law's prohibitions; and

exclusion from the Medicare and Medicaid programs.

Many states where we operate have laws similar to the Antifraud Amendments and the Stark Law, but with broader effect since they apply regardless of the source of payment for care. These laws typically provide criminal and civil penalties, as well as loss of licensure. The scope of these state laws is broad and little precedent exists for their interpretation or enforcement.

The Health Insurance Portability and Accountability Act of 1996 (HIPAA) includes comprehensive revisions or supplements to the Antifraud Amendments. Under HIPAA, it is a federal criminal offense to commit healthcare fraud. Healthcare fraud is defined as knowingly and willfully executing or attempting to execute a scheme or device to defraud any healthcare benefit program. In addition, for the first time, HIPAA granted federal enforcement officials the ability to exclude from the Medicare and Medicaid programs any investors, officers and managing employees associated with business entities that have committed healthcare fraud, even if the investor, officer or employee had no actual knowledge of the fraud. HIPAA established that it is a violation to pay or otherwise give anything of value to a Medicare or Medicaid beneficiary if one knows or has reason to know that the payment would be likely to influence such beneficiary to order or receive services from a particular provider or practitioner.

The Budget Act also contained a significant number of new fraud and abuse provisions. For example, civil money penalties may also be imposed for violations of the Antifraud Amendments (previously, exclusion or criminal prosecution were the only actions under the Antifraud Amendments), as well as for contracting with an individual or entity that a provider knows or should know is excluded from a federal healthcare program. A person is subject to mandatory exclusion from participation in federal healthcare programs upon conviction for certain defined healthcare offenses. The Budget Act provides a minimum ten-year period for exclusion from participation in federal healthcare programs for providers convicted of a prior healthcare offense. The Budget Act also provides for civil money penalties of \$50,000 and damages of not more than three times the amount of payment received from the prohibited activity.

In 1976, Congress established the OIG at HHS to identify and eliminate fraud, abuse and waste in HHS programs and to promote efficiencies in HHS departmental operations. The OIG carries out this mission through a nationwide program of audits, investigations and inspections. In order to provide guidance to healthcare providers on ways to engage in legitimate business practices and avoid scrutiny under the fraud and abuse statutes, the OIG has from time to time issued fraud alerts identifying segments of the healthcare industry and particular practices that are vulnerable to abuse. The fraud alerts encourage persons having

Table of Contents

information about potentially abusive practices or transactions to report such information to the OIG. The OIG has issued three fraud alerts targeting the skilled nursing industry:

an August 1995 alert which relates to the provision of medical supplies to nursing facilities, fraudulent billing for medical supplies and equipment and fraudulent supplier transactions;

a May 1996 alert which focuses on the provision of fraudulent professional services to nursing facility residents; and

a March 1998 alert which addresses the interrelationship between hospice services and the nursing facility industry, and potentially illegal practices and arrangements.

In addition to laws addressing referral relationships, several federal laws impose criminal and civil sanctions for fraudulent and abusive billing practices. The Federal False Claims Act imposes sanctions, consisting of monetary penalties of up to \$11,000 for each claim and three times the amount of damages, on entities and persons who knowingly present or cause to be presented to the federal government a false or fraudulent claim for payment. Also, the statute allows private parties to bring *qui tam* whistleblower lawsuits alleging false claims. Some states have adopted similar whistleblower and/or false claims provisions. The Social Security Act prohibits the knowing and willful making of a false statement or misrepresentation of a material fact with respect to the submission of a claim for payment under government health programs (including the Medicare and Medicaid programs). Violations of this provision are a felony offense punishable by fines and imprisonment. Government prosecutors are increasing their use of the Federal False Claims Act to prosecute quality of care deficiencies in healthcare facilities. Their theory behind this is that the submission of a claim for services provided in a manner that falls short of quality of care standards can constitute the submission of a false claim.

In addition to increasing the resources devoted to investigating allegations of fraud and abuse in the Medicare and Medicaid programs, federal and state regulatory and law enforcement authorities are taking an increasingly strict view of the requirements imposed on healthcare providers by the Social Security Act and Medicare and Medicaid regulations. From time to time, we, like other healthcare providers, are required to provide records to state or federal agencies to aid in such investigations. It is possible that these entities could initiate investigations in the future at facilities we operate and that such investigations could result in significant penalties, as well as adverse publicity.

Regulation Governing the Privacy and Transmission of Healthcare Information

In addition to its antifraud provisions, HIPAA also requires improved efficiency in healthcare delivery by standardizing electronic data interchange and by protecting the confidentiality and security of health data. More specifically, HIPAA calls for:

standardization of certain electronic patient health, administrative and financial data;

unique health identifiers for employers, health plans and healthcare providers;

privacy standards protecting the privacy of individually identifiable health information; and

security standards protecting the confidentiality and integrity of electronically held individually identifiable health information.

In August 2000, final regulations establishing standards for electronic data transactions and code sets, as required under HIPAA, were released. These standards are designed to allow entities within the healthcare industry to exchange medical, billing and other information and to process transactions in a more timely and cost effective manner. Modifications to the electronic data transactions and code sets standards were issued on February 20, 2003, and further modifications were released March 10, 2003. Subsequently, on July 24, 2003 and September 23, 2003, Congress granted extensions to providers whose Medicare and Medicaid trading partners were not ready to implement these standards. We are already complying with the transactions standards where possible. We will begin operating in a compliant manner with the remaining trading partners as they become ready.

Table of Contents

The HIPAA privacy standards are designed to protect the privacy of certain individually identifiable health information. The privacy standards have required us to make certain updates to our policies and procedures and conduct training for our employees surrounding these standards. We believe we are compliant with the privacy standards.

We must comply with the HIPAA security standards by April 21, 2005, with civil and criminal penalties for noncompliance. We must comply with the employer identification standard before May 23, 2005. We believe that we will be in compliance with these standards as required.

HHS has estimated that implementation of the electronic transactions and code sets, the privacy standards and the security standards will cost the healthcare industry between \$1.8 billion and \$6.3 billion over a five-year period. We continue to evaluate and update our processes and procedures to meet the requirements of the new standards; however, we cannot assure you that all of the parties with whom we do business will be in compliance with HIPAA. We do not believe our ongoing implementation to comply with HIPAA will have a material impact on our consolidated financial position, results of operations or cash flows.

Competitive Conditions

Our nursing facilities compete primarily on a local and regional basis with other long-term care providers, some of whom may own as few as a single nursing facility. Our primary national competitors include Manor Care, Inc., Kindred Healthcare, Inc., Genesis HealthCare Corporation, Extencicare Health Services, Inc. and Mariner Health Care, Inc. We also compete with a variety of other companies in providing rehabilitation therapy services, hospice services and assisted living services.

Our ability to compete successfully varies from location to location and depends on a number of factors, which include:

the number of competitors in the local market;

the types of services available;

quality of care;

reputation, age and appearance of each facility; and

the cost of care in each locality.

In general, we seek to compete in each market by establishing a reputation within the local community for quality healthcare services, attractive and comfortable facilities, and providing specialized healthcare. Increased competition in the future could limit our ability to attract and retain residents or to expand our business.

Employees and Labor Relations

At April 30, 2004, we had approximately 35,400 full and part-time employees.

Approximately 9% of our employees, employed in 71 of our nursing facilities, are represented by various labor unions. Although our facilities have never experienced any material work stoppages and we believe that our relations with employees and labor organizations are generally good, we cannot predict the effect continued union representation or organizational activities will have on our future operations.

A national shortage of nurses and other trained personnel and general inflationary pressures have required us to adjust our wage and benefits packages in order to compete for qualified personnel. For the three months ended March 31, 2004, labor costs accounted for approximately 54% of the operating expenses of our Nursing Facilities segment, 92% of our Aegis segment and 59% of our Home Care segment. We compete with other healthcare providers to attract and retain qualified or skilled personnel. We also compete with various industries for lower-wage employees. We are not currently facing a staffing shortage in all markets where we operate; however, in certain markets with shortages of healthcare workers we have used high-cost temporary help to supplement staffing levels. We are addressing our staffing challenges through recruiting and retention

Table of Contents

programs and training initiatives. However, these programs and initiatives may not stabilize or improve our ability to attract and retain these personnel. Our inability to control labor availability and costs could have an adverse effect on our future operating results.

Executive Officers

The following table sets forth the name, position and age of each of our executive officers. Each executive officer is elected or appointed by the Board of Directors. The executive officers as of May 31, 2004, are as follows:

| Name | Position | Age |
|------------------------|--|-----|
| William R. Floyd | Chairman of the Board, President, Chief Executive Officer and Director | 59 |
| Douglas J. Babb | Executive Vice President, Chief Administrative and Legal Officer and Secretary | 52 |
| David R. Devereaux | Chief Operating Officer Nursing Facilities | 42 |
| Jeffrey P. Freimark | Executive Vice President, Chief Financial and Information Officer | 49 |
| Cindy H. Susienka | Executive Vice President and President Aegis Therapies and Home Care | 44 |
| Patrice K. Acosta | Senior Vice President Quality of Life Programs | 48 |
| Pamela H. Daniels | Senior Vice President, Controller and Chief Accounting Officer | 40 |
| Lawrence Deans | Senior Vice President Human Resources | 52 |
| James M. Griffith | Senior Vice President Investor Relations and Corporate Communications | 61 |
| Patricia C. Kolling | Senior Vice President Compliance | 57 |
| Andrea J. Ludington | Senior Vice President Professional Services | 58 |
| Blaise J. Mercadante | Senior Vice President Marketing and New Business Innovation | 50 |
| Barbara R. Paul | Senior Vice President and Chief Medical Officer | 50 |
| Harold A. Price | Senior Vice President Sales and Business Development | 54 |
| Richard D. Skelly, Jr. | Senior Vice President and Treasurer | 44 |
| Chris W. Roussos | President Ceres Purchasing Solutions | 39 |

Mr. Floyd joined us in April 2000 as President and Chief Operating Officer. He was elected Chief Executive Officer in February 2001 and Chairman of the Board in December 2001. From 1996 to 1998, he was Chief Executive Officer of Choice Hotels International, and from 1995 to 1996, he was Chief Operating Officer of Taco Bell Corporation. He has been a director since July 2000.

Mr. Babb joined us in April 2000 as Executive Vice President, General Counsel and Secretary. He was named head of Government Relations in January 2001 and Chief Administrative and Legal Officer in October 2002. Mr. Babb was Senior Vice President Merchandise Business Unit for Burlington Northern Santa Fe Corporation from 1997 to 1999.

Mr. Devereaux joined us in August 1998 as Senior Vice President Operations for the Specialty Services Division of the Nursing Facilities segment. He was elected President of the corporations within the Nursing Facilities segment in January 2001 and Chief Operating Officer in July 2001.

Mr. Freimark joined us in January 2002 as Executive Vice President and Chief Financial Officer. He became head of Information Technology in October 2002. From May 2001 to January 4, 2002, he was Senior Executive Vice President and Chief Financial Officer of OfficeMax, Inc. From March 1997 to May 2001, he

Table of Contents

was with The Grand Union Company where he held positions as Executive Vice President, Chief Financial Officer and President and Chief Executive Officer.

Ms. Susienka joined us in June 1998 as President Aegis Therapies and was elected President Home Care Services in March 2002. She was elected Executive Vice President in December 2003.

Ms. Acosta joined us in October 1996 as Vice President Risk Management. She was elected Senior Vice President Professional Services in January 2001 and Senior Vice President Quality of Life Programs in October 2003.

Ms. Daniels joined us in May 1988 as Audit Coordinator. She was elected Vice President, Controller and Chief Accounting Officer in October 1996 and Senior Vice President in December 1999.

Mr. Deans joined us in November 2003 as Senior Vice President Human Resources. From September 1999 to November 2003, he was Chief Human Resources Officer at Jones Lang LaSalle. From February 1998 to June 1999, he was Vice President Human Resources of Alliant Foodservice, Inc.

Mr. Griffith joined us in November 1995 as Senior Vice President Investor Relations and Corporate Communications.

Ms. Kolling joined us in February 1989 as a rehabilitation consultant. She was elected Vice President Rehabilitation in 1994, Vice President PPS in 1998 and Vice President Medicare Programs in 2000. She was elected Senior Vice President Compliance in October 2002.

Ms. Ludington joined us in 1999 as Regional Director of Professional Services. She was elected Senior Vice President of Professional Services in 2004.

Mr. Mercadante joined us in January 2002 as Senior Vice President Marketing and New Business Innovation. From 1999 to 2002, he was President of Blazing Insights Group, and from 1996 to 1999, he was Executive Vice President Marketing at Universal Studios.

Ms. Paul joined us in March 2004 as Chief Medical Officer. From 1999 to 2004, she was director of the Quality Measurement and Health Assessment Group for CMS at HHS.

Mr. Price joined us in August 2002 as Senior Vice President Sales and Business Development. Prior to that, he worked with us on a consulting basis for 18 months. Before becoming a consultant, he was Vice President Strategic Relations and Business Development for SelfCare, Inc. from 1999 to 2000.

Mr. Skelly joined us in April 2002 as Senior Vice President and Treasurer. From September 2001 to March 2002, he served as Senior Vice President and Treasurer of OfficeMax, Inc. From June 1997 to August 2001, he held various positions with The Grand Union Company, including Acting Chief Financial Officer and Treasurer.

Mr. Roussos joined us in August 2001 as a management designee of our former Matrix segment. He was elected President of Matrix in February 2002 and President of Ceres Purchasing Solutions in October 2002. From 2000 to 2001, he was Division General Manager of American Homestar, and from 1996 to 2000, he was General Manager of Fleetwood Enterprises.

Risks Relating to Our Company

Our substantial indebtedness could adversely affect our financial health.

We have a significant amount of indebtedness. At March 31, 2004, we had total indebtedness on our consolidated balance sheet of \$562.6 million. On March 31, 2004, our consolidated balance sheet also included a liability of \$58.4 million, representing the present value of the remaining obligation we owe to the federal government under a civil settlement agreement. In addition, at March 31, 2004, we had \$70.0 million of off-balance sheet obligations. Our level of indebtedness has declined significantly over the last two years. The reduction in these obligations was primarily accomplished through the use of proceeds from divestitures and cash generated from the collection of accounts receivable. We expect to continue to reduce our indebtedness

Table of Contents

through cash on hand, cash generated by operations and proceeds from selected divestitures of non-strategic assets.

Our substantial indebtedness could have important consequences to you. For example, it could:

increase our vulnerability to general adverse economic and industry conditions;

require us to dedicate a substantial portion of our cash flow from operations to payments on our indebtedness, thereby reducing the availability of our cash flow to fund working capital, capital expenditures and other general corporate activities;

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

place us at a competitive disadvantage compared to other less leveraged competitors;

limit our ability to pursue business opportunities that may be in our interest; and

limit our ability to borrow additional funds.

In addition, the indentures relating to our publicly traded notes contain restrictive covenants and our senior credit facility contains financial and other restrictive covenants that limit our ability to engage in activities that may be in our long-term best interest. Our failure to comply with those covenants could result in an event of default, which, if not cured or waived, could result in the acceleration of a substantial amount of our debt.

Despite current indebtedness levels, we and our subsidiaries may still be able to incur substantially more debt. This could further increase the risks associated with our substantial leverage.

We may be able to incur substantial additional indebtedness in the future. The terms of our existing debt instruments and the indentures relating to our public notes do not fully prohibit us from doing so. As of March 31, 2004, we were able to borrow up to \$75.0 million of revolving credit under our senior credit facility (\$35.3 million of which availability at March 31, 2004 was being used for letters of credit). If new indebtedness is added to our current debt levels, the related risks that we now face could increase.

To service our indebtedness, we will require a significant amount of cash. Our ability to generate cash depends on many factors, some of which are beyond our control.

Our ability to make payments on and to refinance our indebtedness 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.

At March 31, 2004, we had cash and cash equivalents totaling \$230.2 million and availability under our revolving credit facility of \$39.7 million. We currently anticipate that cash on hand, cash flows from operations and availability under our banking arrangements will be adequate to repay our debts due within one year of \$13.1 million, to make normal recurring annual capital additions and improvements of \$80.0 million, to make operating lease and other contractual obligation payments, to make selective acquisitions, including the purchase of previously leased facilities, and to meet working capital requirements for the twelve months ending March 31, 2005.

We cannot assure you, 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 future borrowings will be available in an amount sufficient to enable us to pay our indebtedness or to fund our other liquidity needs. We may need to refinance all or a portion of our indebtedness on or before maturity. We cannot assure you that we will be able to refinance any of our indebtedness on commercially reasonable terms or at all.

Table of Contents

Our reported earnings per share may be more volatile because of the contingent conversion provision of our 2.75% convertible subordinated notes.

Holders of the convertible subordinated notes are entitled to convert the notes into our common stock if the closing sale price of our common stock for at least 20 consecutive trading days in the 30 consecutive trading day period ending on the last day of the immediately preceding fiscal quarter is more than 120% of the conversion price (or \$8.94 per share) in effect on that 30th trade day, among other circumstances. Until this contingency or another conversion contingency is met, the shares underlying the notes are not included in the calculation of our basic or diluted earnings per share. Should a conversion contingency be met, diluted earnings per share is expected to decrease as a result of the inclusion of the underlying shares in the diluted earnings per share calculation. Volatility in our stock price could cause this condition to be met in one quarter and not in a subsequent quarter, increasing the volatility of our diluted earnings per share. (See Part II Item 8 Note 9.)

The price of our common stock may fluctuate significantly.

The price of our common stock has been, and is likely to continue to be, highly volatile, which means that it could decline substantially. The price of our common stock could fluctuate significantly for the following reasons, among others:

future announcements concerning us or our competitors;

quarterly variations in operating results;

business acquisitions or divestitures;

changes in earnings estimates by analysts;

changes in third-party reimbursement practices;

regulatory developments;

changes in the number of outstanding shares; or

fluctuations in the economy or general market conditions.

In addition, stock markets in general, and the market for shares of healthcare stocks in particular, have experienced extreme price and volume fluctuations in recent years which have frequently been unrelated to the operating performance of the affected companies. These broad market fluctuations may adversely affect the market price of our common stock. The market price of our common stock could decline below its current price and the market price of our common stock may fluctuate significantly in the future. These fluctuations may be unrelated to our performance.

In the past, stockholders have often instituted securities class action litigation after periods of volatility in the market price of a company's securities. If a stockholder files a securities class action lawsuit against us, we would incur substantial legal fees and our management's attention and resources would be diverted from operating our business in order to respond to the litigation. (See Item 3. Legal Proceedings.)

We rely on reimbursement from governmental programs for a majority of our revenues and we cannot assure you that reimbursement levels will not decrease in the future.

For the three months ended March, 31, 2004, 51%, 28% and 21% of our revenues were derived from Medicaid, Medicare and private and other sources, respectively. Changes in the reimbursement policies of the Medicare or Medicaid programs as a result of budget cuts by federal and state governments or other legislative and regulatory actions could have an adverse effect on our consolidated financial position, results of operations and cash flows.

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We have experienced an increase in our state Medicaid rates averaging 6.3% for the three months ended March 31, 2004, over the same period in 2003, and 4.6%, 3.6% and 6.7% for the years ended December 31, 2003, 2002 and 2001, respectively. However, in the past, states have curtailed their Medicaid payments as a

Table of Contents

result of budget considerations. Curtailments of Medicaid funding by a state can affect long-term care providers and/or other non-eldercare providers in that state. Currently, several states in which we operate are experiencing deficits in their fiscal operating budgets. There can be no assurance that those states in which we operate that are experiencing budget deficits, as well as other states in which we operate, will not reduce payment rates.

The Budget Act broadened the states' authority to develop their own standards for setting payment rates. It requires each state to use a public process for establishing proposed rates whereby the methodologies and justifications used for setting such rates are available for public review and comment. This requires nursing facilities to become more involved in the rate setting process since failure to do so may interfere with a facility's ability to challenge rates later.

In recent years, there have also been reductions in payments to skilled nursing facilities under the Medicare program. Although the Balanced Budget Refinement Act of 1999 (BBRA) and the Benefits Improvement and Protection Act of 2000 (BIPA) reversed certain rate reductions enacted under the Budget Act, some of these increases expired on September 30, 2002, the so-called Medicare cliff. While CMS announced two increases to skilled nursing facility rates effective October 2003, and will continue certain add-ons for high-acuity patients until CMS refines the RUG system, there can be no assurances that payments from the Medicare program will remain at levels comparable to present levels or will, in the future, be sufficient to cover the costs allocable to Medicare patients.

In addition, as required by the Budget Act, CMS imposed annual limits per beneficiary of \$1,590 for physical and speech therapy services combined and \$1,590 for occupational therapy. These caps were applied to services provided during the period from September 1, 2003 through December 8, 2003. Although Congress imposed a further moratorium from December 8, 2003 through December 31, 2005 in the provisions of the Prescription Drug Bill, there can be no assurance that the caps will not go into effect on January 1, 2006.

On February 10, 2003, CMS published a proposed rule to reduce by 30 percent the amount that Medicare reimburses skilled nursing facilities and other non-hospital providers for bad debts arising from uncollectible Medicare coinsurance and deductibles. The proposal is to phase in the reduction over a three-year period at 10 percent per year. Based on our current volume of Medicare bad debts, this proposed rule would reduce our revenues by \$1.9 million, \$3.8 million and \$5.7 million for the first, second and third year, respectively. We cannot currently determine if and when this rule will be implemented.

Governmental payment programs are subject to statutory and regulatory changes, retroactive rate adjustments, administrative or executive orders and government funding restrictions, all of which may materially decrease the rate of government program payments to us for our services. Our financial condition and results of operations may be adversely affected by reductions in reimbursement levels and the reimbursement process in general, which in the healthcare industry is complex and can involve lengthy delays between the time that revenue is recognized and the time that reimbursement amounts are settled.

Our industry is heavily regulated by the government, which requires our compliance with a variety of laws.

The operation of our facilities and the services we provide are subject to periodic inspection by governmental authorities to ensure that we are complying with standards established for continued licensure under state law and certification for participation under the Medicare and Medicaid programs. Additionally, in certain states, certificates of need or other similar approvals are required for expansion of our operations. We could be adversely affected if we are unable to obtain these approvals, if the standards applicable to approvals or the interpretation of those standards change and by possible delays and expenses associated with obtaining approvals. Our failure to obtain, retain or renew any required regulatory approvals, licenses or certificates could prevent us from being reimbursed for certain of our services.

In the ordinary course of our business, and like other providers in the healthcare industry, we receive requests for information from government agencies in connection with their regulatory or investigational authority and notices of deficiencies for failure to comply with various regulatory requirements. We review all

Table of Contents

such notices and we believe that we take timely and appropriate corrective action. In most cases, with respect to these notices, the facility and the reviewing agency will agree upon the steps to be taken to bring the facility into compliance with regulatory requirements. In some cases or upon repeat violations, the reviewing agency may take a number of adverse actions against a facility. These adverse actions include:

the imposition of fines;

temporary suspension of payment for new patients to the facility;

decertification from participation in the Medicare or Medicaid programs; or

in extreme circumstances, revocation of a facility's license.

We have been subject to certain of these adverse actions in the past and could be subject to adverse actions in the future which could result in significant penalties, as well as adverse publicity. Any such penalties or adverse publicity could have an adverse effect on our financial condition and results of operations.

We face periodic reviews, audits and investigations under our contracts with federal and state government agencies, and these audits could have adverse findings that may negatively impact our business.

As a result of our participation in the Medicare and Medicaid programs, we are subject to various governmental reviews, audits and investigations to verify our compliance with these programs and applicable laws and regulations. Private pay sources also reserve the right to conduct audits. An adverse review, audit or investigation could result in:

refunding amounts we have been paid pursuant to the Medicare or Medicaid programs or from private payors;

state or federal agencies imposing fines, penalties and other sanctions on us;

loss of our right to participate in the Medicare or Medicaid programs or one or more private payor networks; and

damage to our reputation in various markets.

Both federal and state government agencies have heightened and coordinated civil and criminal enforcement efforts as part of numerous ongoing investigations of healthcare companies and, in particular, skilled nursing facilities. The investigations include:

cost reporting and billing practices;

quality of care;

financial relationships with referral sources; and

medical necessity of services provided.

We also are subject to potential lawsuits under a federal whistleblower statute designed to combat fraud and abuse in the healthcare industry. These lawsuits can involve significant monetary awards to private plaintiffs who successfully bring these suits.

We are required to comply with laws governing the transmission and privacy of health information.

HIPAA requires us to comply with certain standards for the exchange of individually identifiable health information within our Company and with third parties, such as payors, business associates and patients. These include standards for common healthcare transactions, such as claims information, plan eligibility, payment information and the use of electronic signatures; unique identifiers for providers, employers, and health plans; security; and privacy.

Sanctions for failing to comply with the HIPAA health information practices provisions include criminal penalties and civil sanctions. The security standards went into effect in April 2003, with a compliance date in

Table of Contents

April 2005 for most covered entities. We cannot assure you that all of the parties with whom we do business will be in compliance with HIPAA. If we fail to comply with these standards, we could be subject to criminal penalties and civil sanctions, which could have an adverse effect on our financial condition and results of operations.

Healthcare reform legislation may adversely affect our business.

In recent years, there have been numerous initiatives on the federal and state levels for comprehensive reforms affecting the payment for and availability of healthcare services. Aspects of certain of these healthcare initiatives, such as reductions in funding of the Medicare and Medicaid programs, potential changes in reimbursement regulations by CMS, enhanced pressure to contain healthcare costs by Medicare, Medicaid and other payors, greater state flexibility and additional operational requirements, could adversely affect us. There can be no assurance as to the ultimate content, timing or effect of any healthcare reform legislation, nor is it possible at this time to estimate the impact of potential legislation on us. That impact may have an adverse effect on our financial condition and results of operations.

We are subject to increasingly expensive and unpredictable patient care liability costs.

General and professional liability costs for the long-term care industry have become increasingly expensive and difficult to estimate. We and others have experienced substantial increases in both the number of claims and lawsuits, as well as the size of the typical claim and lawsuit. The long-term care industry has previously experienced significant, unexpected increases in estimated ultimate costs for claims in certain states or areas. In Texas and Florida, for example, the growth in patient care liability claims and lawsuits reached a level where it was not possible for us to continue to operate profitably and we disposed of all our facilities in Texas in 1996 and Florida in 2002.

We also have initiated several strategic and tactical actions to mitigate the impact of these rising costs. In late 2002, we identified those nursing facilities that represented a disproportionately high share of projected patient care liability costs. In early 2003, we began implementing a strategy to divest, over a two-year period, properties that accounted for approximately 50% of our annual patient care liability costs projected at that time. We upgraded our risk management and litigation functions, and adopted a more coordinated and aggressive legal defense strategy. We began using voluntary arbitration agreements in most of our nursing facilities and improved communications with residents and their families to resolve issues before they reach litigation. In addition, we remain committed to continually improving the quality of care we provide, adopting clinical performance indicators to evaluate the care at each facility and including quality care as a significant component of incentive compensation at the facility, regional and corporate levels. If patient care claims continue to increase in number and size, our future financial condition and results of operations may be adversely affected.

Insurance coverage is becoming increasingly expensive and difficult to obtain for long-term care companies, and our insurance carriers could become insolvent and unable to reimburse us.

Primarily as a result of patient care liability costs for long-term care providers, insurance companies are ceasing to insure long-term care companies, or severely limiting their capacity to write long-term care general and professional liability insurance. In addition, in the wake of the September 11, 2001 events, reduced overall insurance capacity and increasing insurance company losses, the insurance environment in general has become unstable, making it increasingly difficult to obtain coverage for patient care liabilities and certain other risks. When insurance coverage is available, insurance carriers are typically requiring companies to significantly increase their liability retention levels and/or pay substantially higher premiums for reduced coverage. This has been the case for most insurance coverages, including workers' compensation, employee healthcare and patient care liability. We have experienced higher premiums and retention levels in the past. Our insurance covering patient care liability and workers' compensation was renewed in the second quarter of 2004 with retention levels remaining consistent and premiums being generally the same or less than the prior year. However, we cannot assure you that we will be able to renew our insurance coverages in future years on terms as favorable as those we currently have.

Table of Contents

We have purchased insurance for workers' compensation, property, casualty and other risks from numerous insurance companies. In many cases, the policies provide coverage for events occurring in specific time frames that may only be determined in later years. We exercise care in selecting companies from which we purchase insurance, including review of published ratings by recognized rating agencies, advice from national brokers and consultants and review of trade information sources. There exists a risk that any of these insurance companies may become insolvent and unable to fulfill their obligation to defend, pay or reimburse us when that obligation becomes due. Although we believe the companies we have purchased insurance from are solvent, in light of the dramatic changes occurring in the insurance industry in recent years, we cannot assure you that they will remain solvent and able to fulfill their obligations.

State efforts to regulate the construction or expansion of healthcare providers could impair our ability to expand our operations.

Some states require healthcare providers (including skilled nursing facilities, home health agencies, hospices and assisted living centers) to obtain prior approval, known as a certificate of need (a CON), for:

the purchase, construction or expansion of healthcare facilities;

capital expenditures exceeding a prescribed amount; or

changes in services or bed capacity.

To the extent that we are required to obtain a CON or other similar approvals to expand our operations, either by acquiring facilities or expanding or providing new services or other changes, our expansion could be adversely affected by our failure or inability to obtain the necessary approvals, changes in the standards applicable to those approvals, and possible delays and expenses associated with obtaining those approvals. We cannot assure you that we will be able to obtain CON approval for all future projects requiring this approval.

Our civil settlement agreement with the United States Government with respect to alleged violations of cost allocations under Medicare negatively impacts our cash flows and subjects us to a Corporate Integrity Agreement.

On February 3, 2000, we entered into a series of separate agreements with the OIG of HHS. Under the civil settlement agreement, we paid the federal government \$25.0 million during the first quarter of 2000 and agreed to reimburse the federal government an additional \$145.0 million through withholdings from our biweekly Medicare periodic interim payments in equal installments ending in the first quarter of 2008. As of March 31, 2004, the present value of the remaining obligation was \$58.4 million. As a result of such withholdings, our cash flows from operations were negatively impacted by \$4.9 million for the three months ended March 31, 2004, and \$18.1 million during the year ended December 31, 2003, and are expected to be negatively impacted at an annual rate of \$18.1 million.

As part of this series of agreements, we entered into a Corporate Integrity Agreement with the OIG. This agreement requires that we monitor, on an ongoing basis, our compliance with the requirements of the federal healthcare programs. This agreement addresses our obligations to ensure that we comply with the requirements of participation in the federal healthcare programs. It also includes functional and training obligations, audit and review requirements and record keeping and reporting requirements. In 2002, certain revisions were made to our Corporate Integrity Agreement to reflect a permanent injunction requiring our nursing facilities in California to conduct additional training programs and to hire an independent quality monitor for our nursing facilities in California, Arizona, Hawaii and Washington to assess our quality care systems. By March 31, 2004, we had divested all of our nursing facilities in Arizona, Washington and Hawaii and a substantial portion of our nursing facilities in California. In April 2004, additional revisions were made to our Corporate Integrity Agreement to extend the services of the quality monitor to all of our nursing facilities and to reflect a modification of the requirements under the agreement with respect to training and education. We believe that we are generally in compliance with the requirements of our Corporate Integrity Agreement and file annual reports with the OIG documenting our compliance. If we fail to comply with our Corporate Integrity Agreement, we may be subject to penalties or exclusion from the Medicare and Medicaid programs, which could have an adverse effect on our financial condition and results of operations.

Table of Contents

We are subject to material litigation.

We are, and may in the future be, subject to litigation which, if determined adversely against us, could have a material adverse effect on our business, financial condition and results of operations. (See Item 3. Legal Proceedings.)

If we fail to cultivate new, or maintain existing, relationships with the physicians in the communities in which we operate, our patient base may decrease.

Our patient base depends in part upon the admissions and referral practices of the physicians in the communities in which we operate and our ability to cultivate and maintain relationships with these physicians. Physicians referring patients to our facilities are not our employees and are free to refer their patients to other providers. If we are unable to successfully cultivate and maintain strong relationships with these physicians, our patient population may decline, which, if significant, could have an adverse effect on our financial condition and results of operations.

Changes in the mix of our patient population among the Medicare, Medicaid and private categories may significantly affect our nursing revenues and profitability.

The sources and amounts of our patient revenues are determined by a number of factors, including licensed bed capacity and census of our nursing facilities, average length of stay of our residents, the mix of our patients by payor type (for example, Medicare versus Medicaid or private) and the acuity level of our patients. Changes in the case mix of patients, the mix of patients by payor type and payment methodologies may significantly affect our profitability. In particular, changes which increase the percentage of Medicaid residents within our nursing facilities could have an adverse effect on our financial condition and results of operations, especially in states whose reimbursement levels are below our operating costs.

Certain trends in the healthcare industry are putting pressure on our ability to maintain nursing facility census.

Over the past decade, a number of trends have developed that impact our census. These trends include:

overbuilding of nursing facilities in states that have eliminated the CON process for new construction;

creation of nursing facilities by acute-care hospitals to keep discharged patients within their complex;

rapid growth of assisted living centers, which sometimes are more attractive to less medically complex patients; and

the availability of eldercare services delivered to the home.

The negative impact of these trends on nursing facility census varies from facility to facility, from community to community and from state to state, and if we are not successful in responding to them, these trends could have an adverse effect on our financial condition and results of operations.

Available Information

Our website, www.beverlycares.com, provides access, free of charge, to our SEC reports, including our annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and amendments to these reports, as soon as reasonably practicable. In addition, our corporate governance guidelines, code of conduct, code of ethics for senior financial officers, Audit and Compliance Committee Charter and Nominating and Compensation Committee Charter will be available on this website and in print to any shareholder who request them.

You may read and copy any materials we file with the SEC at the SEC's Public Reference Room at 450 Fifth Street, NW, Washington, DC 20549. You may obtain information on the operation of the Public Reference Room by calling the SEC at 1-800-SEC-0330. The SEC maintains a website that contains reports, proxy and information statements, and other information regarding issuers that file electronically with the SEC, including us, at <http://www.sec.gov>.

Table of Contents**ITEM 2. PROPERTIES.**

On April 30, 2004, we operated 368 nursing facilities, 19 assisted living centers, 25 hospice and home care centers and 10 outpatient clinics in 25 states and the District of Columbia. Most of our 96 leased nursing facilities are subject to net leases which require us to pay all taxes, insurance and maintenance costs. Most of these leases have original terms from ten to fifteen years and contain at least one renewal option. Renewal options typically extend the original terms of the leases by five to fifteen years. Many of these leases also contain purchase options. We consider our physical properties to be in good operating condition and suitable for the purposes for which they are being used. Certain of our nursing facilities and assisted living centers are included in the collateral securing our obligations under various debt agreements. (See Item 8, Note 9.)

The following is a summary of our nursing facilities, assisted living centers, hospice and home care centers and outpatient clinics at April 30, 2004:

| Location | Nursing Facilities | | Assisted Living Centers | | Hospice and Home Care Centers | Outpatient Clinics |
|-----------------------|--------------------|---------------------|-------------------------|-------------|-------------------------------|--------------------|
| | Number | Total Licensed Beds | Number | Total Units | | |
| Alabama | 14 | 1,669 | | | | |
| Arkansas | 29 | 3,572 | 2 | 48 | | |
| California | 25 | 2,405 | | | 2 | |
| District of Columbia | 1 | 355 | | | | |
| Georgia | 13 | 1,595 | 2 | 72 | 1 | |
| Illinois | 3 | 275 | | | | |
| Indiana | 27 | 3,221 | | | 1 | |
| Iowa | | | | | 1 | |
| Kansas | 19 | 1,175 | | | | |
| Kentucky | 8 | 1,039 | | | | |
| Maryland | 4 | 585 | 1 | 19 | | |
| Massachusetts | 18 | 2,048 | | | | |
| Minnesota | 29 | 2,353 | 1 | 16 | | |
| Mississippi | 10 | 1,149 | | | | |
| Missouri | 18 | 1,728 | 3 | 105 | 2 | |
| Nebraska | 24 | 2,045 | 1 | 19 | 3 | |
| New Jersey | 1 | 140 | | | | |
| North Carolina | 10 | 1,278 | | | 1 | 10 |
| Ohio | 9 | 1,222 | | | | |
| Pennsylvania | 42 | 4,769 | 3 | 72 | 8 | |
| South Dakota | 17 | 1,167 | 1 | 36 | | |
| Tennessee | 5 | 555 | 2 | 55 | | |
| Texas | | | | | 3 | |
| Virginia | 14 | 1,840 | 3 | 84 | | |
| West Virginia | 3 | 310 | | | | |
| Wisconsin | 25 | 2,379 | | | 3 | |
| | 368 | 38,874 | 19 | 526 | 25 | 10 |
| Classification | | | | | | |
| Owned | 272 | 28,315 | 17 | 425 | | |
| Leased | 96 | 10,559 | 2 | 101 | 25 | 10 |

| | | | | | |
|------------|---------------|-----------|------------|-----------|-----------|
| <u>368</u> | <u>38,874</u> | <u>19</u> | <u>526</u> | <u>25</u> | <u>10</u> |
|------------|---------------|-----------|------------|-----------|-----------|

Table of Contents

ITEM 3. LEGAL PROCEEDINGS.

(a) As previously reported, the following derivative lawsuits have been filed in the state court of Arkansas, as well as the federal district court in Arkansas, assertedly on our behalf (collectively, the Derivative Actions):

Norman M. Lyons v. David R. Banks, et. al., Case No. OT99-4041, was filed in the Chancery Court of Pulaski County, Arkansas (4th Division) on or about July 29, 1999, and the parties filed an Agreed Motion to Stay the proceedings on January 17, 2000;

Badger v. David R. Banks, et. al., Case No. LR-C-99-881, was filed in the United States District Court for the Eastern District of Arkansas (Western Division) on November 30, 1999; and

Richardson v. David R. Banks, et. al., Case No. LR-C-99-826, was filed in the United States District Court for the Eastern District of Arkansas (Western Division) on November 4, 1999.

The Derivative Actions each name our directors as defendants, as well as the Company as a nominal defendant. The Lyons action also names as defendants certain of our current and former officers. The Derivative Actions each allege breach of fiduciary duties to the Company and its stockholders as a result of alleged conduct giving rise to the Class Action. The Lyons and Richardson actions also assert claims for abuse of control and constructive fraud arising from the same allegations and the Richardson action also claims unjust enrichment.

The Badger and Richardson actions were ordered to be consolidated as *In re Beverly Enterprises, Inc. Derivative Litigation* and by agreed motion, plaintiffs filed an amended, consolidated complaint on April 21, 2000. Defendants filed a motion to dismiss the consolidated derivative complaint and a motion to strike portions thereof on July 21, 2000. The parties agreed to stay the consolidated action pending the outcome of the motion to dismiss in a former class action suit. In light of the dismissal of the former class action suit, the Court entered a Scheduling Order dated July 17, 2003, which set a trial date of March 29, 2004, for this case. Defendants filed a motion to renew their motion to dismiss on December 17, 2003. Subsequently, the trial date was postponed based on the mutual agreement of the parties. The parties have agreed on a settlement in principle for these actions, which provides that we will incorporate various corporate governance practices that are consistent with our policies. In addition, the directors and officers liability insurance carriers, on behalf of the individual defendants, will pay no more than \$375,000 for plaintiffs attorney s fees.

(b) On August 16, 2002, August 26, 2002, and September 26, 2002, respectively, *Ernest Baer v. Beverly Enterprises, Inc., et. al.* (CIV. No. 02-2190), *Stanley V. Kensic v. Beverly Enterprises, Inc., et. al.* (CIV. No. 02-2193) and *Charles Krebs v. Beverly Enterprises, Inc., et. al.* (CIV. No. 02-2222) were filed in the United States District Court, Western District of Arkansas, Fort Smith Division. These cases were filed as purported securities fraud class actions under Sections 10(b) and 20(a) of the Securities Exchange Act of 1934 and Rule 10b-5.

These cases separately name Beverly Enterprises, Inc. as a defendant along with various current officers and our independent auditors. In all three cases, the purported class period runs from October 16, 2000 to and including July 19, 2002. Plaintiffs claim that the defendants, during the purported class period, made multiple false and misleading statements. In early March 2003, these cases were consolidated as *In re Beverly Enterprises, Inc. Securities Litigation*. On April 30, 2003, plaintiffs filed an amended complaint. On May 30, 2003, the defendants filed a motion to dismiss the amended complaint. Briefing on the motion to dismiss was completed July 11, 2003. The court heard oral arguments on the defendants motion on August 28, 2003. On December 23, 2003, the court granted defendants motions to dismiss with prejudice and denied plaintiffs motion to amend the complaint. Plaintiffs filed a notice of appeal on January 22, 2004. On April 2, 2004, plaintiffs and defendants jointly moved to dismiss the appeal with prejudice and on April 19, 2004, the court dismissed the action.

(c) On October 31, 2002, a shareholder derivative action entitled *Paul Dunne and Helene Dunne, derivatively on behalf of nominal defendant Beverly Enterprises, Inc. v. Beryl F. Anthony, Jr., et. al.* was filed in the Circuit Court of Sebastian County, Arkansas, Fort Smith Division (No. CIV-2002-1241). This case is

Table of Contents

purportedly brought derivatively on our behalf against various current and former officers and directors. The complaint alleges causes of action for breach of fiduciary duty against the defendants based on: (1) allegations that defendants failed to establish and maintain adequate accounting controls such that we failed to record adequate reserves for patient care liability costs; and (2) allegations that certain defendants sold Company stock while purportedly in possession of material non-public information. On May 16, 2003, two additional derivative complaints (*Holcombe v. Floyd, et. al.* and *Flowers v. Floyd, et. al.*) were filed and subsequently transferred to the Circuit Court of Sebastian County, Arkansas, Fort Smith Division and consolidated with the Dunne action as *Holcomb v. Beverly Enterprises, Inc.* The Dunes were subsequently dismissed as plaintiffs.

On June 9, 2003, pursuant to a stipulation of the parties, the Court entered a Scheduling Order providing, among other things, that plaintiffs will have thirty days from a ruling on the motion to dismiss filed by defendants in the related securities class action in federal court, *In re Beverly Enterprises, Inc. Securities Litigation* (Case No. 2:02 cv 2190), to file an amended complaint and that defendants shall have thirty days thereafter to respond to the complaint. The court entered a ruling on the defendants' motion to dismiss in the federal securities class action on December 23, 2003, and the plaintiffs filed a notice of appeal on January 22, 2004. In light of the plaintiffs' appeal, the parties agreed to a further stay of this derivative action pending resolution of the appeal. The dismissal of the appeal on April 19, 2004, described in paragraph (b) above, began the thirty-day period for plaintiffs to file an amended complaint in the derivative action, which they declined to do. Defendants' response to the complaint is currently due on June 19, 2004. Due to the preliminary state of this action, we are unable to assess the probable outcome of the case and can give no assurance of the ultimate impact on our financial position, results of operations and cash flows.

(d) In 2002, we notified federal and California healthcare regulatory authorities (Centers for Medicare and Medicaid Services, Office of Inspector General, the California Attorney General's office and the California Department of Health) of our intent to conduct an internal investigation of past billing practices relating to MK Medical, our former medical equipment business unit based in Fresno, California. An independent accounting firm has reviewed MK Medical's government payor billings since October 1, 1998, the date Beverly acquired the business unit. Deficiencies identified by the accounting firm primarily relate to inadequate documentation supporting Medicare and Medi-Cal claims for reimbursement for drugs, wheelchairs, and other durable medical equipment distributed by MK Medical. Specifically, the review identified instances of missing or incomplete certificates of medical necessity, treatment authorization requests, prescriptions and other documentation MK Medical is required to maintain in order to be entitled to reimbursement from government payors. Based on the results of the accounting firm's review, we established a reserve in 2002, included in Other accrued liabilities on the consolidated balance sheets in the amount of \$18.0 million to cover potential overpayments from government payors for the period from October 1, 1998 to 2002. We have advised regulatory authorities of the results of the accounting firm's review. On September 15, 2003, we received a subpoena from the United States Attorney's Office in Oakland, California, requesting the production of additional documents relating to MK Medical's operations and our review of MK Medical's claims. We have produced documents in response to this subpoena and continue to cooperate with the government's request for information. Our liability with respect to this matter could exceed the reserved amount, which continues to be our best estimate of our exposure on this matter. We can give no assurance of the final outcome of this matter or its impact on our financial position, results of operations and cash flows.

(e) We are party to various legal matters relating to patient care, including claims that our services have resulted in injury or death to residents of our facilities. Over the past few years, we have experienced an increasing trend in the number and severity of the claims asserted against us. We believe that there has been, and will continue to be, an increase in governmental investigations of long-term care providers. Adverse determinations in legal proceedings or governmental investigations, whether currently asserted or arising in the future, could have a material adverse effect on us.

(f) There are various other lawsuits and regulatory actions pending against us arising in the normal course of business, some of which seek punitive damages that are generally not covered by insurance. We do not believe that the ultimate resolution of such other matters will have a material adverse effect on our consolidated financial position, results of operations or cash flows.

Table of Contents

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS.

There were no matters submitted to a vote of our security holders during the last quarter of our fiscal year ended December 31, 2003.

Table of Contents**PART II****ITEM 5. MARKET FOR THE COMPANY S COMMON EQUITY AND RELATED STOCKHOLDER MATTERS.**

Our common stock is listed on the New York and Pacific Stock Exchanges under the symbol BEV. The table below sets forth, for the periods indicated, the range of high and low sales prices of our common stock as reported on the New York Stock Exchange composite tape.

| | Prices | |
|---------------------------------|--------|--------|
| | High | Low |
| 2002 | | |
| First Quarter | \$9.50 | \$5.66 |
| Second Quarter | 9.18 | 6.95 |
| Third Quarter | 7.95 | 1.90 |
| Fourth Quarter | 3.89 | 1.60 |
| 2003 | | |
| First Quarter | \$3.00 | \$1.63 |
| Second Quarter | 4.30 | 1.80 |
| Third Quarter | 6.99 | 3.71 |
| Fourth Quarter | 8.60 | 5.06 |
| 2004 | | |
| First Quarter | \$8.96 | \$5.84 |
| Second Quarter (through June 8) | 8.85 | 5.83 |

On May 31, 2004, there were 4,950 record holders of our common stock.

We are subject to certain restrictions under our long-term debt agreements related to the payment of cash dividends on our common stock. We have not paid any cash dividends on our common stock since 1987, and no future dividends are currently planned. In deciding whether to propose a dividend and determining the dividend amount, our Board of Directors would take into account such matters as the availability of funds for dividends, general business conditions, our financial results, other capital requirements, contractual, legal and regulatory restrictions on the payment of dividends to our stockholders and such other factors as our Board of Directors may deem relevant.

Table of Contents**ITEM 6. SELECTED FINANCIAL DATA.**

The following table of selected financial data should be read along with our consolidated financial statements and related notes for 2003, 2002 and 2001 included in Item 8. Consolidated Financial Statements and Supplementary Data.

| | At or for the Years Ended December 31, | | | | |
|---|--|---------------------|---------------------|---------------------|---------------------|
| | 2003 ⁽¹⁾ | 2002 ⁽¹⁾ | 2001 ⁽¹⁾ | 2000 ⁽¹⁾ | 1999 ⁽¹⁾ |
| (Dollars in thousands, except per share data) | | | | | |
| Consolidated Statement of Operations Data: | | | | | |
| Revenues | \$ 1,979,759 | \$ 1,941,313 | \$ 2,127,795 | \$ 2,062,229 | \$ 1,945,404 |
| Costs and expenses: | | | | | |
| Wages and related | 1,178,926 | 1,168,789 | 1,300,527 | 1,274,071 | 1,230,574 |
| Provision for insurance and related items | 125,871 | 93,657 | 82,286 | 107,258 | 78,740 |
| Other operating and administrative | 524,785 | 513,789 | 560,424 | 590,364 | 519,445 |
| Depreciation and amortization | 59,318 | 65,927 | 66,952 | 73,919 | 74,679 |
| Florida insurance reserve adjustment | | 22,179 | | | |
| Special charge and adjustment related to California investigation settlement | (925) | 6,300 | | | |
| Special charges and adjustments related to settlements of federal government investigations | | (9,441) | 77,495 | | 202,447 |
| Asset impairments, workforce reductions and other unusual items | 5,596 | 54,829 | 182,028 | 16,895 | 23,177 |
| Year 2000 remediation | | | | | 12,402 |
| Total costs and expenses | 1,893,571 | 1,916,029 | 2,269,712 | 2,062,507 | 2,141,464 |
| Income (loss) before other income (expenses) | 86,188 | 25,284 | (141,917) | (278) | (196,060) |
| Other income (expenses): | | | | | |
| Interest expense | (63,904) | (63,226) | (75,035) | (75,678) | (69,011) |
| Costs related to early extinguishments of debt | (6,634) | | | (354) | (619) |
| Interest income | 5,365 | 4,690 | 2,916 | 2,485 | 4,198 |
| Net gains (losses) on dispositions | 422 | 2,149 | 696 | 2,433 | (4,007) |
| Gains on sales of equity investments | 6,686 | | 256 | 1,477 | |
| Total other expenses, net | (58,065) | (56,387) | (71,167) | (69,637) | (69,439) |
| Income (loss) before provision for income taxes, discontinued operations and cumulative effect of change in accounting for goodwill | 28,123 | (31,103) | (213,084) | (69,915) | (265,499) |
| Provision for (benefit from) income taxes | 5,069 | 6,085 | 60,132 | (25,450) | (100,185) |
| Income (loss) before discontinued operations and cumulative effect of change in accounting for goodwill | 23,054 | (37,188) | (273,216) | (44,465) | (165,314) |
| Discontinued operations, net of taxes of 2003 \$3,378; 2002 \$0; 2001 \$1,256; 2000 \$3,188; and 1999 \$21,106 | 57,414 | (31,731) | (28,056) | (10,037) | 30,667 |
| Cumulative effect of change in accounting for goodwill, net of income taxes of \$0 ⁽²⁾ | | (77,171) | | | |
| Net income (loss) | \$ 80,468 | \$ (146,090) | \$ (301,272) | \$ (54,502) | \$ (134,647) |
| Basic and diluted net income (loss) per share of common stock: | | | | | |
| | \$ 0.22 | \$ (0.36) | \$ (2.63) | \$ (0.43) | \$ (1.61) |

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| | | | | | |
|---|--------------|--------------|--------------|--------------|--------------|
| Before discontinued operations and cumulative effect of change in accounting for goodwill | | | | | |
| Discontinued operations, net of taxes | 0.53 | (0.29) | (0.27) | (0.10) | 0.30 |
| Cumulative effect of change in accounting for goodwill, net of taxes | | (0.74) | | | |
| Net income (loss) per share of common stock | \$ 0.75 | \$ (1.39) | \$ (2.90) | \$ (0.53) | \$ (1.31) |
| Shares used to compute basic net income (loss) per share | 106,582 | 104,726 | 104,037 | 102,452 | 102,491 |
| Shares used to compute diluted net income (loss) per share | 106,920 | 104,726 | 104,037 | 102,452 | 102,491 |
| Other Financial Data: | | | | | |
| Cash flow from operations | \$ 69,861 | \$ 116,633 | \$ 220,897 | \$ 37,010 | \$ 189,141 |
| Capital expenditures | 43,984 | 100,103 | 89,401 | 76,027 | 95,414 |
| Consolidated Balance Sheet Data: | | | | | |
| Total assets | \$ 1,346,421 | \$ 1,349,895 | \$ 1,681,070 | \$ 1,875,993 | \$ 1,982,880 |
| Current portion of long-term debt | 13,354 | 41,463 | 64,231 | 227,111 | 34,052 |
| Long-term debt, excluding current portion | 552,873 | 588,714 | 677,442 | 564,247 | 746,164 |
| Total stockholders' equity | 238,186 | 153,472 | 296,497 | 583,993 | 641,124 |
| Other Data: | | | | | |
| Average occupancy ⁽³⁾ | 88.2% | 87.9% | 86.6% | 86.5% | 86.7% |

- (1) The operations of Matrix, MK Medical, Care Focus, 84 nursing facilities and seven assisted living centers have been reclassified as discontinued operations for all periods presented, including four nursing facilities and a home medical equipment business disposed of during the three months ended March 31, 2004, since they met the applicable criteria under Statement of Financial Accounting Standards No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets.
- (2) Includes a \$77.2 million goodwill impairment charge relating to the 2002 adoption of Statement of Financial Accounting Standards No. 142, Goodwill and Other Intangible Assets.
- (3) Calculated by dividing the nursing facilities' actual patient days by available patient days from continuing operations. Available patient days are calculated by multiplying total calendar days by the number of beds that are operationally ready for use.

Table of Contents

ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS.

General

Our business consists principally of providing healthcare services, including the operation of nursing facilities, assisted living centers, hospice and home care centers, outpatient clinics and rehabilitation therapy services. We are one of the largest operators of nursing facilities in the United States. As of April 30, 2004, we operated 368 nursing facilities with a total of 38,874 licensed beds. Our nursing facilities are located in 23 states and the District of Columbia and range in capacity from 24 to 355 licensed beds. As of April 30, 2004, we also operated 19 assisted living centers containing 526 units, 25 hospice and home care centers, and 10 outpatient clinics. Our operations also include rehabilitation therapy services in 35 states and the District of Columbia.

Operations and Services

Our operations are currently organized into three primary operating segments: Nursing Facilities, Aegis Therapies and Home Care.

Nursing Facilities. Our Nursing Facilities operations provide long-term healthcare and rehabilitation services through the operation of skilled nursing facilities and assisted living centers and accounted for approximately 92% of our revenues for the three months ended March 31, 2004 and approximately 94% for the year ended December 31, 2003. Our facilities provide residents with routine long-term care services, including daily nursing, dietary, social and recreational services and a full range of pharmacy services and medical supplies. Our skilled nursing staff also provides complex and intensive medical services to residents with higher acuity needs outside the traditional acute-care hospital setting. We have designed our assisted living centers to provide residents with a greater degree of independence while still offering routine services and, if required, limited medical care.

Aegis Therapies. Our Aegis operations provide rehabilitation therapy services under contract to our nursing facilities, as well as 547 third-party customers as of March 31, 2004, and accounted for approximately 5% of our revenues for the three months ended March 31, 2004 and approximately 4% as of December 31, 2003. Aegis offers occupational, physical and speech therapy services designed to maximize function and independence, assist in recovery from medical conditions and compensate for remaining disabilities.

Home Care. Our Home Care operations primarily provide hospice services within our nursing facilities, in facilities operated by other healthcare providers and in patients' homes and accounted for approximately 2% of our revenues for the three months ended March 31, 2004 and the year ended December 31, 2003. Our hospice services include palliative care for terminally ill patients, as well as pastoral, counseling and bereavement services for the families of hospice patients.

In addition, we derived approximately 1% of our revenues for the three months ended March 31, 2004 from certain new business ventures, including pharmacy consulting services, and the sale of procurement-related services.

Governmental Regulation

We are subject to extensive regulation by federal, state and local agencies. Each of our facilities must comply with regulations regarding staffing levels, patient care standards, occupational health and safety, patient confidentiality, billing and reimbursement, as well as environmental and biological hazards, among others. Additionally, government agencies have steadily increased their enforcement activity in this industry over the past several years, particularly with respect to large for-profit, multi-facility providers like us. This regulatory environment may force us to expend considerable resources to ensure compliance and respond to inspections, investigations or other enforcement actions. We believe the government will continue aggressive enforcement in the future.

Table of Contents

On February 3, 2000, we entered into a series of separate agreements with the Office of Inspector General (OIG) of the Department of Health and Human Services (HHS). Under the civil settlement agreement, we paid the federal government \$25.0 million during the first quarter of 2000 and agreed to reimburse the federal government an additional \$145.0 million through withholdings from our biweekly Medicare periodic interim payments in equal installments ending in the first quarter of 2008. As of March 31, 2004, the present value of the remaining obligation was \$58.4 million. As a result of such withholdings, our cash flows from operations were negatively impacted by \$4.9 million for the three months ended March 31, 2004, and \$18.1 million during the year ended December 31, 2003, and are expected to be negatively impacted at an annual rate of \$18.1 million.

As part of this series of agreements, we entered into a Corporate Integrity Agreement with the OIG. This agreement requires that we monitor, on an ongoing basis, our compliance with the requirements of the federal healthcare programs. This agreement addresses our obligations to ensure that we comply with the requirements of participation in the federal healthcare programs. It also includes functional and training obligations, audit and review requirements and record keeping and reporting requirements. In 2002, certain revisions were made to our Corporate Integrity Agreement to reflect a permanent injunction requiring our nursing facilities in California to conduct additional training programs and to hire an independent quality monitor for our nursing facilities in California, Arizona, Hawaii and Washington to assess our quality care systems. By March 31, 2004, we had divested all of our nursing facilities in Arizona, Washington and Hawaii and a substantial portion of our nursing facilities in California. In April 2004, additional revisions were made to our Corporate Integrity Agreement to extend the services of the quality monitor to all of our nursing facilities and to reflect a modification of the requirements under the agreement with respect to training and education.

In the ordinary course of business, we periodically receive notices of deficiencies for allegations of failure to comply with various regulatory requirements. We review all such notices and believe we take timely and appropriate corrective action. In most cases, the facility and the government will agree upon steps to be taken to bring the facility into compliance with regulatory requirements. In some cases or upon repeat violations, the government may take a number of adverse actions against the facility or us, including imposition of fines, temporary suspension of admission of new patients, decertification from participation in Medicare or Medicaid programs and licensure revocation. (See Item 1. Business.)

Critical Accounting Policies

The accompanying consolidated financial statements have been prepared in conformity with U.S. generally accepted accounting principles. The accounting policies discussed below are considered by management to be critical to an understanding of our financial statements because their application requires significant judgment and reliance on estimations of matters that are inherently uncertain. Certain risks related to these critical accounting policies are described in the following paragraphs.

Revenue Recognition, Accounts Receivable and Allowances for Doubtful Accounts

Our revenues are derived primarily from providing long-term healthcare services. Approximately 80% of our current revenues is derived from federal and state healthcare programs (primarily Medicare and Medicaid). As discussed more fully in Item 8 Note 1, we record revenues when services are provided at standard charges adjusted to amounts estimated to be received under governmental programs or other third-party contractual arrangements based on contractual terms and historical experience.

All providers participating in the Medicare and Medicaid programs are required to meet certain financial cost reporting requirements. Federal and state regulations generally require the submission of annual cost reports covering revenues, costs and expenses associated with the services provided to Medicare beneficiaries and Medicaid recipients. Annual cost reports are subject to routine audits and retroactive adjustments. These audits often require several years to reach the final determination of amounts due to, or by, us under these programs.

As adjustments to recorded revenues become known or as cost reporting years are no longer subject to audits, reviews or investigations, the amounts of our revenues and receivables are revised. Our revenues are

Table of Contents

reported at their estimated net realizable amounts, and we believe adequate provision has been made to reflect any adjustments that could result from audits of cost reports. However, due to the complexity of the laws and regulations governing the Medicare and Medicaid programs, there is at least a possibility that recorded estimates will change by a material amount in the near term. Changes in estimates related to third party receivables resulted in an increase in revenues of approximately \$8.7 million and \$745,000 for the years ended December 31, 2003 and 2002, respectively, and a decrease in revenues of approximately \$2.0 million for the year ended December 31, 2001.

Compliance with laws and regulations governing the Medicare and Medicaid programs is subject to government review and interpretation, as well as significant regulatory action including fines, penalties, and possible exclusion from the Medicare and Medicaid programs. In addition, under the Medicare program, if the federal government makes a formal demand for reimbursement, even related to contested items, payment must be made for those items before the provider is given an opportunity to appeal and resolve the issue.

We record bad debt expense monthly as a percentage of revenue reflecting our historical experience. Each quarter we adjust the allowance for doubtful accounts according to the aging and payor mix of the receivables. These adjustments are based on our weighted average collection experience by payor type, and recognize the relative risk depending on the source of the expected payment. Private pay accounts usually represent our highest collectibility risk. In addition, specific accounts that are determined to be uncollectible (due to bankruptcy, insufficient documentation, lack of third-party coverage or financial resources and the like) are fully reserved when such determinations are made. We write-off uncollectible accounts receivable after all collection efforts have been exhausted and we determine they will not be collected. If circumstances change (including, but not limited to: economic downturn; higher than expected defaults or denials; reduced collections; and changes in our payor mix), our estimates of the recoverability of our receivables could be reduced by a material amount.

Our provisions for bad debts represented 1.1%, 2.9% and 2.1% of revenues from continuing operations for the years ended December 31, 2003, 2002 and 2001, respectively. Our allowance for doubtful accounts represented approximately 17% and 20% of patient accounts receivable at December 31, 2003 and 2002, respectively. Our allowance for doubtful accounts represented 127% and 121% of accounts over 180 days old as of December 31, 2003 and 2002, respectively. Accounts receivable for our Nursing Facilities segment have continued to decline in 2003, our aging of receivables has improved and our cash collections continue to be in line with, or ahead of, our generated revenues. These factors have led to a decrease in our provision for bad debts and a reduction in our allowance for doubtful accounts in 2003. We believe adequate provision has been made for receivables that may prove to be uncollectible.

Patient Care Liability and Other Insurance Risks

General and professional liability costs for the long-term healthcare industry have become increasingly expensive and difficult to estimate. In addition, insurance coverage for patient care liability and certain other risks, for nursing facilities specifically and companies in general, has become increasingly difficult to obtain. When obtained, insurance carriers are often requiring companies to significantly increase their liability retention levels and pay substantially higher premiums for reduced terms of coverage. The majority of our workers' compensation and auto liability risks are insured through loss-sensitive insurance policies with affiliated and unaffiliated insurance companies. For our general and professional liabilities, we are responsible for the first dollar of each claim, up to a self-insurance limit determined by the individual policies, subject to aggregate limits in certain prior policy years.

We have purchased insurance for workers' compensation, property, casualty and other risks from numerous insurance companies. In many cases, the policies provide coverage for events occurring in specific time frames that may only be determined in later years. We evaluate our purchased insurance coverage for risk transfer and believe our occurrence-based insurance policies have sufficiently transferred the risk of loss to the insurance carriers we utilize. As a result, we do not recognize a liability in our consolidated financial statements for amounts covered by insurance.

Table of Contents

We exercise care in selecting companies from which we purchase insurance, including review of published ratings by recognized rating agencies, advice from national brokers and consultants and review of trade information sources. There exists a risk that any of these insurance companies may become insolvent and unable to fulfill their obligation to defend, pay or reimburse us when that obligation becomes due. In several prior policy years, losses exceed our self-insurance aggregate limits. For claims relating to these years, our insurers have assumed a more significant role in handling the claims or related obligations and settlements. As a result, it is more difficult to estimate potential losses in those years. However, we expect any losses in those years to be covered by our insurers. Although we believe the companies we have purchased insurance from are solvent, in light of the dramatic changes occurring in the insurance industry in recent years, we cannot assure you that they will remain solvent and able to fulfill their obligations.

Our liabilities for general, professional and workers' compensation risks are estimated by our independent actuaries twice a year using the most recent trends of claims, settlements and other relevant data. On an undiscounted basis, these liabilities totaled \$203.7 million at December 31, 2003. On our financial statements, these liabilities are discounted at 10% to their present value using actuarially determined loss payment timing patterns. The discount rate is based upon our best estimate of the incremental borrowing rate that would be required to fund these liabilities with uncollateralized debt. A reduction in the discount rate by one-half of a percentage point would have resulted in an additional pre-tax charge of \$1.8 million for the year ended December 31, 2003. Based on information provided by our independent actuaries, we estimate our range of discounted exposure for these liabilities to be \$152.5 million to \$179.4 million. At December 31, 2003, our recorded reserves for these liabilities totaled \$159.9 million. We believe adequate provision has been made in the financial statements for liabilities that may arise out of patient care and other services.

Asset Impairments

We recorded pre-tax asset impairment charges from continuing operations of \$2.1 million, \$49.9 million and \$98.9 million for the years ended December 31, 2003, 2002 and 2001, respectively. We also recorded impairments of goodwill of \$77.2 million in 2002 as the cumulative effect of an accounting change in accordance with Statement of Financial Accounting Standards No. 142, *Goodwill and Other Intangible Assets* (SFAS No. 142). We evaluate our long-lived assets for impairment whenever indicators of impairment exist, in accordance with Statement of Financial Accounting Standards No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets* (SFAS No. 144). These indicators of impairment can include, but are not limited to, the following:

- a history of operating losses, with expected future losses;
- changes in the regulatory environment affecting reimbursement;
- decreases in cash flows or cash flow deficiencies;
- changes in the way an asset is used in the business; and
- commitment to a plan to sell or otherwise dispose of an asset.

During 2003, a history of operating losses, with expected future losses, and cash flow deficiencies led to impairments on three facilities in our Nursing Facilities segment. During 2002, changes in the regulatory environment affecting Medicare reimbursement led to a long-lived asset impairment analysis on our Nursing Facilities segment. During 2001, continuing operating losses in several of our lines of business, including certain outpatient clinics, our managed care contracting entity, certain Home Care businesses and a few of our nursing facilities, led to impairment analyses on these assets.

These impairment analyses included:

- estimating the undiscounted cash flows to be generated by each clinic, unit, facility or property, primarily over the remaining life of the primary asset; and
- reducing the carrying value of the asset to the estimated fair value when the total estimated undiscounted cash flows was less than the carrying value of the clinic, unit, facility or property.

Table of Contents

In estimating the undiscounted cash flows for our nursing facilities, we primarily used our internally prepared budgets and forecast information, with certain probability adjustments, including, but not limited to, the following items: Medicare and Medicaid funding; overhead costs; capital expenditures; and patient care liability costs. In order to estimate the fair values of the nursing facilities, we used a discounted cash flow approach, supplemented by public resource information on valuations of nursing facility sales transactions by region of the country. Where the estimated undiscounted cash flows were negative, we estimated the fair values based on discounted public resource information, sales values or estimated salvage values. For other lines of business that lack significant property investments, we discounted the next five years of expected cash flows. A substantial decline in the estimated future cash flows for these facilities or businesses could materially change the estimated fair values of these assets, possibly resulting in an additional impairment.

In July 2001, SFAS No. 142 was issued, which established new rules on the accounting for goodwill and other intangible assets. In accordance with this standard, we performed the initial screening for potential impairments of our indefinite-lived intangible assets by reporting unit as of January 1, 2002. We determined the estimated fair values of each reporting unit using discounted cash flow analyses, along with independent source data related to recent transactions. Based on this determination, we identified potential goodwill impairments at our former Matrix segment and at Care Focus, a former reporting unit within our Home Care segment. We engaged a qualified, independent valuation group to determine the estimated fair values of each of these reporting units. Their analysis was completed in the fourth quarter of 2002, and led to the recording of goodwill impairment charges as the cumulative effect of an accounting change of \$77.2 million as of January 1, 2002, including \$70.6 million for Matrix and \$6.6 million for Care Focus. The outpatient therapy clinic operations and the managed care network of Matrix were sold during January 2003. The Care Focus unit was sold in June 2003. Based on our annual assessments of all reporting units as of October 1, 2003 and 2002, no additional impairments of goodwill were identified.

Off-Balance Sheet Arrangements

At March 31, 2004, we had an off-balance sheet financing arrangement of \$70.0 million of medium-term notes (Medium-Term Notes). These notes are obligations of Beverly Funding Corporation (BFC), a non-consolidated bankruptcy remote, qualifying special purpose entity. BFC was formed to acquire, own, hold, and otherwise administer certain accounts receivable originated and sold to it by certain of our operating subsidiaries through February 29, 2004, and to issue beneficial interests in those receivables. Under the terms of the arrangement, certain of our wholly owned operating subsidiaries (groups of nursing facilities within each state that we operate), which are separate legal entities, sold Medicaid and Veterans Administration accounts receivable to Beverly Health and Rehabilitation Services, Inc. (BHRS), one of our wholly owned operating subsidiaries. BFC then purchased these receivables under a revolving sales structure from BHRS at a discount of 1%. BFC received its funding from: (1) the issuance of debt to third-party investors; and (2) investments made in BFC by us. At March 31, 2004 and December 31, 2003, BFC held \$22.2 million and \$76.1 million, respectively, of accounts receivable. The decrease in accounts receivable held by BFC in 2004 from 2003 is due to BFC ceasing to purchase receivables from BHRS on March 1, 2004 in accordance with its Medium-Term Notes agreement. In addition to accounts receivable, BFC also had \$80.4 million of cash at March 31, 2004. The Medium-Term Notes mature in 2005; however, according to the provisions of the notes, principal payments on these obligations are calculated based on quarterly collections of the underlying receivables. It is expected that the Medium-Term Notes will be repaid by BFC on June 15, 2004. (See Item 8. Note 1.)

The Medium-Term Notes were issued in June and July 1999 to third-party investors. The proceeds were used to redeem \$40.0 million of then outstanding medium-term notes issued by BFC in 1994 that were nearing maturity and to purchase additional eligible receivables from BHRS. In addition, we increased our investment in BFC, allowing BFC to purchase additional eligible receivables to serve as excess collateral for the new Medium-Term Notes. Under the terms of the arrangement, BFC is required to maintain receivables and/or cash in excess of the outstanding balance of the Medium-Term Notes based on a calculated formula included in the Master Sale and Servicing Agreement among BHRS, BFC and Beverly Enterprises, Inc.

BHRS recognizes a loss at the time the receivables are sold to BFC equal to the 1% discount and this loss is included in Other operating and administrative costs and expenses and in Net cash provided by

Table of Contents

operating activities in our consolidated financial statements. BHRS provides invoicing and collection services related to the purchased receivables for a market-based servicing fee. Neither the loss on sale of receivables nor the servicing fee revenue is material to the Company's results of operations or cash flows.

Prior to June 1999, BFC's assets, liabilities and operating results were consolidated with us. However, in June 1999 in connection with the redemption of previously issued medium-term notes, and issuance of the Medium-Term Notes in June and July 1999, the Master Sale and Servicing Agreement was amended so that BFC met the definition of a qualifying special purpose entity as defined in Statement of Financial Accounting Standards No. 125, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*. Specifically, BFC was no longer permitted to hold or purchase receivables that originated prior to January 1, 1997 (a condition that prevented it from becoming a qualifying special purpose entity prior to June 1999). We continually evaluate the organizational structure and operations of BFC to ensure that it remains legally isolated from us and each of our operating subsidiaries and that it maintains its status as a qualifying special purpose entity and, thereby, remains deconsolidated.

Our investment in BFC of \$32.2 million and \$31.3 million at March 31, 2004 and December 31, 2003, respectively, has been recorded as a current asset in our consolidated balance sheet. The investment is recorded at its estimated fair value and is subject to periodic review for other than temporary impairment. The fair value is determined by discounting the expected future cash flows of the underlying receivables purchased and held by BFC at discount rates that reflect the projected payment terms and the credit risk of the receivables. We regularly update our fair value analysis for changes in timing and amount of expected future collections of the receivables. The carrying value of our investment is written down when the analysis indicates that the investment is other than temporarily impaired. Our total investments in BFC have been adjusted from their initial value of \$35.0 million due to cumulative credit losses incurred by BFC associated with the purchased receivables since June 1999. We believe the carrying value of our asset will be fully realized upon the maturity and repayment of the Medium-Term Notes and collection of the excess receivables. We monitor this off-balance sheet obligation throughout the year and believe the obligation and any related assets should not be included in our consolidated financial statements under current generally accepted accounting principles.

As of March 31, 2004 and December 31, 2003, we were contingently liable for approximately \$13.1 million of long-term debt maturing on various dates through 2019, as well as annual interest on that debt. These contingent liabilities principally arose from previous sales of nursing facilities and assisted living centers. We also guarantee certain third-party operating leases. Those guarantees arose from our dispositions of leased facilities and the underlying leases have \$46.6 million of minimum rental commitments remaining through the initial lease terms. In accordance with the FASB's Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others*, we have recorded approximately \$531,000, included in Other accrued liabilities on the condensed consolidated balance sheets, as the estimated fair value of our guarantees.

Operating Results

Reclassification

Results of operations for the years ended December 31, 2003, 2002 and 2001 reflect asset dispositions during 2003 and for the three months ended March 31, 2004, as discontinued operations. The following discussions of *2003 Compared to 2002* and *2002 Compared to 2001* reflect this reclassification.

2003 Compared to 2002

Results of Operations - Continuing Operations

We reported net income from continuing operations for the year ended December 31, 2003 of \$23.1 million, compared to a net loss from continuing operations of \$37.2 million for the year ended

Table of Contents

December 31, 2002. Net income from continuing operations for 2003 included special pre-tax charges totaling \$4.7 million, primarily including:

\$2.1 million for asset impairments, primarily related to three nursing facilities;

\$2.5 million for workforce reductions (see below);

\$1.9 million for exit costs associated with our divestiture strategy; net of

\$1.0 million reversal of previously recorded exit costs and \$447,000 primarily resulting from the settlement of a previously impaired asset above carrying value; and

the reversal of \$925,000 of costs originally accrued for the California investigation settlement.

The \$2.5 million for workforce reductions primarily relates to 67 associates who were notified during 2003 that their positions would be eliminated, and included the following:

\$2.8 million of cash expenses, \$1.8 million of which was paid during the year ended December 31, 2003; and

non-cash expenses of approximately \$84,000 related to the issuance of 108,230 shares under our Stock Grant Plan (the Stock Grant Plan), less approximately \$400,000 due to the cancellation of restricted stock.

We estimate the annual cost savings of this operational reorganization to be approximately \$5.0 million. The following table summarizes activity in our estimated workforce reduction and exit costs for the years ended December 31 (in thousands):

| | 2003 | | 2002 | | 2001 | |
|------------------------------------|----------------------|------------|----------------------|------------|----------------------|------------|
| | Workforce Reductions | Exit Costs | Workforce Reductions | Exit Costs | Workforce Reductions | Exit Costs |
| Balance beginning of year | \$ 5,418 | \$ 4,991 | \$ 7,631 | \$ 15,030 | \$ 4,151 | \$ 5,208 |
| Charged to continuing operations | 2,902 | 887 | 8,454 | | 23,118 | 18,165 |
| Charged to discontinued operations | | 24,828 | | 2,633 | | |
| Cash payments | (4,896) | (22,579) | (9,074) | (10,313) | (15,448) | (8,343) |
| Stock transactions | | | (1,008) | | (4,158) | |
| Reversals | (395) | (857) | (585) | (2,359) | (32) | |
| Balance end of year | \$ 3,029 | \$ 7,270 | \$ 5,418 | \$ 4,991 | \$ 7,631 | \$ 15,030 |

Net loss from continuing operations for 2002 included pre-tax charges totaling \$73.9 million, including \$54.8 million for asset impairments, exit costs and workforce reductions, \$22.2 million for the Florida insurance reserve adjustment, \$6.3 million for the California investigation settlement, offset by a decrease of \$9.4 million in reserves established in connection with previous settlements of Federal government investigations. (See *2002 Compared to 2001*.)

Costs Related to Early Extinguishments of Debt

During the fourth quarter of 2003, we entered into a \$210.0 million senior credit facility and issued \$115.0 million of 2.75% convertible subordinated notes. The net proceeds from these transactions were used to pay off our 9% senior notes and certain mortgages, bonds and other debt obligations. In conjunction with these transactions, we wrote off \$3.9 million of deferred financing costs related to our former credit facility, the 9% senior notes and the other debt obligations. We also paid a prepayment premium of \$2.7 million related to the early extinguishment of the 9% senior notes.

Table of Contents

Gain on Sale of Equity Investment

During the fourth quarter of 2003, we sold all of our holdings in a publicly traded equity security that was acquired in 1995. This investment had been accounted for as available for sale, with all changes in fair value being recorded as comprehensive income. In conjunction with the sale of the investment, we reversed the accumulated comprehensive income and recognized a pre-tax gain of \$6.7 million.

Revenues

We reported revenues of \$1,979.8 million during the year ended December 31, 2003, compared to \$1,941.3 million for the same period in 2002. Approximately 94% and 95% of our revenues for the years ended December 31, 2003 and 2002, respectively, were derived from services provided by our Nursing Facilities segment. The increase in revenues of \$38.5 million for the year ended December 31, 2003, as compared to the same period in 2002, is due to the following:

an increase of \$44.4 million from facilities we operated during each of the years ended December 31, 2003 and 2002 (same facility operations);

an increase of \$22.9 million from growth in Aegis external therapy business;

an increase of \$15.5 million due to a facility acquisition, the opening of a newly constructed facility and three hospice and home care centers, and two start-up businesses; net of

a decrease of \$44.3 million due to dispositions during 2002 not reported as discontinued operations.

The increase in revenues of \$44.4 million from same facility operations for the year ended December 31, 2003, as compared to the same period in 2002, was primarily due to the following:

\$56.3 million due to an increase in Medicaid and private payment rates;

\$9.2 million due to a positive shift in our patient mix primarily from private to Medicare;

\$6.1 million adjustment related to favorable prior year cost report settlements;

\$7.0 million due to an increase in average daily census in our Home Care segment;

partially offset by a decrease of \$13.6 million in Medicare payment rates. Effective October 1, 2002, certain Medicare add-on payments were eliminated when the federal government did not pass legislation to restore the funding. The impact of these eliminations was partially offset by a 6.26% increase in Medicare rates effective October 1, 2003;

a decrease of \$12.0 million due to a decline in same facility census; and

\$8.6 million due to a decrease in various other items.

Costs and Expenses

We reported costs and expenses of \$1,893.6 million during the year ended December 31, 2003, compared to \$1,916.0 million for the same period in 2002. Excluding special pre-tax charges of \$4.7 million in 2003 and \$73.9 million in 2002, discussed above, our costs and expenses increased \$46.8 million, consisting of the following:

an increase of \$75.3 million in same facility operations;

an increase of \$12.0 million due to a facility acquisition, and the opening of a newly constructed facility and three hospice and home care centers and two start-up businesses;

partially offset by a decrease of \$40.5 million due to dispositions during 2002 not reported as discontinued operations.

Table of Contents

The increase in costs and expenses of \$75.3 million from same facility operations for the year ended December 31, 2003, as compared to the same period in 2002, was due primarily to the following:

\$51.9 million of additional wages and related expenses primarily due to an increase in our weighted average wage rate, an increase in nursing hours per patient day and an increase in associate incentives;

\$32.2 million increase in our provision for insurance and related items, as discussed below;

\$5.4 million due to an increase in contracted services, primarily due to outsourcing certain housekeeping, laundry and dietary services in our Nursing Facilities segment;

partially offset by an \$18.2 million decrease in our provision for reserves on accounts and notes receivable due to improvements in the timing and amount of collections, as well as the collection of certain accounts that had previously been fully reserved; and

\$3.7 million decrease in depreciation and amortization expense due to the impact of asset impairments recorded in the fourth quarter of 2002.

Our provision for insurance and related items for continuing operations increased during 2003, as compared to 2002, primarily due to the following:

an increase in fixed premiums and related costs for general and professional liabilities, directors and officers insurance and workers compensation;

2002 accruals for patient care liability costs were low due to aggregate limits on our insurance policies in place for a portion of 2002. Such aggregate limits were reached during 2001 due to the sale of our Florida facilities; and

an increase in the actuarial projection of patient care liability claims.

We adjust our accruals for prior policy-year patient care and workers compensation liabilities and our accrual of expected losses for the current year based primarily on actuarial studies conducted twice per year. Adjustments to premiums and other costs are recorded as incurred.

Income Taxes

We recorded a provision for income taxes, including \$5.1 million from continuing operations and \$3.4 million from discontinued operations for the year ended December 31, 2003, primarily related to state income taxes. We decreased our valuation allowance on our deferred tax assets by \$30.1 million during 2003 to \$169.1 million as of December 31, 2003. This valuation allowance is required under the guidance of Statement of Financial Accounting Standards No. 109, *Accounting for Income Taxes* (SFAS No. 109) due to our historical operating performance and our reported cumulative net losses. Our realization of the deferred tax benefits, primarily associated with our net operating losses, is dependent upon our achieving sufficient future pre-tax income. Under federal income tax regulations, we have up to 20 years to generate sufficient taxable income to realize the deferred benefits. However, given the size of our pre-tax losses in prior years, a valuation allowance was considered to be appropriate under the more stringent accounting standards for the realization of these deferred tax benefits, which is contingent upon future income in the near term.

At December 31, 2003, for income tax purposes, we had federal net operating loss carryforwards of \$93.2 million which expire in years 2018 through 2023; general business tax credit carryforwards of \$37.7 million which expire in years 2006 through 2023; and alternative minimum tax credit carryforwards of \$21.3 million which do not expire. Future tax benefits associated with these carryforwards are not recorded in our 2003 and 2002 consolidated financial statements as a result of the valuation allowance recorded in 2001.

Results of Operations - Discontinued Operations

The results of operations of disposed facilities, clinics and other assets during 2003 and for the three months ended March 31, 2004, as well as the results of operations of held-for-sale assets, have been reported as discontinued operations for all periods presented in the consolidated statements of operations. A summary

Table of Contents

of discontinued operations by operating segment for the years ended December 31 is as follows (in thousands):

| | 2003 | | | | 2002 | | | |
|--|-----------|------------|--------------------|------------|-----------|-------------|--------------------|-------------|
| | Matrix | Home Care | Nursing Facilities | Total | Matrix | Home Care | Nursing Facilities | Total |
| Revenues ⁽¹⁾ | \$ 18,550 | \$ 20,395 | \$ 338,181 | \$ 377,126 | \$ 86,109 | \$ 20,894 | \$ 471,151 | \$ 578,154 |
| Operating income (loss) ⁽¹⁾⁽²⁾ | \$ 749 | \$ (2,446) | \$ 62 | \$ (1,635) | \$ 810 | \$ (31,057) | \$ 29,575 | \$ (672) |
| Gain (loss) on sales and exit costs | 11,120 | 1,557 | 67,113 | 79,790 | (1,001) | (1,257) | (114) | (2,372) |
| Impairments and other unusual items ⁽³⁾ | | (540) | (16,823) | (17,363) | 230 | (4,239) | (24,678) | (28,687) |
| Pre-tax income (loss) | \$ 11,869 | \$ (1,429) | \$ 50,352 | 60,792 | \$ 39 | \$ (36,553) | \$ 4,783 | (31,731) |
| Provision for state income taxes | | | | 3,378 | | | | |
| Discontinued operations, net of taxes | | | | \$ 57,414 | | | | \$ (31,731) |

(1) Includes an adjustment of \$18.0 million in 2002 for estimated overpayments to MK Medical by government payors. MK Medical was part of our Home Care segment.

(2) Includes net interest expense of \$2.2 million and \$3.5 million for 2003 and 2002, respectively. Also includes depreciation and amortization of \$10.3 million and \$23.0 million for 2003 and 2002, respectively.

(3) Includes an accrual in 2003 for the purchase of incremental patient care liability insurance on disposed nursing facilities. Includes an accrual of \$1.0 million in 2002 for legal and related fees associated with the MK Medical estimated overpayment issue, and asset impairment charges related to certain nursing facilities and our MK Medical business unit.

We recognized net gains on sales of \$67.1 million in discontinued operations related to divestitures of certain nursing facilities and assisted living centers during the year ended December 31, 2003. During 2002, we recognized asset impairment charges on certain of these divested facilities, amounting to \$24.7 million. These impairments were precipitated by an estimated decline in future cash flows, primarily associated with Medicare funding reductions. Of the divested nursing facilities that incurred impairment charges in 2002, we recognized net losses on sales of \$5.3 million.

Cumulative Effect of Accounting Change

See *2002 Compared to 2001* for a discussion of the cumulative effect of a change in accounting for goodwill recorded in 2002 as a result of adopting SFAS No. 142. In accordance with SFAS No. 142, we completed our annual impairment assessment of all of our indefinite-lived intangible assets, including goodwill, as of October 1, 2003 with no additional impairment identified.

*2002 Compared to 2001**Results of Operations - Continuing Operations*

We reported a net loss from continuing operations of \$37.2 million for the year ended December 31, 2002, compared to a net loss from continuing operations of \$273.2 million for the year ended December 31, 2001. The net loss from continuing operations for 2002 included special pre-tax charges totaling \$73.9 million, including:

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\$54.8 million for asset impairments, workforce reductions and other unusual items;

\$22.2 million for the Florida insurance reserve adjustment (See *Costs and Expenses*);

\$6.3 million for the California investigation settlement and related costs;

partially offset by a decrease of \$9.4 million in reserves established in conjunction with previous settlements of federal government investigations.

Table of Contents

The \$54.8 million for asset impairments, workforce reductions and other unusual items includes the following:

\$49.9 million write-down of property and equipment on certain assets of the Nursing Facilities segment;

\$8.5 million of workforce reductions (see below); and

\$3.0 million adjustment to asset impairments and approximately \$600,000 reversal of workforce reduction charges recorded in 2001, which were no longer needed.

The net loss from continuing operations for 2001 included special pre-tax charges totaling \$259.5 million, primarily including \$155.7 million for asset impairments and exit costs, \$24.2 million for workforce reductions and \$77.5 million related to a settlement with the federal government to resolve open reimbursement issues under the former cost-reimbursement system for Medicare. The asset impairment and exit costs, which are included in the consolidated statements of operations caption "Asset impairments, workforce reductions and other unusual items," relate to:

\$75.1 million write-down of Florida facilities and \$55.1 million of Florida exit and other costs related to a formal plan initiated by management to pursue the sale of our nursing facility operations in Florida. These assets were included in the total assets of the Nursing Facilities segment as of December 31, 2001;

write-down of goodwill of \$5.8 million, and recording of closing and other costs of \$2.8 million on under-performing Home Care businesses. These assets were included in the total assets of the Home Care segment as of December 31, 2001;

write-down of property and equipment of \$5.2 million, and goodwill and other intangibles of \$600,000 on certain under-performing nursing facilities. These assets were included in the total assets of the Nursing Facilities segment as of December 31, 2001;

write-off of abandoned projects and investments totaling \$7.8 million; and

\$3.3 million related to the termination of a lease in Indiana and the write-off of the net book value of the related assets.

We recorded a special pre-tax charge of \$8.5 million during 2002 for workforce reductions which were primarily the result of a continuing operational reorganization required to support the implementation of our three-year strategic plan. During 2002, we notified 133 employees that their positions would be eliminated. The charge included the following:

\$8.0 million of cash expenses, \$2.8 million and \$4.1 million of which was paid during the years ended December 31, 2003 and 2002, respectively; and

non-cash expenses of approximately \$500,000 related to the issuance of 124,212 shares under our Stock Grant Plan.

We estimate the annual cost savings of this operational reorganization to be approximately \$11.2 million.

During 2001, we recorded special pre-tax charges totaling \$24.2 million for workforce reductions and related costs, of which \$23.1 million related to severance and other employment agreements for approximately 240 employees who were notified in 2001 that their positions would be eliminated, including:

\$18.0 million of cash expenses, \$271,000, \$4.9 million and \$11.3 million of which was paid during the years ended December 31, 2003, 2002 and 2001, respectively;

non-cash expenses of \$4.5 million related to the issuance of 545,542 shares under the Stock Grant Plan; and

non-cash expenses of \$600,000 related to other long-term incentive agreements.

Table of Contents

We estimated the annual costs savings of this operational reorganization to be approximately \$14.0 million. Much of this savings was realized in 2001, since the majority of the workforce reductions took place in the first quarter. These estimated savings are net of the additional costs we incurred to increase the operations and clinical staff at the facility and district level. Approximately \$600,000 of these workforce reduction charges in 2001 were reversed during 2002.

On February 4, 2002, we made a settlement offer to the federal government to resolve open reimbursement issues under the former cost-reimbursement system for Medicare. For accounting purposes, this settlement offer was required to be recorded in our operating results for the year ended December 31, 2001, and resulted in a pre-tax charge of \$77.5 million which is included in the caption Special charges and adjustment related to settlements of federal government investigations. This charge included a \$35.0 million cash settlement and the write-off of \$81.5 million of related cost report receivables, offset by a \$39.0 million reserve established in 1999 for related issues. This matter was settled with CMS in the fourth quarter of 2002, and required no increase in accruals previously recorded.

Revenues

We reported revenues of \$1,941.3 million during the year ended December 31, 2002, compared to \$2,127.8 million for the same period in 2001. Approximately 95% and 97% of our revenues for each of the years ended December 31, 2002 and 2001, respectively, were derived from services provided by our Nursing Facilities segment. The decrease in revenues of \$186.5 million for the year ended December 31, 2002, as compared to the same period in 2001, consists of the following:

a decrease of \$321.2 million due to dispositions, primarily related to our Florida facilities;

partially offset by an increase of \$96.0 million from facilities we operated during each of the years ended December 31, 2002 and 2001 (same facility operations);

an increase of \$35.6 million from growth in Aegis external therapy business; and

an increase of \$3.1 million due to acquisitions and openings of newly-constructed facilities.

The increase in revenues of \$96.0 million from same facility operations for the year ended December 31, 2002, as compared to the same period in 2001, was primarily due to the following:

\$67.8 million due to an increase in Medicaid, Medicare and private payment rates;

\$8.3 million due to an increase in Medicare Part B revenues;

\$16.4 million due to a positive shift in our patient mix;

partially offset by a decrease of \$14.2 million due to a decline in same facility census.

Costs and Expenses

We reported costs and expenses of \$1,916.0 million during the year ended December 31, 2002, compared to \$2,269.7 million for the same period in 2001. Excluding special pre-tax charges of \$73.9 million in 2002 and \$259.5 in 2001, discussed above, our costs and expenses decreased \$168.0 million, consisting of the following:

a decrease of \$272.0 million due to dispositions primarily related to our Florida facilities;

partially offset by an increase of \$96.6 million in same facility operations; and

an increase of \$7.4 million due to acquisitions and openings of newly constructed facilities.

The increase in costs and expenses of \$96.6 million from same facility operations for the year ended December 31, 2002, as compared to the same period in 2001, was due primarily to the following:

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\$29.3 million of additional wages and related expenses, primarily due to an increase in our weighted average wage rate and an increase in nursing hours per patient day;

\$28.1 million additional provision for reserves on accounts and notes receivable;

38

Table of Contents

\$20.4 million due to an increase in contracted services, primarily due to outsourcing certain housekeeping, laundry and dietary services in our Nursing Facilities segment; and

\$11.4 million increase in our provision for insurance and related claims, as discussed below.

Our provision for insurance and related items increased in 2002 over 2001 primarily due to rising patient care liability costs. Based on the results of our 2002 mid-year actuarial study completed in mid-July, we recorded a pre-tax charge of \$43.3 million to increase our reserves for prior policy-year patient care liability costs, including \$22.2 million related to our previously operated Florida facilities and \$21.1 million related to same facility operations.

Interest Income and Expense

Interest income increased to \$4.7 million for the year ended December 31, 2002, as compared to \$2.9 million for the same period in 2001 primarily due to certain notes receivable accepted as partial consideration for the sale of our Florida facilities. Interest expense decreased to \$63.2 million for the year ended December 31, 2002, as compared to \$75.0 million for the same period in 2001. This was primarily due to the reduction of debt using the net proceeds from the sale of our Florida facilities in January 2002.

Income Taxes

We recorded a provision for income taxes of \$6.1 million for the year ended December 31, 2002, primarily related to state income taxes. We increased our valuation allowance on our deferred tax assets by \$45.5 million during 2002 to \$199.2 million as of December 31, 2002. This valuation allowance is required under the guidance of SFAS No. 109 due to our historical operating performance and our reported cumulative net losses.

Results of Operations Discontinued Operations

The results of operations of disposed facilities, clinics and other assets in the three months ended March 31, 2004, as well as the results of operations of held-for-sale assets, have been reported as discontinued operations for all periods presented in the consolidated statements of operations. A summary of the discontinued operations by operating segment for the years ended December 31 is as follows (in thousands):

| | 2002 | | | | 2001 | | | |
|--|----------|------------|--------------------|------------|------------|------------|--------------------|------------|
| | Matrix | Home Care | Nursing Facilities | Total | Matrix | Home Care | Nursing Facilities | Total |
| Revenues ⁽¹⁾ | \$86,109 | \$20,894 | \$471,151 | \$578,154 | \$90,907 | \$52,714 | \$460,684 | \$604,305 |
| Operating income (loss) ⁽¹⁾⁽²⁾ | \$810 | \$(31,057) | \$29,575 | \$(672) | \$(8,652) | \$(13,366) | \$51,292 | \$29,274 |
| Loss on sales and exit costs | (1,001) | (1,257) | (114) | (2,372) | | | | |
| Impairments and other unusual items ⁽³⁾ | 230 | (4,239) | (24,678) | (28,687) | (32,482) | (18,760) | (4,832) | (56,074) |
| Pre-tax income (loss) | \$39 | \$(36,553) | \$4,783 | \$(31,731) | \$(41,134) | \$(32,126) | \$46,460 | \$(26,800) |
| Provision for income taxes | | | | | | | | 1,256 |
| Discontinued operations, net of taxes | | | | \$(31,731) | | | | \$(28,056) |

(1)

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Includes an adjustment of \$18.0 million in 2002 for estimated overpayments to MK Medical by government payors. MK Medical was part of our Home Care segment.

- (2) Includes net interest expense of \$3.5 million and \$4.2 million for 2002 and 2001, respectively and depreciation and amortization of \$23.0 million and \$26.0 million for 2002 and 2001, respectively.
- (3) Includes an accrual of \$1.0 million in 2002 for legal and related fees associated with the MK Medical estimated overpayment issue, and asset impairment charges in 2002 and 2001 related to certain nursing facilities, our former Matrix segment and our MK Medical business unit.

Table of Contents*Cumulative Effect of Accounting Change*

In July 2001, the Financial Accounting Standards Board issued SFAS No. 142, which established new rules on the accounting for goodwill and other intangible assets. Under SFAS No. 142, goodwill and intangible assets with indefinite lives are no longer amortized; however, they are subject to annual impairment tests as prescribed by the Statement. Intangible assets with definite lives will continue to be amortized over their estimated useful lives. With respect to our goodwill and intangible assets, SFAS No. 142 was effective for us beginning January 1, 2002. For 2001, our goodwill and operating rights amortization was \$3.9 million and \$252,000, respectively, net of income taxes, or \$0.04 per share diluted.

We completed the impairment assessment of our indefinite-lived intangible assets, other than goodwill, during the first quarter of 2002, with no impairment identified. SFAS No. 142 described a two-step process for testing goodwill for impairment. The first step is a screen for potential impairment, while the second step measures the amount of the impairment, if any. Upon completion of the first step of the goodwill impairment test for all of our reporting units, results indicated that goodwill appeared to be impaired for our former Matrix and Home Care Services Care Focus reporting units. We subjected the goodwill at these reporting units to step two under SFAS No. 142.

We engaged a qualified, independent third-party to determine the estimated fair value of these two reporting units. Their valuation was completed during the fourth quarter of 2002, and the resulting impairment losses amounted to \$70.6 million for Matrix and \$6.6 million for Home Care Services Care Focus. As required by SFAS No. 142, these impairment losses were recorded in the 2002 consolidated statement of operations as the cumulative effect of a change in accounting for goodwill as of January 1, 2002.

Liquidity and Capital Resources

At March 31, 2004, we had \$230.2 million in cash and cash equivalents. We anticipate that \$42.4 million of this cash balance, while not legally restricted, will be utilized primarily to fund certain general and professional liabilities and workers compensation claims and expenses. At March 31, 2004, we had \$39.7 million of unused commitments under our \$75.0 million revolving credit facility, with utilization being for standby letters of credit primarily in support of certain insurance programs, security deposits, and debt or guaranteed debt obligations. At March 31, 2004, we had positive working capital of \$139.6 million reflected on our condensed consolidated balance sheet. Our cash flows consisted of the following for the three months ended March 31 (in thousands):

| | 2004 | 2003 |
|--|------------|-----------|
| Net cash provided by (used for) operating activities | \$(36,572) | \$ 11,358 |
| Net cash provided by investing activities | 11,726 | 18,572 |
| Net cash used for financing activities | (3,742) | (23,256) |
| Net increase (decrease) in cash and cash equivalents | \$(28,588) | \$ 6,674 |

For the three months ended March 31, 2004, proceeds from dispositions and collections on notes receivable totaling \$26.0 million were primarily used to fund capital expenditures of \$9.8 million and to pay down debt of \$3.6 million. Net cash provided by (used for) operating activities, under the direct method, for the three months ended March 31, consists of the following (in thousands):

| | 2004 | 2003 |
|--|-------------|-------------|
| Cash paid to suppliers and employees | \$(504,580) | \$(564,084) |
| Interest paid | (5,218) | (14,633) |
| Income taxes (paid) refunds received | (2,450) | 1,146 |
| Cash received from patients and third-party payors | 474,108 | 587,717 |
| Interest received | 1,568 | 1,212 |
| Net cash provided by (used for) operating activities | \$ (36,572) | \$ 11,358 |

Table of Contents

For the three months ended March 31, 2004, the \$36.6 million net cash used by operating activities was not caused by operational issues, but was primarily due to a \$53.6 million increase in accounts receivable, principally resulting from BFC ceasing to purchase receivables from us. According to the provisions of BFC's \$70.0 million Medium-Term Notes, BFC ceased its daily purchases of accounts receivable from BHRS on March 1, 2004, and will accumulate cash collected on previously purchased receivables in order to make the principal payments on its Medium-Term Notes, which begin in the second quarter of 2004. Based on current collection trends, it is expected that the Medium-Term Notes will be repaid by BFC on June 15, 2004. Collections of BFC receivables that are in excess of the \$70.0 million of Medium-Term Notes are expected to be paid to the Company in cash to redeem our investment in BFC during the second quarter of 2004. When the Medium-Term Notes are repaid, BFC will no longer have third-party beneficial owners and is expected to be consolidated with us as of June 2004, in accordance with SFAS No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*.

With the termination of daily purchases of receivables by BFC from BHRS, accounts receivable on our condensed consolidated balance sheet have increased and have resulted in a use of cash from operating activities on our condensed consolidated statement of cash flows for the first quarter of 2004. These receivables will be collected from the applicable governmental agencies to relieve the aging, but the timing of collections will be longer than when they were being purchased daily by BFC.

At December 31, 2003, we had \$258.8 million in cash and cash equivalents. We anticipated that \$29.9 million of this cash balance, while not legally restricted, would be utilized primarily to fund certain general and professional liabilities and workers' compensation claims and expenses. At December 31, 2003, we had \$33.7 million of unused commitments under our \$75.0 million revolving credit facility, with utilization being for standby letters of credit primarily in support of certain insurance programs, security deposits, and debt or guaranteed debt obligations. At December 31, 2003, we had positive working capital of \$101.5 million reflected on our consolidated balance sheet. Our cash flows consisted of the following for the years ended December 31 (in thousands):

| | <u>2003</u> | <u>2002</u> | <u>2001</u> |
|--|-------------------|------------------|------------------|
| Net cash provided by operating activities | \$ 69,861 | \$ 116,633 | \$ 220,897 |
| Net cash provided by (used for) investing activities | 219,188 | 62,335 | (86,654) |
| Net cash used for financing activities | (145,679) | (152,866) | (70,808) |
| Net increase in cash and cash equivalents | <u>\$ 143,370</u> | <u>\$ 26,102</u> | <u>\$ 63,435</u> |

Net cash provided by operating activities, under the direct method, for the years ended December 31, consists of the following (in thousands):

| | <u>2003</u> | <u>2002</u> | <u>2001</u> |
|--|------------------|-------------------|-------------------|
| Cash received from patients and third-party payors | \$ 2,342,917 | \$ 2,527,363 | \$ 2,728,577 |
| Income taxes (paid) refunds received | 7,656 | 3,705 | (6,299) |
| Interest received | 5,524 | 4,749 | 3,077 |
| Cash paid to suppliers and employees | (2,218,526) | (2,353,526) | (2,428,100) |
| Interest paid | (67,710) | (65,658) | (76,358) |
| Net cash provided by operating activities | <u>\$ 69,861</u> | <u>\$ 116,633</u> | <u>\$ 220,897</u> |

The decrease in net cash provided by operating activities of \$46.8 million in 2003 from 2002 was primarily related to a reduction in Medicare funding, an increase in our insurance and related payments, as well as a decrease in our incremental cash collections on patient accounts receivable. Our Nursing Facilities patient accounts receivable have continued to decline throughout 2003 and our cash collections on these accounts receivable continue to be in line with, or ahead of, our generated revenues. However, during 2002 our cash collections were significantly higher than our generated revenues due to collections of old patient balances. Having substantially completed these collection efforts during 2002, our incremental cash collections returned to a more normalized amount in 2003. In addition, our patient accounts receivable increased during 2003 due

Table of Contents

to certain Medicaid rate increases for which we will not receive payment until 2004. These factors have resulted in a year over year decline in the cash generated from accounts receivable.

In 2002, we completed a full evaluation of our nursing facility portfolio, which included the identification of non-strategic facilities and facilities that account for a disproportionately high share of projected patient care liability costs. As a result of this analysis, we have divested a significant portion of our nursing facility capacity. During the year ended December 31, 2003, we sold, closed or terminated the leases on 81 nursing facilities, seven assisted living centers, and one managed facility, of which 72 nursing facilities and six assisted living centers were part of this divestiture strategy. We received net cash proceeds of \$275.0 million from the sales of these nursing facilities, our former Matrix outpatient therapy clinics and managed care network, certain assets of our Home Care segment and other assets. These net proceeds were primarily used to:

repay approximately \$84.0 million of long-term debt;

pay off \$69.5 million of off-balance sheet lease financing;

fund capital expenditures totaling \$44.0 million; and

increase our cash on hand.

During October 2003, we entered into a new \$210.0 million senior credit facility (the Credit Facility). The Credit Facility consists of a five-year \$135.0 million term loan facility and a four-year \$75.0 million revolving credit facility. The revolving credit facility is available for general corporate purposes and up to \$55.0 million for the issuance of letters of credit. The term loan facility is fully drawn and as of March 31, 2004, we were utilizing \$35.3 million of the revolving credit facility for letters of credit. The Credit Facility currently bears interest at the prime lending rate plus 2.25%, or the Eurodollar rate plus 3.25%, at our option. The Credit Facility is secured by mortgages on certain nursing facilities, has a security interest in certain patient accounts receivable, is guaranteed by substantially all of our present and future subsidiaries and imposes on us certain financial tests and restrictive covenants.

Concurrent with the Credit Facility transaction, we issued through a public offering \$115.0 million of 2.75% convertible subordinated notes due 2033 (the Convertible Notes). The Convertible Notes are subordinated in right of payment to all of our existing and future senior debt. The Convertible Notes are convertible into shares of our common stock at an initial conversion price of \$7.45 per share, at the option of the holder when certain conditions are met prior to maturity. As of December 31, 2003, none of the conversion conditions had been met and therefore, the common shares into which the Convertible Notes may be converted were not included in the calculation of our diluted earnings per share. Assuming the Convertible Notes had been converted into shares of our common stock effective January 1, 2003, our diluted net income per share for the year ended December 31, 2003 would have been reduced by \$0.09 per share to \$0.66 per share diluted, based on a total number of shares outstanding of approximately 122,352,000.

The net proceeds from these refinancing transactions were used as follows:

to redeem all \$180.0 million of our outstanding 9% Senior Notes due 2006 and to pay the applicable premium of \$2.7 million;

to redeem \$31.0 million of our industrial development revenue and first mortgage bonds;

to repay \$18.6 million of our mortgage obligations; and

to pay transaction fees and expenses and for general corporate purposes.

These transactions enabled us to extend principal maturities, invest significantly more capital expenditures for future growth and reduce our weighted average interest rate by approximately two percentage points (or approximately \$11.0 million in annual interest expense).

In November 2003, the Board of Directors authorized a stock repurchase program whereby we may repurchase, from time to time on the open market, up to \$20.0 million of our outstanding common stock, effective December 1, 2003 and remaining in effect for one year. No shares have been repurchased under this authorization and any such repurchases will occur during open trading windows, if at all.

Table of Contents

We expect the successful completion of our divestiture strategy, while resulting in a significant reduction in our revenues, will reduce our patient care liability costs, reduce outstanding debt and strengthen the nursing facility portfolio going forward. We expect to continue the implementation of initiatives to improve our fundamental business processes and reduce costs throughout the organization. We can give no assurance that we will be able to execute the divestiture strategy in a timely manner at fair values or that we will be able to fully implement planned initiatives to reduce costs.

We currently anticipate that cash on hand, cash flows from operations and availability under our banking arrangements will be adequate to repay our debts due within one year of \$13.1 million, to make capital additions and improvements of approximately \$80.0 million, to make operating lease and other contractual obligation payments, to make selective acquisitions, including the potential purchase of Hospice USA, LLC and the purchase of previously leased facilities, and to meet working capital requirements for the twelve months ending March 31, 2005. If cash flows from operations or availability under our existing banking arrangements fall below expectations, we may be required to utilize cash on hand, delay capital expenditures, dispose of certain assets, issue additional debt securities, or consider other alternatives to improve liquidity.

Our ability to make payments on and to refinance our indebtedness and to fund planned capital expenditures and research and development efforts 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. However, based on our current level of operations and anticipated cost savings and operating improvements, we believe our cash flows from operations, available cash and cash equivalents and available borrowings will be adequate to meet our future liquidity needs for at least the next few years.

We cannot assure you, 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 future borrowings will be available to us in an amount sufficient to enable us to pay our indebtedness or to fund our other liquidity needs. We may need to refinance all or a portion of our indebtedness on or before maturity. We cannot assure you that we will be able to refinance any of our indebtedness on commercially reasonable terms or at all. (See Item 1. Business Risk Relating to our Company To service our indebtedness, we will require a significant amount of cash. Our ability to generate cash depends on many factors, some of which are beyond our control.)

Obligations and Commitments

As of March 31, 2004, we have off-balance sheet debt guarantees of \$13.1 million that primarily arose from our sales of nursing facilities. We also guarantee certain third-party operating leases. Those guarantees arose from our dispositions of leased facilities, and the underlying leases have \$46.6 million of minimum rental commitments remaining through the initial lease terms, with the latest termination date being February 2019. We have recorded approximately \$531,000, included in Other accrued liabilities on the consolidated balance sheet, as the estimated fair value of 2003 guarantees in accordance with the FASB's Interpretation No. 45, *Guarantors Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others*.

Table of Contents

A summary of our long-term contractual obligations and commitments in future years as of December 31, 2003, including principal and interest, is shown below (in thousands):

| | Payments Due by Period | | | | |
|---|------------------------|-------------------|-------------------|-------------------|-------------------|
| | Total | 2004 | 2005-2006 | 2007-2008 | After 2008 |
| Contractual obligations: | | | | | |
| Long-term debt ^(a) | \$ 854,131 | \$ 50,722 | \$ 101,288 | \$ 226,920 | \$ 475,201 |
| Capital lease obligations | 7,626 | 887 | 1,215 | 901 | 4,623 |
| Operating leases | 134,002 | 43,504 | 50,201 | 20,164 | 20,133 |
| Federal government settlement obligations | 73,894 | 18,125 | 36,250 | 19,519 | |
| Data processing agreement | 8,073 | 2,437 | 4,874 | 762 | |
| Total contractual obligations | \$ 1,077,726 | \$ 115,675 | \$ 193,828 | \$ 268,266 | \$ 499,957 |

| | Total Amounts Committed | Amount of Commitment Expiration Per Period | | | |
|-------------------------------------|-------------------------------|--|-----------|-----------------|------------------|
| | | 2004 | 2005-2006 | 2007-2008 | After 2008 |
| Other commercial commitments: | | | | | |
| Letters of credit | \$ 41,266 | \$ 41,266 | \$ | \$ | \$ |
| Guarantees | 13,083 | 345 | | 2,508 | 10,230 |
| Other commercial commitments | 403 | 403 | | | |
| Total commercial commitments | \$ 54,752 | \$ 42,014 | \$ | \$ 2,508 | \$ 10,230 |

(a) For variable-rate debt, we estimated future interest payments based on published forward yield curve analyses.

These obligations and commitments do not include \$70.0 million of Medium-Term Notes due March 2005, which are off-balance sheet obligations of BFC. (See Item 8 Note 1.)

During 2003, we acquired six leased properties (649 beds) and our corporate office building, which had been subject to our off-balance sheet lease arrangement, for cash of \$69.5 million. These acquisitions were in accordance with the 2003 amendments to our former senior credit facility and our off-balance sheet lease arrangement. These acquisitions were primarily funded with the proceeds from the sale of nursing facilities, outpatient therapy clinics and Care Focus.

Table of Contents**ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK.**

We are exposed to market risk because we utilize financial instruments. The market risks inherent in these instruments are attributable to the potential loss from adverse changes in the general level of United States interest rates. We manage our interest rate risk exposure by maintaining a mix of fixed and variable rates for debt and notes receivable. The following table provides information regarding our market sensitive financial instruments and constitutes a forward-looking statement.

| | Expected Maturity Dates | | | | | | Total | Fair Value | Fair Value |
|--|-------------------------|-----------|----------|-----------|-----------|------------|------------|----------------------|----------------------|
| | 2004 | 2005 | 2006 | 2007 | 2008 | Thereafter | | December 31, 2003 | December 31, 2002 |
| (Dollars in thousands) | | | | | | | | | |
| Total long-term debt ⁽¹⁾ : | | | | | | | | | |
| Fixed rate | \$ 11,743 | \$ 11,786 | \$ 9,567 | \$ 15,423 | \$ 8,994 | \$ 371,914 | \$ 429,427 | \$ 503,923 | \$ 578,282 |
| Average interest rate | 7.53% | 7.53% | 7.55% | 7.55% | 7.55% | 7.55% | | | |
| Variable rate | \$ 1,611 | \$ 1,635 | \$ 1,663 | \$ 33,759 | \$ 97,581 | \$ 551 | \$ 136,800 | \$ 136,800 | \$ 7,375 |
| Average interest rate | 4.43% | 5.54% | 6.64% | 7.46% | 8.04% | 7.83% | | | |
| Total notes receivable: | | | | | | | | | |
| Fixed rate | \$ 14,378 | \$ 650 | \$ 402 | \$ 13,766 | \$ 291 | \$ 3,299 | \$ 32,786 | \$ 27,459 | \$ 24,548 |
| Average interest rate | 10.88% | 8.39% | 9.16% | 9.98% | 9.07% | 8.71% | | | |
| Variable rate | \$ 37 | \$ 39 | \$ 41 | \$ 43 | \$ 46 | \$ 208 | \$ 414 | \$ 414 | \$ 449 |
| Average interest rate | 5.00% | 5.00% | 5.00% | 5.00% | 5.00% | 5.00% | | | |
| Off-balance sheet obligations ⁽²⁾ : | | | | | | | | | |
| Variable rate | \$ 70,000 | \$ | \$ | \$ | \$ | \$ | \$ 70,000 | \$ 70,000 | \$ 139,456 |
| Average interest | 1.87% | | | | | | | | |

- (1) See Item 8-Note 9 for a discussion of our 2003 refinancing. For variable-rate debt, we estimated future interest payments based on published forward yield curve analyses.
- (2) Our off-balance sheet lease obligation of \$69.5 million was satisfied in June 2003 when we acquired the remaining leased properties and our corporate office building, which had been subject to this arrangement. We expect the \$70.0 million of Medium-Term Notes will be paid by BFC on June 15, 2004.

Table of Contents

ITEM 8. CONSOLIDATED FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA.

| | Page |
|--|-------------|
| Report of Ernst & Young LLP, Independent Registered Public Accounting Firm | 47 |
| Consolidated Balance Sheets | 48 |
| Consolidated Statements of Operations | 49 |
| Consolidated Statements of Stockholders' Equity | 50 |
| Consolidated Statements of Cash Flows | 51 |
| Notes to Consolidated Financial Statements | 52 |
| Supplementary Data (Unaudited) - Quarterly Financial Data | 84 |

Table of Contents

REPORT OF ERNST & YOUNG LLP,

INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

The Board of Directors and Stockholders

Beverly Enterprises, Inc.

We have audited the accompanying consolidated balance sheets of Beverly Enterprises, Inc. as of December 31, 2003 and 2002, and the related consolidated statements of operations, stockholders' equity, and cash flows for each of the three years in the period ended December 31, 2003. Our audits also included the financial statement schedule listed in the Index at Item 15(a). These financial statements and schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and schedule based on our audits.

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

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of Beverly Enterprises, Inc. at December 31, 2003 and 2002, and the consolidated results of its operations and its cash flows for each of the three years in the period ended December 31, 2003, in conformity with U.S. generally accepted accounting principles. Also, in our opinion, the related financial statement schedule, when considered in relation to the basic consolidated financial statements taken as a whole presents fairly in all material respects the information set forth therein.

As discussed in Note 1 to the consolidated financial statements, in 2002 the Company changed its method of accounting for goodwill.

Little Rock, Arkansas
June 4, 2004, except for Note 15, paragraph 1
as to which the date is June 9, 2004

Table of Contents**BEVERLY ENTERPRISES, INC.****CONSOLIDATED BALANCE SHEETS**

(Dollars in thousands)

| | December 31, | |
|---|--------------------|--------------------|
| | 2003 | 2002 |
| ASSETS | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 258,815 | \$ 115,445 |
| Accounts receivable patient, less allowance for doubtful accounts: 2003 \$30,048; 2002 \$43,189 | 149,108 | 169,100 |
| Accounts receivable non-patient, less allowance for doubtful accounts: 2003 \$1,567; 2002 \$1,347 | 15,527 | 6,799 |
| Notes receivable, less allowance for doubtful notes: 2003 \$3,336; 2002 \$6,038 | 13,724 | 10,388 |
| Operating supplies | 10,425 | 13,980 |
| Assets held for sale | 3,498 | 36,418 |
| Investment in Beverly Funding Corporation | 31,342 | |
| Prepaid expenses and other | 33,377 | 23,577 |
| | <u>515,816</u> | <u>375,707</u> |
| Total current assets | 515,816 | 375,707 |
| Property and equipment, net | 694,220 | 789,283 |
| Other assets: | | |
| Goodwill, net | 57,102 | 63,377 |
| Other, less allowance for doubtful accounts and notes: 2003 \$2,120; 2002 \$1,853 | 79,283 | 121,528 |
| | <u>136,385</u> | <u>184,905</u> |
| Total other assets | 136,385 | 184,905 |
| | <u>\$1,346,421</u> | <u>\$1,349,895</u> |
| | <u>\$1,346,421</u> | <u>\$1,349,895</u> |
| LIABILITIES AND STOCKHOLDERS EQUITY | | |
| Current liabilities: | | |
| Accounts payable | \$ 67,572 | \$ 65,546 |
| Accrued wages and related liabilities | 116,717 | 98,206 |
| Accrued interest | 6,896 | 12,783 |
| General and professional liabilities | 93,736 | 77,025 |
| Federal government settlement obligations | 13,125 | 11,915 |
| Liabilities held for sale | 672 | 3,239 |
| Other accrued liabilities | 102,289 | 107,241 |
| Current portion of long-term debt | 13,354 | 41,463 |
| | <u>414,361</u> | <u>417,418</u> |
| Total current liabilities | 414,361 | 417,418 |
| Long-term debt | 552,873 | 588,714 |
| Other liabilities and deferred items | 141,001 | 190,291 |
| Commitments and contingencies | | |
| Stockholders equity: | | |
| Preferred stock, shares authorized: 25,000,000 | | |
| Common stock, shares issued: 2003 115,594,806; 2002 113,249,341 | 11,559 | 11,325 |

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| | | |
|---|--------------------|--------------------|
| Additional paid-in capital | 895,950 | 891,782 |
| Accumulated deficit | (560,825) | (641,293) |
| Accumulated other comprehensive income | | 517 |
| Treasury stock, at cost: 2003 8,283,316; 2002 8,391,546 | (108,498) | (108,859) |
| | <u>238,186</u> | <u>153,472</u> |
| Total stockholders equity | <u>\$1,346,421</u> | <u>\$1,349,895</u> |

See accompanying notes.

Table of Contents**BEVERLY ENTERPRISES, INC.****CONSOLIDATED STATEMENTS OF OPERATIONS****(In thousands, except per share amounts)**

| | Years Ended December 31, | | |
|---|--------------------------|--------------|--------------|
| | 2003 | 2002 | 2001 |
| | (Restated) | (Restated) | (Restated) |
| Revenues | \$ 1,979,759 | \$ 1,941,313 | \$ 2,127,795 |
| Costs and expenses: | | | |
| Wages and related | 1,178,926 | 1,168,789 | 1,300,527 |
| Provision for insurance and related items | 125,871 | 93,657 | 82,286 |
| Other operating and administrative | 524,785 | 513,789 | 560,424 |
| Depreciation and amortization | 59,318 | 65,927 | 66,952 |
| Florida insurance reserve adjustment | | 22,179 | |
| Special charge and adjustment related to California investigation settlement | (925) | 6,300 | |
| Special charge and adjustment related to settlements of federal government investigations | | (9,441) | 77,495 |
| Asset impairments, workforce reductions and other unusual items | 5,596 | 54,829 | 182,028 |
| Total costs and expenses | 1,893,571 | 1,916,029 | 2,269,712 |
| Income (loss) before other income (expenses) | 86,188 | 25,284 | (141,917) |
| Other income (expenses): | | | |
| Interest expense | (63,904) | (63,226) | (75,035) |
| Costs related to early extinguishments of debt | (6,634) | | |
| Interest income | 5,365 | 4,690 | 2,916 |
| Net gains on dispositions | 422 | 2,149 | 696 |
| Gains on sales of equity investments | 6,686 | | 256 |
| Total other expenses, net | (58,065) | (56,387) | (71,167) |
| Income (loss) before provision for income taxes, discontinued operations and cumulative effect of change in accounting for goodwill | 28,123 | (31,103) | (213,084) |
| Provision for income taxes | 5,069 | 6,085 | 60,132 |
| Income (loss) before discontinued operations and cumulative effect of change in accounting for goodwill | 23,054 | (37,188) | (273,216) |
| Discontinued operations, net of taxes: 2003 \$3,378; 2002 \$0; 2001 \$1,256 | 57,414 | (31,731) | (28,056) |
| Cumulative effect of change in accounting for goodwill, net of income taxes of \$0 | | (77,171) | |
| Net income (loss) | \$ 80,468 | \$ (146,090) | \$ (301,272) |
| Net income (loss) per share of common stock: | | | |
| Basic and diluted: | | | |
| Before discontinued operations and cumulative effect of change in accounting for goodwill | \$ 0.22 | \$ (0.36) | \$ (2.63) |
| Discontinued operations, net of taxes | 0.53 | (0.29) | (0.27) |
| | | (0.74) | |

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Cumulative effect of change in accounting for goodwill, net of taxes

| | | | |
|--|---------|-----------|-----------|
| Net income (loss) per share of common stock | \$ 0.75 | \$ (1.39) | \$ (2.90) |
| Shares used to compute basic net income (loss) per share | 106,582 | 104,726 | 104,037 |
| Shares used to compute diluted net income (loss) per share | 106,920 | 104,726 | 104,037 |

See accompanying notes.

Table of Contents**BEVERLY ENTERPRISES, INC.****CONSOLIDATED STATEMENTS OF STOCKHOLDERS EQUITY**

(Dollars in thousands)

| | Common Stock | Additional Paid-in Capital | Accumulated Deficit | Accumulated Other Comprehensive Income (Loss) | Treasury Stock | Total |
|--|-----------------|----------------------------------|------------------------|---|-------------------|------------|
| Balances at January 1, 2001 | \$ 11,282 | \$ 876,981 | \$(193,931) | \$ 718 | \$(111,057) | \$ 583,993 |
| Employee stock transactions related to 5,495 shares of common stock, net | (1) | 8,456 | | | | 8,455 |
| Reissuance of 545,542 shares of common stock from treasury | | 2,231 | | | 1,779 | 4,010 |
| Comprehensive income (loss): | | | | | | |
| Foreign currency translation adjustments, net of income tax benefit of \$222 | | | | (330) | | (330) |
| Unrealized gains on securities, net of income taxes of \$1,104 | | | | 1,641 | | 1,641 |
| Net loss | | | (301,272) | | | (301,272) |
| Total comprehensive loss | | | | | | (299,961) |
| Balances at December 31, 2001 | 11,281 | 887,668 | (495,203) | 2,029 | (109,278) | 296,497 |
| Employee stock transactions related to 436,038 shares of common stock, net | 44 | 3,680 | | | | 3,724 |
| Reissuance of 124,212 shares of common stock from treasury | | 434 | | | 419 | 853 |
| Comprehensive loss: | | | | | | |
| Unrealized losses on securities, net of income taxes of \$0 | | | | (1,464) | | (1,464) |
| Foreign currency translation adjustments, net of income taxes of \$0 | | | | (48) | | (48) |
| Net loss | | | (146,090) | | | (146,090) |
| Total comprehensive loss | | | | | | (147,602) |
| Balances at December 31, 2002 | 11,325 | 891,782 | (641,293) | 517 | (108,859) | 153,472 |
| Employee stock transactions related to 2,345,465 shares of common stock, net | 234 | 4,274 | | | | 4,508 |
| Reissuance of 108,230 shares of common stock from treasury | | (106) | | | 361 | 255 |
| Comprehensive income (loss): | | | | | | |
| Unrealized losses on securities, net of income taxes of \$0 | | | | (512) | | (512) |
| Foreign currency translation adjustments, net of income taxes of \$0 | | | | (5) | | (5) |

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| | | | | | | |
|-------------------------------|-----------|------------|--------------|----|--------------|------------|
| Net income | | | 80,468 | | | 80,468 |
| Total comprehensive income | | | | | | 79,951 |
| Balances at December 31, 2003 | \$ 11,559 | \$ 895,950 | \$ (560,825) | \$ | \$ (108,498) | \$ 238,186 |

See accompanying notes.

Table of Contents**BEVERLY ENTERPRISES, INC.****CONSOLIDATED STATEMENTS OF CASH FLOWS****(In thousands)**

| | Years Ended December 31, | | |
|---|---------------------------------|-------------|-------------|
| | 2003 | 2002 | 2001 |
| Cash flows from operating activities: | | | |
| Net income (loss) | \$ 80,468 | \$(146,090) | \$(301,272) |
| Adjustments to reconcile net income (loss) to net cash provided by operating activities, including discontinued operations: | | | |
| Depreciation and amortization | 69,663 | 88,943 | 93,001 |
| Provision for reserves on patient, notes and other receivables, net | 21,605 | 55,570 | 44,251 |
| Amortization of deferred financing costs | 4,474 | 3,096 | 4,051 |
| Florida insurance reserve adjustment | | 22,179 | |
| Special charge and adjustment related to California investigation settlement | (925) | 6,300 | |
| Special charge and adjustment related to settlements of federal government investigations | | (9,441) | 77,495 |
| Asset impairments, workforce reductions and other unusual items | 7,459 | 85,773 | 238,102 |
| Costs related to early extinguishments of debt | 6,634 | | |
| Cumulative effect of change in accounting for goodwill | | 77,171 | |
| Gains on dispositions of facilities and other assets, net | (81,508) | (1,855) | (568) |
| Deferred income taxes | | | 54,901 |
| Insurance related accounts | (32,727) | 8,411 | 11,830 |
| Changes in operating assets and liabilities, net of acquisitions and dispositions: | | | |
| Accounts receivable patient | (13,968) | 7,896 | (3,523) |
| Operating supplies | 1,467 | 3,081 | 567 |
| Prepaid expenses and other receivables | (2,502) | 988 | 728 |
| Accounts payable and other accrued expenses | 117 | (85,335) | 8,846 |
| Income taxes payable | 16,103 | 9,790 | 188 |
| Other, net | (6,499) | (9,844) | (7,700) |
| Total adjustments | (10,607) | 262,723 | 522,169 |
| Net cash provided by operating activities | 69,861 | 116,633 | 220,897 |
| Cash flows from investing activities: | | | |
| Capital expenditures | (43,984) | (100,103) | (89,401) |
| Proceeds from dispositions of facilities and other assets, net | 275,039 | 169,471 | 20,795 |
| Collections on notes receivable | 8,689 | 1,616 | 238 |
| Payments for designated funds, net | (5,183) | (260) | (8,950) |
| Other, net | (15,373) | (8,389) | (9,336) |
| Net cash provided by (used for) investing activities | 219,188 | 62,335 | (86,654) |
| Cash flows from financing activities: | | | |
| Revolver borrowings | | | 442,000 |
| Repayments of revolver borrowings | | | (606,000) |

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| | | | |
|---|-------------------|-------------------|-------------------|
| Proceeds from issuance of long-term debt | 250,000 | 5,000 | 205,248 |
| Repayments of long-term debt | (313,352) | (116,496) | (106,150) |
| Repayments of off-balance sheet financing | (69,456) | (42,901) | |
| Proceeds from exercise of stock options | 1,108 | 1,699 | 3,648 |
| Deferred financing and other costs | (13,979) | (168) | (9,554) |
| | <u> </u> | <u> </u> | <u> </u> |
| Net cash used for financing activities | (145,679) | (152,866) | (70,808) |
| | <u> </u> | <u> </u> | <u> </u> |
| Net increase in cash and cash equivalents | 143,370 | 26,102 | 63,435 |
| Cash and cash equivalents at beginning of year | 115,445 | 89,343 | 25,908 |
| | <u> </u> | <u> </u> | <u> </u> |
| Cash and cash equivalents at end of year | \$ 258,815 | \$ 115,445 | \$ 89,343 |
| | <u> </u> | <u> </u> | <u> </u> |
| Supplemental schedule of cash flow information: | | | |
| Cash paid (received) during the year for: | | | |
| Interest, net of amounts capitalized | \$ 67,710 | \$ 65,658 | \$ 76,358 |
| Income tax payments (refunds), net | (7,656) | (3,705) | 6,299 |

See accompanying notes.

Table of Contents

BEVERLY ENTERPRISES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Years ended December 31, 2003, 2002 and 2001

1. Summary of Significant Accounting Policies

Basis of Presentation

References herein to the Company include Beverly Enterprises, Inc. and its wholly owned subsidiaries.

On December 31, 2003, we operated 373 nursing facilities, 20 assisted living centers, 23 hospice and home care centers and 10 outpatient clinics in 26 states and the District of Columbia. Our operations also include rehabilitation therapy services in 36 states and the District of Columbia. Our consolidated financial statements include the accounts of the Company and all of its wholly owned subsidiaries. All significant intercompany accounts and transactions have been eliminated.

Restatement

The accompanying consolidated financial statements have been restated to report facilities, clinics and other assets which have been sold, closed or classified as held-for-sale during the three months ended March 31, 2004 as discontinued operations.

Use of Estimates

Generally accepted accounting principles require management to make estimates and assumptions when preparing financial statements that affect:

the reported amounts of assets and liabilities at the date of the financial statements; and

the reported amounts of revenues and expenses during the reporting period.

They also require management to make estimates and assumptions regarding contingent assets and liabilities at the date of the financial statements. Actual results could differ from those estimates.

Cash and Cash Equivalents

Cash and cash equivalents include time deposits and certificates of deposit with original maturities of three months or less.

Property and Equipment, Net

Property and equipment is stated at the lower of carrying value or fair value, or where appropriate, the present value of the related capital lease obligations less accumulated amortization. Depreciation and amortization are computed using the straight-line method over the estimated useful lives of the assets.

Intangible Assets

Following is a summary of our goodwill and other indefinite-lived intangible assets, included in Other assets, and related accumulated amortization, at December 31 (in thousands):

| <u>Cost Basis</u> | <u>Accumulated Amortization</u> | <u>Carrying Value</u> |
|-------------------|-------------------------------------|-----------------------|
|-------------------|-------------------------------------|-----------------------|

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| | <u>2003</u> | <u>2002</u> | <u>2003</u> | <u>2002</u> | <u>2003</u> | <u>2002</u> |
|---|-----------------|-----------------|-----------------|-----------------|-----------------|-----------------|
| Goodwill | \$78,609 | \$87,895 | \$21,507 | \$24,518 | \$57,102 | \$63,377 |
| Other indefinite-lived intangible assets | <u>9,546</u> | <u>11,368</u> | <u>4,547</u> | <u>5,376</u> | <u>4,999</u> | <u>5,992</u> |
| | <u>\$88,155</u> | <u>\$99,263</u> | <u>\$26,054</u> | <u>\$29,894</u> | <u>\$62,101</u> | <u>\$69,369</u> |

Table of Contents**BEVERLY ENTERPRISES, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****Years ended December 31, 2003, 2002 and 2001****1. Summary of Significant Accounting Policies (Continued)**

In July 2001, Statement of Financial Accounting Standards No. 142, *Goodwill and Other Intangible Assets* (SFAS No. 142) was issued, which established new rules on the accounting for goodwill and other intangible assets. Under SFAS No. 142, goodwill and intangible assets with indefinite lives are no longer amortized; however, they are subject to annual impairment tests as prescribed by the Statement. Intangible assets with definite lives continue to be amortized over their estimated useful lives. With respect to our goodwill and intangible assets, SFAS No. 142 was effective for us beginning January 1, 2002. For 2001, our goodwill and operating rights amortization was \$3.9 million and \$252,000, respectively, net of income taxes, or \$0.04 per share diluted.

In accordance with this standard, we performed the initial screening for potential impairments of our indefinite-lived intangible assets by reporting unit as of January 1, 2002. We determined the estimated fair values of each reporting unit using discounted cash flow analyses, along with independent source data related to recent transactions. Based on this determination, we identified potential goodwill impairments at our former Matrix and Home Care Services Care Focus reporting units.

We engaged a qualified independent valuation group to determine the estimated fair values of each of these reporting units. Their valuation analysis was completed in the fourth quarter of 2002, and led to the recording of a cumulative effect of a change in accounting for goodwill of \$77.2 million as of January 1, 2002, including \$70.6 million for Matrix and \$6.6 million for Care Focus. In accordance with SFAS No. 142, we test goodwill for impairment on an annual basis as of October 1 for each of our reporting units. We also test goodwill for impairment, between annual tests, if an event occurs that would more likely than not reduce the fair value of a reporting unit below its carrying amount. Based on the October 1, 2003 and 2002 analyses, no additional impairments of goodwill or other indefinite-lived intangibles were identified.

Following is a summary of our finite-lived intangible assets and related accumulated amortization, by major classification, which are included in Other assets at December 31 (in thousands):

| | Cost Basis | | Accumulated Amortization | | Carrying Value | |
|-------------------------------|-----------------|-----------------|--------------------------|-----------------|-----------------|-----------------|
| | 2003 | 2002 | 2003 | 2002 | 2003 | 2002 |
| Operating rights and licenses | \$ 1,801 | \$ 2,161 | \$ 203 | \$ 114 | \$ 1,598 | \$ 2,047 |
| Leasehold interests | 439 | 2,134 | 389 | 2,053 | 50 | 81 |
| | <u>\$ 2,240</u> | <u>\$ 4,295</u> | <u>\$ 592</u> | <u>\$ 2,167</u> | <u>\$ 1,648</u> | <u>\$ 2,128</u> |

The weighted-average amortization period for these intangibles is approximately 15 years, including 16 years for operating rights and licenses and 6 years for leasehold interests. Amortization expense related to these intangibles for the years ended December 31, 2003, 2002 and 2001 was approximately \$100,000, \$300,000 and \$400,000, respectively. Our estimated aggregate annual amortization expense for these intangibles for each of the next five years is approximately \$100,000.

On an ongoing basis, we review the carrying value of our finite-lived intangibles in light of any events or circumstances that indicate they may be impaired or that the amortization period may need to be adjusted and make any necessary adjustments. As of December 31, 2003, we do not believe there are any indications that the carrying values, or the useful lives, of these assets need to be adjusted. We have no residual values assigned to our finite-lived intangible assets.

Table of Contents

BEVERLY ENTERPRISES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Years ended December 31, 2003, 2002 and 2001

1. Summary of Significant Accounting Policies (Continued)

Impairment of Long-Lived Assets

In August 2001, the FASB issued Statement of Financial Accounting Standards No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets* (SFAS No. 144), which addresses financial accounting and reporting for the impairment of long-lived assets (other than goodwill and indefinite-lived intangibles). SFAS No. 144 supersedes Statement of Financial Accounting Standards No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed Of* (SFAS No. 121) and Accounting Principles Board Opinion No. 30, *Reporting the Results of Operations - Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions*. We adopted the provisions of SFAS No. 144 in 2002. Similar to SFAS No. 121, SFAS No. 144 requires impairment losses to be recognized for long-lived assets used in operations when indicators of impairment are present and the estimated undiscounted cash flows are not sufficient to recover the assets' carrying amounts. The impairment loss is measured by comparing the estimated fair value of the asset, usually based on discounted cash flows, to its carrying amount. In accordance with SFAS No. 144, we assess the need for an impairment write-down when such indicators of impairment are present. (See Note 5.)

Discontinued Operations

SFAS No. 144 also addresses the accounting for and disclosure of long-lived assets to be disposed of by sale. Under SFAS No. 144, when a long-lived asset or group of assets (disposal group) meets certain criteria set forth in the Statement, including a commitment by the Company to a plan to sell the long-lived asset (disposal group) within one-year:

the long-lived asset (disposal group) will be measured and reported at the lower of its carrying value or fair value less costs to sell and classified as held for sale on the consolidated balance sheet; and

the related operations of the long-lived asset (disposal group) will be reported as discontinued operations in the consolidated statement of operations, with all comparable periods restated.

SFAS No. 144 also addresses the accounting for and disclosure surrounding the disposal of long-lived assets. Our consolidated statements of operations have been restated for all periods presented to report as discontinued operations 80 nursing facilities, seven assisted living centers, our Matrix outpatient therapy clinics, our Care Focus business unit and certain business units of our Home Care segment which were disposed of during the year ended December 31, 2003 and four nursing facilities and a home medical equipment business disposed of during the three months ended March 31, 2004. At December 31, 2002, our former Matrix segment and our MK Medical business unit met the criteria set forth in SFAS No. 144 to be classified as held for sale and reported in discontinued operations. At December 31, 2003, the remaining assets and liabilities of our former Matrix segment are classified as held for sale. (See Note 6.)

Transfers of Financial Assets

The Company has an agreement to sell, on an ongoing basis, certain of its patient accounts receivable through a revolving sales structure and retains servicing responsibilities for the transferred receivables. The Company accounts for the transfers of receivables as sales in accordance with Statement of Financial Accounting Standards No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* (SFAS No. 140). Accordingly, the related patient accounts receivable are not included in our consolidated balance sheets.

During 2003, 2002 and 2001, the Company, through its wholly owned subsidiary Beverly Health and Rehabilitation Services, Inc. (BHRS), sold on a revolving basis certain Medicaid and Veterans Administra-

Table of Contents**BEVERLY ENTERPRISES, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****Years ended December 31, 2003, 2002 and 2001****1. Summary of Significant Accounting Policies (Continued)**

tion (VA) patient accounts receivable to a non-consolidated bankruptcy remote, qualifying special purpose entity (QSPE), Beverly Funding Corporation (BFC) at a discount of 1%. These daily transactions constitute true sales of receivables for which BFC bears the risk of collection.

Activities related to the revolving sales structure with BFC were as follows for the years ended December 31 (in thousands):

| | 2003 | 2002 | 2001 |
|-----------------------------|-----------|-----------|-----------|
| New receivables sold | \$824,475 | \$867,772 | \$801,707 |
| Cash collections remitted | 830,457 | 857,731 | 818,168 |
| Fees received for servicing | 2,142 | 2,119 | 2,085 |
| Loss on sale of receivables | (8,245) | (8,678) | (8,017) |

BHRS provides invoicing and collection services related to the receivables for a market-based servicing fee. BHRS recognizes a loss for the 1% discount at the time of sale which is included in Other operating and administrative costs and expenses and in Net cash provided by operating activities in our consolidated financial statements.

BFC has \$70.0 million of medium-term notes (the Medium-Term Notes), which are collateralized by outstanding Medicaid and VA patient accounts receivable purchased from BHRS. BFC is required to maintain receivables and/or a cash balance in excess of the outstanding balance of the Medium-Term Notes, based on a calculated formula in the Master Sale and Servicing Agreement. Based on ongoing reviews of BFC s operations, the Company believes that BFC meets the criteria set forth in SFAS No. 140, and related interpretive guidance, to be a QSPE. Therefore, the assets and liabilities of BFC are not consolidated with Beverly Enterprises, Inc. At December 31, 2003, BFC had total assets of approximately \$108.5 million, substantially all of which are pledged as collateral for the Medium-Term Notes. The assets of BFC cannot be used to satisfy claims of the Company or any of its subsidiaries. The Medium-Term Notes currently mature in March 2005; however, according to the provisions of the notes, principal payments on these obligations, calculated based on quarterly collections of the underlying receivables, begin in the second quarter of 2004. Based on current collection trends, it is expected that these obligations will be paid off on June 15, 2004.

At December 31, 2003, our investment in BFC of \$31.3 million has been recorded as a current asset in our consolidated balance sheet. The investment is recorded at its estimated fair value and is subject to periodic review for other than temporary impairment. The fair value is determined by discounting the expected future cash flows of the underlying receivables purchased and held by BFC at discount rates that reflect the projected payment terms and the credit risk of the receivables. We regularly update our fair value analysis for changes in timing and amount of expected future collections of the receivables. The carrying value of our investment is written down when the analysis indicates that the investment is other than temporarily impaired. Our total investments in BFC have been adjusted from their initial value of \$35.0 million due to cumulative credit losses incurred by BFC associated with the purchased receivables since June 1999. We believe the carrying value of our asset will be fully realized upon the maturity and repayment of the Medium-Term Notes and collection of the excess receivables. We monitor this off-balance sheet obligation throughout the year and believe the obligation and any related assets should not be included in our consolidated financial statements under current generally accepted accounting principles.

Table of Contents**BEVERLY ENTERPRISES, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****Years ended December 31, 2003, 2002 and 2001****1. Summary of Significant Accounting Policies (Continued)***Insurance*

We record our provisions for insurance based primarily on independent actuarial valuations using the most recent trends of claims, settlements and other relevant data. Premiums and other costs for our insurance programs are recorded as incurred. See Note 2 for a discussion of our insurance liabilities and related items.

Earnings Per Share

The following table sets forth the calculation of basic and diluted earnings per share for the years ended December 31 (in thousands, except per share data):

| | Years Ended December 31, | | |
|---|--------------------------|-------------|-------------|
| | 2003 | 2002 | 2001 |
| Numerator: | | | |
| Numerator for basic and diluted net income (loss) per share | \$ 80,468 | \$(146,090) | \$(301,272) |
| Denominator: | | | |
| Denominator for basic net income (loss) per share weighted average shares | 106,582 | 104,726 | 104,037 |
| Effect of dilutive securities: | | | |
| Employee stock options | 338 | | |
| Denominator for diluted net income (loss) per share weighted average shares and assumed conversions | 106,920 | 104,726 | 104,037 |
| Basic and diluted net income (loss) per share | \$ 0.75 | \$ (1.39) | \$ (2.90) |

Diluted earnings per share does not include the impact of 4.0 million, 8.9 million and 5.8 million of employee stock options outstanding for the years ended December 31, 2003, 2002 and 2001, respectively, because their effect would have been antidilutive.

Stock-Based Awards

On December 31, 2002, the FASB issued Statement of Financial Accounting Standards No. 148, *Accounting for Stock-Based Compensation Transition and Disclosure* (SFAS No. 148). SFAS No. 148 amends Statement of Financial Accounting Standards No. 123, *Accounting for Stock-Based Compensation* (SFAS No. 123) to provide alternative methods of transition for an entity that changes to the fair value method of accounting for stock-based employee compensation. In addition, SFAS No. 148 amends the disclosure provisions of SFAS No. 123 and Accounting Principles Board Opinion No. 28, *Interim Financial Reporting* (APB 28) to require expanded disclosure of the effects of an entity's accounting policy with respect to stock-based employee compensation on reported net income and earnings per share in annual and interim financial statements and allows companies to continue to use the intrinsic value method of APB 25.

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We continue to use the intrinsic value method to account for our stock options. Accordingly, we do not recognize compensation expense for our stock option grants, which are issued at fair market value on the date of grant. However, we recognize compensation expense for our restricted stock grants at the fair market value of our common stock on the date of grant over the respective vesting periods on a straight-line basis. See Note 11 for the pro forma effects on our reported net income (loss) and diluted net income (loss) per share if

Table of Contents

BEVERLY ENTERPRISES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Years ended December 31, 2003, 2002 and 2001

1. Summary of Significant Accounting Policies (Continued)

we recognized compensation expense on all stock-based awards using estimated fair values over the vesting periods and other disclosures required by SFAS No. 148.

Revenues

Our revenues are derived primarily from providing long-term healthcare services. Approximately 80% of our revenues is derived from federal (Medicare) and state (Medicaid) medical assistance programs. Approximately 56% and 57% of our net patient accounts receivable at December 31, 2003 and 2002, respectively, are due from such programs. We record revenues when services are provided at standard charges adjusted to amounts estimated to be received under governmental programs and other third-party contractual arrangements based on contractual terms and historical experience. These revenues and receivables are reported at their estimated net realizable amounts and are subject to audit and retroactive adjustment.

Retroactive adjustments are estimated in the recording of revenues in the period the related services are rendered. These amounts are adjusted in future periods as adjustments become known or as cost reporting years are no longer subject to audits, reviews or investigations. Due to the complexity of the laws and regulations governing the Medicare and Medicaid programs, there is at least a possibility that recorded estimates will change by a material amount in the near term. See Note 4 for a discussion of a settlement with the federal government related to Medicare cost reimbursement issues and Note 10 for the estimated potential overpayment from government programs resulting from an internal investigation of our former MK Medical business unit. Excluding these items, changes in estimates related to third-party receivables resulted in an increase in revenues of approximately \$8.7 million and \$745,000 for the years ended December 31, 2003 and 2002, respectively, and a decrease in revenues of approximately \$2.0 million for the year ended December 31, 2001.

Compliance with laws and regulations governing the Medicare and Medicaid programs is subject to government review and interpretation, as well as significant regulatory action including fines, penalties and possible exclusion from the Medicare and Medicaid programs. In addition, under the Medicare program, if the federal government makes a formal demand for reimbursement, even related to contested items, payment must be made for those items before the provider is given an opportunity to appeal and resolve the issue.

Receivables and Concentration of Credit Risk

We have significant accounts receivable and notes receivable whose collectibility or realizability is dependent upon the performance of certain governmental programs, primarily Medicare and Medicaid. These receivables represent our only concentration of credit risk. We do not believe there are significant credit risks associated with these governmental programs. We believe that an adequate provision, based on historical experience, has been made for the possibility of a portion of these and other receivables becoming uncollectible and we continually monitor and adjust these allowances as necessary. In establishing our estimate of uncollectible accounts and notes, we consider our historical collection experience, the aging of the account, and the payor classification, as well as the collateral value for notes receivable. Private pay accounts usually represent our highest collectibility risk. We write-off uncollectible accounts and notes receivable after all collection efforts have been exhausted and we determine they will not be collected. Our allowance for doubtful accounts represented approximately 17% and 20% of patient accounts receivable at December 31, 2003 and 2002, respectively. Certain interest-bearing notes receivable are placed on a nonaccrual basis when uncertainty arises as to the collectibility of principal or interest. Notes receivable of \$6.7 million and \$9.5 million at December 31, 2003 and 2002, respectively, were on a nonaccrual basis and specific collectibility allowances of \$3.7 million and \$6.9 million, respectively, have been recorded on these nonaccrual notes.

Table of Contents

BEVERLY ENTERPRISES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Years ended December 31, 2003, 2002 and 2001

1. Summary of Significant Accounting Policies (Continued)

Income Taxes

We follow the liability method in accounting for income taxes. The liability method requires deferred tax assets and liabilities to be recorded at currently enacted tax rates based on the difference between the tax basis of assets and liabilities and their carrying amounts for financial reporting purposes, referred to as temporary differences. Due to uncertainties surrounding the generation of sufficient future income in the near term necessary to realize certain deferred tax benefits, primarily relating to net operating loss carryforwards, we have established a full valuation allowance on our net deferred tax assets. (See Note 12.)

Comprehensive Income (Loss)

During the fourth quarter of 2003, we sold all of our holdings in a publicly traded equity security that was acquired in 1995 for gross proceeds of \$8.5 million. This investment had been accounted for as available for sale, with all changes in fair value being recorded as comprehensive income. In conjunction with the sale of the investment, we reversed accumulated comprehensive income, net of income taxes, of \$512,000 and recognized a pre-tax gain of \$6.7 million. Comprehensive income (loss) for 2002 includes charges and credits to stockholders equity not included in net loss. Accumulated other comprehensive income, net of income taxes, of \$517,000 at December 31, 2002, primarily consisted of net unrealized gains on available-for-sale securities of \$512,000.

During the year ended December 31, 2000, we transferred one of our equity securities from the available-for-sale category to the trading category. During 2001, this security was sold and we recognized a pre-tax gain of \$256,000 included in Gains on sales of equity investments on the consolidated statements of operations.

Other

Certain prior year amounts have been reclassified to conform with the 2003 financial statement presentation. Assets and liabilities held for sale are reported based on their status as of the balance sheet date.

2. Insurance

General and professional liability costs for the long-term care industry have become increasingly expensive and difficult to estimate. In addition, insurance coverage for patient care liability and certain other risks, for nursing facilities specifically and companies in general, has become increasingly difficult to obtain. When obtained, insurance carriers are often requiring companies to significantly increase their liability retention levels and/or pay substantially higher premiums for reduced coverage. We exercise care in selecting companies from which we purchase insurance, including review of published ratings by recognized rating agencies, advice from national brokers and consultants and review of trade information sources. There exists a risk that any of these insurance companies may become insolvent and unable to fulfill their obligation to defend, pay or reimburse us when that obligation becomes due. Although we believe the companies we have purchased insurance from are solvent, in light of the dramatic changes occurring in the insurance industry in recent years, we cannot be assured that they will remain solvent and able to fulfill their obligations.

We believe that adequate provision has been made in the financial statements for liabilities that may arise out of patient care and related services provided to date. These provisions are based primarily upon the results of independent actuarial valuations, prepared by actuaries with long-term care industry experience. These independent valuations are formally prepared twice a year using the most recent trends of claims, settlements and other relevant data. In addition to the actuarial estimate of retained losses, our provision for insurance

Table of Contents**BEVERLY ENTERPRISES, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****Years ended December 31, 2003, 2002 and 2001****2. Insurance (Continued)**

includes accruals for insurance premiums and related costs for the coverage period and our estimate of any experience adjustments to premiums. The following table summarizes our provisions for insurance and related items, including the Florida insurance reserve adjustment in 2002, for the years ended December 31 (in thousands):

| | <u>2003</u> | <u>2002</u> | <u>2001</u> |
|---|-------------------|-------------------|-------------------|
| General and professional liability: | | | |
| Continuing operations | \$ 68,009 | \$ 46,774 | \$ 39,148 |
| Florida insurance reserve adjustment | | 22,179 | |
| Discontinued operations | 38,650 | 23,603 | 11,069 |
| | <u>\$ 106,659</u> | <u>\$ 92,556</u> | <u>\$ 50,217</u> |
| Workers compensation: | | | |
| Continuing operations | \$ 44,060 | \$ 38,995 | \$ 37,875 |
| Discontinued operations | 7,801 | 8,899 | 7,528 |
| | <u>\$ 51,861</u> | <u>\$ 47,894</u> | <u>\$ 45,403</u> |
| Other insurance: | | | |
| Continuing operations | \$ 13,802 | \$ 7,888 | \$ 5,263 |
| Discontinued operations | 553 | 833 | 678 |
| | <u>\$ 14,355</u> | <u>\$ 8,721</u> | <u>\$ 5,941</u> |
| Total provision for insurance and related items: | | | |
| Continuing operations | \$ 125,871 | \$ 93,657 | \$ 82,286 |
| Florida insurance reserve adjustment | | 22,179 | |
| Discontinued operations | 47,004 | 33,335 | 19,275 |
| | <u>\$ 172,875</u> | <u>\$ 149,171</u> | <u>\$ 101,561</u> |

(1) Includes an accrual in 2003 for the purchase of incremental patient care liability insurance on divested nursing facilities.

Based on the results of the 2002 mid-year actuarial study, performed by our independent actuaries, we recorded a pre-tax charge of \$43.3 million related to an increase in our reserves for prior policy year patient care liability costs, including \$22.2 million attributable to our previously operated Florida facilities. We completed the sale of our Florida facilities in January 2002; however, we are liable for patient care liability claims and other costs for those facilities through the date of sale, subject to insurance.

We insure certain of our auto liability, general liability, professional liability and workers compensation risks through various types of loss sensitive insurance policies with affiliated and unaffiliated insurance companies. For our general and professional liabilities, we are typically responsible for the first dollar of each claim, up to a self-insurance limit determined by the individual policies, subject to aggregate limits for certain policy years. In several prior policy years, losses exceed our self-insurance aggregate limits. For claims relating to these years, our insurers have assumed a more significant role in handling the claims or related obligations and settlements. As a result, it is more difficult to

estimate potential losses in these years. However, we expect any losses in those years to be covered by our insurers. The liabilities for incurred losses retained by Beverly and not covered by insurance are estimated by the independent actuaries and are discounted on our financial statements at 10% to their present value using actuarially determined loss payment timing patterns. The

Table of Contents**BEVERLY ENTERPRISES, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****Years ended December 31, 2003, 2002 and 2001****2. Insurance (Continued)**

discount rate is based upon our best estimate of the incremental borrowing rate that would be required to fund these liabilities with uncollateralized debt. A reduction in the discount rate by one-half of a percentage point would have resulted in an additional pre-tax charge of approximately \$1.8 million for the year ended December 31, 2003.

The discounted insurance liabilities are included in the consolidated balance sheet captions as follows at December 31 (in thousands):

| | <u>2003</u> | <u>2002</u> |
|---------------------------------------|-------------------|-------------------|
| Accrued wages and related liabilities | \$ 2,528 | \$ 2,574 |
| General and professional liabilities | 93,736 | 77,025 |
| Other accrued liabilities | 10,678 | 8,142 |
| Other liabilities and deferred items | 52,954 | 102,418 |
| | <u>\$ 159,896</u> | <u>\$ 190,159</u> |

On an undiscounted basis, total retained liabilities as of December 31, 2003 and 2002 were approximately \$203.7 million and \$224.2 million, respectively. As of December 31, 2003, approximately \$11.8 million in funds (the Beverly Indemnity funds) are restricted for the payment of insured claims and included in Prepaid expenses and other on our consolidated balance sheet. In addition, we anticipate that approximately \$29.9 million of our existing cash at December 31, 2003, while not legally restricted, will be utilized primarily to fund certain workers' compensation, general and professional liability claims and expenses. We do not expect to use this cash for other purposes.

3. California Investigation Settlement and Related Costs

On August 1, 2002, the Company and the State of California reached an agreement on the settlement of an investigation by the Attorney General's office and the District Attorney of Santa Barbara County of patient care issues in several California nursing facilities. In accordance with the terms of the settlement agreement, Beverly Enterprises - California, Inc. entered a plea of *nolo contendere* to two felony charges under California's Elder Abuse statute and paid a fine of \$54,000 related to the plea. In addition, Beverly Enterprises - California, Inc. reimbursed the Attorney General and the Santa Barbara County District Attorney \$533,000 for the costs of their investigations and paid a \$2.0 million civil penalty in four equal, quarterly installments of \$500,000.

A Permanent Injunction (Permanent Injunction) was entered requiring nursing facilities in California, operated by subsidiaries of the Company, to comply with all applicable laws and regulations and conduct certain training and education programs. The Company recorded a pre-tax charge against earnings of \$6.3 million during the second quarter of 2002 to reflect the terms of the settlement and related costs. During the second quarter of 2003, approximately \$925,000 of the reserves related to this settlement were reversed when it was determined they were no longer required.

Certain revisions were made to our Corporate Integrity Agreement in conjunction with the Permanent Injunction requiring:

additional training for clinical associates, contractors and agents who perform services in our California nursing facilities; and

hiring an independent quality monitor to assess the effectiveness, reliability and thoroughness of our quality care systems and our response to quality of care issues in our nursing facilities in California, Arizona, Hawaii and Washington. By March 31, 2004, we had divested all of our nursing facilities in Arizona, Washington and Hawaii and a substantial portion of our nursing facilities in California. (See Note 15.)

Table of Contents**BEVERLY ENTERPRISES, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****Years ended December 31, 2003, 2002 and 2001****4. Special Charge and Adjustment Related to Settlements with the Federal Government**

Effective October 15, 2002, we entered into a settlement agreement with the Centers for Medicare and Medicaid Services (CMS), which resolved certain reimbursement issues relating to: (1) costs of services provided to Medicare patients during 1996 through 1998 under the federal government's former cost-reimbursement system; (2) co-payments due from Medicare beneficiaries, who were also eligible for Medicaid, for the years 1996 through 2000; and (3) all outstanding issues from our Allocation Investigations (see Note 10). Under the terms of the settlement agreement, we paid CMS \$35.0 million in November 2002.

Because the issues related to this matter arose prior to December 31, 2001 and an offer to settle was made prior to releasing our 2001 consolidated financial statements, we reflected a pre-tax charge related to this matter of \$77.5 million in our 2001 results of operations, including:

\$35.0 million related to the cash payment to CMS, which was made in November 2002;

\$81.5 million related to the write-off of Medicare cost report receivables for 1996 through 1998 and co-payment issues for 1999 and 2000;

partially offset by \$39.0 million in reserves established in conjunction with the Allocation Investigations (see Note 10).

In connection with the final settlement with CMS in 2002, we were able to revise the amount of legal fees and other costs we originally expected to incur in conjunction with these settlements. Accordingly, legal and related fees accrued for these matters in prior years were reduced by \$9.4 million during 2002.

The present value of our remaining obligation under the Civil Settlement Agreement (see Note 10) is included in the consolidated balance sheet captions as follows at December 31 (in thousands):

| | <u>2003</u> | <u>2002</u> |
|---|-----------------|-----------------|
| Federal government settlement obligations | \$ 13,125 | \$ 11,915 |
| Other liabilities and deferred items | 48,763 | 61,976 |
| | <u>\$61,888</u> | <u>\$73,891</u> |

5. Asset Impairments, Workforce Reductions and Other Unusual Items

We recorded pre-tax charges for asset impairments, workforce reductions and other unusual items as follows for the years ended December 31 (in thousands):

| | <u>2003</u> | <u>2002</u> | <u>2001</u> |
|---|-------------|-------------|-------------|
| Asset impairments | \$2,076 | \$49,927 | \$ 98,894 |
| Workforce reductions | 2,507 | 7,869 | 24,236 |
| Other unusual items, including exit costs | 1,410 | | 58,898 |
| Adjustment of previously recorded charges | (397) | (2,967) | |

| | | |
|---------|----------|-----------|
| \$5,596 | \$54,829 | \$182,028 |
|---------|----------|-----------|

Asset Impairments

During 2003, we recorded asset impairments of \$2.1 million primarily related to the write-down of property and equipment on three nursing facilities included in the Nursing Facilities segment, utilizing the same method described below for 2002. These facilities had a history of operating losses with expected future losses and cash flow deficiencies.

Table of Contents

BEVERLY ENTERPRISES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Years ended December 31, 2003, 2002 and 2001

5. Asset Impairments, Workforce Reductions and Other Unusual Items (Continued)

During 2002, we recorded asset impairments of \$49.9 million relating to the write-down of property and equipment on certain assets of the Nursing Facilities segment. The October 1, 2002 elimination of certain funding under the Medicare program affected the cash flows, and therefore the fair values, of each of our nursing facilities. This event led to an impairment assessment on each of our nursing facilities, including:

estimating the undiscounted cash flows to be generated by each of the facilities over the remaining life of the primary asset; and

reducing the carrying value of the asset to the estimated fair value when the total estimated undiscounted future cash flows was less than the current book value of the long-lived assets (excluding goodwill and other indefinite-lived intangible assets).

In estimating the undiscounted cash flows for the 2002 impairment assessment, we primarily used our internally prepared budgets and forecast information, with certain probability adjustments, including, but not limited to, the following items: Medicare and Medicaid funding; overhead costs; capital expenditures; and patient care liability costs. In order to estimate the fair values of the nursing facilities, we used a discounted cash flow approach, supplemented by public resource information on valuations of nursing facility sales transactions by region of the country. Where the estimated undiscounted cash flows were negative, we estimated the fair values based on discounted public resource information, sales values or estimated salvage values. A substantial change in the estimated future cash flows for these facilities could materially change the estimated fair values of these assets, possibly resulting in an additional impairment.

During 2001, we recorded asset impairments of \$98.9 million, primarily including:

\$75.1 million write-down of Florida facilities, as discussed below. These assets were included in the total assets of the Nursing Facilities segment as of December 31, 2001;

write-down of goodwill of \$5.8 million and other assets of \$1.1 million on under-performing Home Care businesses. These assets were included in the total assets of the Home Care segment as of December 31, 2001;

write-down of property and equipment of \$5.2 million, and goodwill and other intangibles of \$600,000 on certain under-performing nursing facilities. These assets were included in the total assets of the Nursing Facilities segment as of December 31, 2001;

write-off of abandoned projects and investments totaling \$7.8 million; and

\$3.3 million related to the termination of a lease in Indiana, including the write-off of net book value of the related assets.

The asset impairment analyses on our under-performing units and facilities in 2001 included:

estimating the undiscounted cash flows to be generated by each unit or facility, primarily over the weighted average remaining life of the assets; and

reducing the carrying value of the assets to the estimated fair value when the total undiscounted cash flows was less than the carrying value of the unit or facility.

In order to estimate the fair values of the unit, facility or property for the 2001 impairment assessment, we used a discounted cash flow approach. For the nursing facilities, we discounted the estimated future cash flows over the remaining life of the primary asset. For the Home Care businesses that lacked significant property investments, we discounted the next 10 years of expected cash flows. Cash flows for all lines of business were estimated using historical results, without an inflation factor, and adjusted for known trends.

Table of Contents

BEVERLY ENTERPRISES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Years ended December 31, 2003, 2002 and 2001

5. Asset Impairments, Workforce Reductions and Other Unusual Items (Continued)

Those cash flows were discounted at our weighted average cost of capital. A one percent change in the discount rate would not have had a material impact on the impairment calculations. Where the cash flows were negative, we estimated the fair values based on our knowledge of recent or pending sales of comparable businesses.

During 2001, a formal plan was initiated by management to pursue the sale of our nursing home operations in Florida, which included 49 nursing facilities and four assisted living centers (the Florida facilities). The plan included the pursuit of the sale of one additional nursing facility in Florida and certain other assets which would be sold in separate transactions. The decision to sell these properties was made primarily due to the disproportionately high patient care liability costs that we had been incurring in the state of Florida. Accordingly, the property and equipment, identifiable intangibles and operating supplies of our Florida nursing home operations were considered assets held for sale. Management estimated the fair value less selling costs of such assets and took special pre-tax charges in 2001 totaling \$75.1 million to write-down the Florida assets. Effective December 1, 2001, we entered into a lease agreement on the Florida facilities with Florida Health Care Properties and we closed the real estate sale in January 2002, with no further gain or loss. Annualized revenues for the Florida facilities were approximately \$288.0 million. During the year ended December 31, 2001, our Florida nursing home operations recorded pre-tax income of approximately \$600,000.

Workforce Reductions

During 2003, we recorded \$2.5 million for workforce reductions primarily relating to 67 associates who were notified during 2003 that their positions would be eliminated, and included the following:

\$2.8 million of cash expenses, \$1.8 million of which was paid during the year ended December 31, 2003; and

non-cash expenses of approximately \$84,000 related to the issuance of 108,230 shares under our Stock Grant Plan (the Stock Grant Plan), less approximately \$400,000 due to the cancellation of restricted stock.

During 2002, we recorded \$7.9 million for workforce reductions, which included a charge of approximately \$8.5 million for 133 associates who were notified in 2002 that their positions would be eliminated, net of a \$600,000 reversal of workforce reduction charges recorded in 2001 which were no longer needed. The \$8.5 million pre-tax charges included the following:

\$8.0 million of cash expenses, approximately \$2.8 million and \$4.1 million of which was paid during the years ended December 31, 2003 and 2002; and

non-cash expenses of \$500,000 related to the issuance of 124,212 shares under our Stock Grant Plan.

In January 2001, we implemented a new three-year strategic plan and operationally reorganized our business. As a result of this operational reorganization, we recorded special pre-tax charges totaling approximately \$24.2 million during 2001. Approximately \$23.1 million of these pre-tax charges related to severance and other employment agreements for approximately 240 associates who were notified in 2001 that their positions would be eliminated, including:

\$18.0 million of cash expenses, approximately \$271,000, \$4.9 million and \$11.3 million of which was paid during the years ended December 31, 2003, 2002 and 2001, respectively;

Table of Contents**BEVERLY ENTERPRISES, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****Years ended December 31, 2003, 2002 and 2001****5. Asset Impairments, Workforce Reductions and Other Unusual Items (Continued)**

non-cash expenses of \$4.5 million related to the issuance of 545,542 shares under our Stock Grant Plan; and

non-cash expenses of \$600,000 related to other long-term incentive agreements.

Other Unusual Items

During 2001, in conjunction with the sale of our Florida facilities, we recorded special pre-tax charges totaling \$55.1 million for certain exit and other costs. These costs related to severance agreements, termination payments on certain contracts and various other items.

The following table summarizes activity in our estimated workforce reduction and exit costs for the years ended December 31 (in thousands):

| | 2003 | | 2002 | | 2001 | |
|------------------------------------|----------------------|------------|----------------------|------------|----------------------|------------|
| | Workforce Reductions | Exit Costs | Workforce Reductions | Exit Costs | Workforce Reductions | Exit Costs |
| Balance beginning of year | \$ 5,418 | \$ 4,991 | \$ 7,631 | \$ 15,030 | \$ 4,151 | \$ 5,208 |
| Charged to continuing operations | 2,902 | 887 | 8,454 | | 23,118 | 18,165 |
| Charged to discontinued operations | | 24,828 | | 2,633 | | |
| Cash payments | (4,896) | (22,579) | (9,074) | (10,313) | (15,448) | (8,343) |
| Stock transactions | | | (1,008) | | (4,158) | |
| Reversals | (395) | (857) | (585) | (2,359) | (32) | |
| Balance end of year | \$ 3,029 | \$ 7,270 | \$ 5,418 | \$ 4,991 | \$ 7,631 | \$ 15,030 |

6. Discontinued Operations

During the fourth quarter of 2002, a formal plan was approved by our Board of Directors to pursue the sale of our Matrix segment and MK Medical business unit. The decision to sell these non-strategic assets was made primarily to allow us to further reduce our debt level and to reinvest in facilities, technology and other business opportunities consistent with our strategic objectives.

During 2002, in accordance with SFAS No. 144, the assets and liabilities of our former Matrix segment, the assets of our MK Medical business unit, and certain non-strategic assets of our Nursing Facilities Segment were reclassified to the corresponding held for sale asset and liability line items in the 2002 consolidated balance sheet. The outpatient therapy clinics and managed care network of Matrix, the MK Medical business unit, and certain non-strategic assets of our Nursing Facilities segment were sold during 2003. We continue to actively market the remaining Matrix assets and expect to dispose of them within the next six months.

Table of Contents**BEVERLY ENTERPRISES, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****Years ended December 31, 2003, 2002 and 2001****6. Discontinued Operations (Continued)**

A summary of the asset and liability line items from which the reclassifications have been made at December 31, is as follows (in thousands):

| | 2003 | | 2002 | | |
|-----------------------------------|----------------|-----------------|----------------|----------------|-----------------|
| | Matrix | Matrix | MK Medical | Nursing | Total |
| Current assets: | \$2,042 | \$13,711 | \$ 923 | \$ | \$14,634 |
| Property and equipment, net | 1,100 | 6,588 | 1,183 | 6,696 | 14,467 |
| Goodwill | 332 | 3,713 | | | 3,713 |
| Other assets | 24 | 3,531 | 73 | | 3,604 |
| Total assets held for sale | \$3,498 | \$27,543 | \$2,179 | \$6,696 | \$36,418 |
| Current liabilities held for sale | \$ 672 | \$ 3,239 | \$ | \$ | \$ 3,239 |

The following facilities, clinics and other assets disposed of during the year ended December 31, 2003, are reflected as discontinued operations in the accompanying consolidated statements of operations:

80 nursing facilities (9,468 beds), seven assisted living centers (278 units) and certain other assets for cash proceeds totaling approximately \$223.8 million and a \$4.0 million note receivable;

the outpatient rehabilitation clinic operations and the managed care network of our former Matrix segment for cash proceeds of \$36.0 million; and

the Care Focus and MK Medical business units and certain other assets of our Home Care segment for cash proceeds totaling \$11.0 million and a \$1.0 million note receivable.

The following facilities and business disposed of during the three months ended March 31, 2004, are reflected as discontinued operations in the accompanying consolidated statements of operations:

four nursing facilities (353 beds) for cash proceeds totaling \$8.4 million; and

a home medical equipment business of our Home Care segment for cash proceeds totaling \$165,000.

The results of operations of disposed facilities, clinics and other assets during the three months ended March 31, 2004, and the year ended December 31, 2003, as well as the results of operations of the held-for-sale assets, have been reported as discontinued operations for all periods presented in the accompanying consolidated statements of operations. Also included in discontinued operations are gains and losses on sales,

Table of Contents**BEVERLY ENTERPRISES, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****Years ended December 31, 2003, 2002 and 2001****6. Discontinued Operations (Continued)**

additional impairments and exit costs relative to these facilities, clinics and other assets. A summary of the discontinued operations by operating segment for the years ended December 31 is as follows (in thousands):

| | 2003 | | | | 2002 | | | |
|--|-------------|-------------|--------------------|-------------|-----------|-------------|--------------------|-------------|
| | Matrix | Home Care | Nursing Facilities | Total | Matrix | Home Care | Nursing Facilities | Total |
| Revenues ⁽¹⁾ | \$ 18,550 | \$ 20,395 | \$ 338,181 | \$ 377,126 | \$ 86,109 | \$ 20,894 | \$ 471,151 | \$ 578,154 |
| Operating income (loss) ⁽¹⁾⁽²⁾ | \$ 749 | \$ (2,446) | \$ 62 | \$ (1,635) | \$ 810 | \$ (31,057) | \$ 29,575 | \$ (672) |
| Gain (loss) on sales and exit costs | 11,120 | 1,557 | 67,113 | 79,790 | (1,001) | (1,257) | (114) | (2,372) |
| Impairments and other unusual items ⁽³⁾ | | (540) | (16,823) | (17,363) | 230 | (4,239) | (24,678) | (28,687) |
| Pre-tax income (loss) | \$ 11,869 | \$ (1,429) | \$ 50,352 | 60,792 | \$ 39 | \$ (36,553) | \$ 4,783 | (31,731) |
| Provision for state income taxes | | | | 3,378 | | | | |
| Discontinued operations, net of taxes | | | | \$ 57,414 | | | | \$ (31,731) |
| | | | | | | | | |
| | | | | | | | | |
| | 2001 | | | | | | | |
| | Matrix | Home Care | Nursing Facilities | Total | | | | |
| Revenues | \$ 90,907 | \$ 52,714 | \$ 460,684 | \$ 604,305 | | | | |
| Operating income (loss) ⁽²⁾ | \$ (8,652) | \$ (13,366) | \$ 51,292 | \$ 29,274 | | | | |
| Gain (loss) on sale and exit costs | | | | | | | | |
| Impairments and other unusual items | (32,482) | (18,760) | (4,832) | (56,074) | | | | |
| Pre-tax income (loss) | \$ (41,134) | \$ (32,126) | \$ 46,460 | (26,800) | | | | |
| Provision for income taxes | | | | 1,256 | | | | |
| Discontinued operations, net of taxes | | | | \$ (28,056) | | | | |

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- (1) Includes an adjustment of \$18.0 million in 2002 for estimated overpayments to MK Medical by government payors. MK Medical was part of our Home Care segment. (See Note 10.)
- (2) Includes net interest expense of \$2.2 million, \$3.5 million and \$4.2 million for 2003, 2002 and 2001, respectively. Also includes depreciation and amortization of \$10.3 million, \$23.0 million and \$26.0 million for 2003, 2002 and 2001, respectively.
- (3) Includes an accrual in 2003 for the purchase of incremental patient care liability insurance on divested nursing facilities. Includes an accrual of \$1.0 million in 2002 for legal and related fees associated with the MK Medical estimated overpayment issue, and asset impairment charges in 2002 and 2001 related to certain nursing facilities, our former Matrix segment and our MK Medical business unit.

We recognized net gains on sales of \$67.1 million related to divestitures of certain nursing facilities and assisted living centers during the year ended December 31, 2003. During 2002, we recognized asset impairment charges on certain of these divested facilities, amounting to \$24.7 million. These impairments were precipitated by an estimated decline in future cash flows, primarily associated with Medicare funding reductions. Of the divested nursing facilities that incurred impairment charges in 2002, we recognized net losses on sales of \$5.3 million.

7. Acquisitions and Dispositions

During the year ended December 31, 2003, we acquired the remaining six leased properties (649 beds) and our corporate office building, which had been subject to our off-balance sheet lease arrangement, for cash of \$69.5 million. These acquisitions were in accordance with amendments made in 2003 to our former credit facility and our off-balance sheet lease arrangement. The acquisitions were primarily funded with the proceeds

Table of Contents

BEVERLY ENTERPRISES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Years ended December 31, 2003, 2002 and 2001

7. Acquisitions and Dispositions (Continued)

from the sales of nursing facilities, our outpatient rehabilitation clinics and Care Focus. We also entered into an operating lease on a nursing facility (140 beds) and purchased certain other assets for cash of approximately \$400,000 plus closing and other costs. Excluding discontinued operations during 2003 (see Note 6), we closed one nursing facility (94 beds), sold one non-operational nursing facility (120 beds) and certain other assets for \$7.6 million, including cash and a \$4.1 million note receivable. We recognized net pre-tax gains of \$400,000 during the year ended December 31, 2003, included in *Net gains on dispositions* on the consolidated statements of operations, as a result of these disposal activities. These dispositions did not meet the criteria in SFAS No. 144 to be included in discontinued operations.

During the year ended December 31, 2002, we sold, closed or terminated the leases on 69 nursing facilities (8,132 beds), four assisted living centers (315 units), four home care centers, 10 outpatient clinics and certain other assets for cash proceeds of approximately \$170.9 million and notes receivable of approximately \$21.7 million. In December 2001, we leased to another operator 49 nursing facilities (6,129 beds) and four assisted living centers, all of which were located in Florida (see Note 5). Excluding the Florida properties, which had been written down to net realizable value in 2001, we recognized net pre-tax gains of \$2.1 million during the year ended December 31, 2002, included in *Net gains on dispositions* on the consolidated statements of operations, as a result of these disposal activities. The majority of these disposed assets were classified as held for sale at December 31, 2001 and, therefore, did not meet the criteria for classification as discontinued operations.

During the year ended December 31, 2001, we acquired one nursing facility (185 beds), eight previously leased nursing facilities (903 beds) and certain other assets for cash of approximately \$3.7 million, assumed debt of approximately \$18.4 million, security deposits of \$200,000 and incurred closing and other costs of approximately \$300,000. These acquisitions were accounted for as purchases. Also during such period, we sold, closed or terminated the leases on 18 nursing facilities (1,768 beds), one assisted living center (12 units), three outpatient therapy clinics, one home care center and certain other assets for cash proceeds of approximately \$20.4 million and a note receivable of approximately \$3.9 million. We did not operate three of the nursing facilities (355 beds) which had been leased to other nursing home operators. We recognized net pre-tax gains of \$700,000 during the year ended December 31, 2001, included in *Net gains on dispositions* on the consolidated statements of operations, as a result of these dispositions. In addition, we terminated the lease on one nursing facility (223 beds) in Indiana and recorded a pre-tax charge of approximately \$3.3 million which was included in the consolidated statements of operations caption *Asset impairments, workforce reductions and other unusual items*.

Table of Contents**BEVERLY ENTERPRISES, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****Years ended December 31, 2003, 2002 and 2001****8. Property and Equipment**

A summary of property and equipment and related accumulated depreciation and amortization, by major classification, at December 31 is as follows (in thousands):

| | Total | | Owned | | Leased | |
|--|-------------------|-------------------|-------------------|-------------------|-----------------|-----------------|
| | 2003 | 2002 | 2003 | 2002 | 2003 | 2002 |
| Land, buildings and improvements | \$ 1,038,702 | \$ 1,153,084 | \$ 1,029,657 | \$ 1,138,054 | \$ 9,045 | \$ 15,030 |
| Furniture and equipment | 241,412 | 301,604 | 239,071 | 298,244 | 2,341 | 3,360 |
| Construction in progress | 8,091 | 6,974 | 8,091 | 6,974 | | |
| | <u>1,288,205</u> | <u>1,461,662</u> | <u>1,276,819</u> | <u>1,443,272</u> | <u>11,386</u> | <u>18,390</u> |
| Less accumulated depreciation and amortization | 593,985 | 672,379 | 585,995 | 659,746 | 7,990 | 12,633 |
| | <u>\$ 694,220</u> | <u>\$ 789,283</u> | <u>\$ 690,824</u> | <u>\$ 783,526</u> | <u>\$ 3,396</u> | <u>\$ 5,757</u> |

We record depreciation and amortization using the straight-line method over the following estimated useful lives: land improvements 5 to 15 years; buildings 35 to 40 years; building improvements 5 to 20 years; leasehold improvements 5 to 20 years; furniture and equipment 5 to 15 years. Capital leased assets are amortized over the remaining initial terms of the leases.

Depreciation and amortization expense related to property and equipment, including the amortization of assets under capital lease obligations, for the years ended December 31, 2003, 2002 and 2001 was \$61.9 million, \$77.7 million and \$76.3 million, respectively, including depreciation and amortization expense on discontinued operations of \$10.0 million, \$19.7 million and \$18.4 million, respectively.

Capitalized software costs of \$53.4 million and \$53.6 million at December 31, 2003 and 2002, respectively, net of accumulated amortization of \$28.4 million and \$30.8 million, respectively, are included in the accompanying consolidated balance sheet caption Other assets. Amortization expense related to capitalized software costs for the years ended December 31, 2003, 2002 and 2001 was \$8.0 million, \$10.3 million and \$8.6 million, respectively, including amortization expense on discontinued operations of \$337,000, \$2.4 million and \$1.8 million, respectively.

Table of Contents**BEVERLY ENTERPRISES, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****Years ended December 31, 2003, 2002 and 2001****9. Long-term Debt**

Long-term debt consists of the following at December 31 (in thousands):

| | <u>2003</u> | <u>2002</u> |
|---|------------------|------------------|
| Revolving credit facility | \$ | \$ |
| 9 5/8% Senior Notes due April 15, 2009, unsecured | 200,000 | 200,000 |
| 9% Senior Notes due February 15, 2006, unsecured, prepaid December 1, 2003 | | 180,000 |
| Term Loan due October 22, 2008 secured by first priority liens on 79 nursing facilities (9,157 beds) with a carrying value of \$190,816 at December 31, 2003 | 134,662 | |
| 2.75% Convertible Subordinated Notes due November 1, 2033, unsecured | 115,000 | |
| Notes and mortgages, less imputed interest; due in installments through the year 2031, at effective interest rates of 4.75% to 12.50%, a portion of which is secured by property, equipment and other assets with a carrying value of \$85,416 at December 31, 2003 | 63,584 | 133,554 |
| Industrial development revenue bonds, due in installments through the year 2013, at effective interest rates of 4.98% to 10.00%, a portion of which is secured by property and other assets with a carrying value of \$58,475 at December 31, 2003 | 48,565 | 78,530 |
| 8.750% First Mortgage Bonds due July 1, 2008, prepaid November 26, 2003 | | 11,041 |
| 8.625% First Mortgage Bonds due October 1, 2008, prepaid November 26, 2003 | | 17,900 |
| | <u>561,811</u> | <u>621,025</u> |
| Present value of capital lease obligations, less imputed interest: 2003 \$3,210; 2002 \$6,977; at effective interest rates of 6.62% to 13.89% | 4,416 | 9,152 |
| | <u>566,227</u> | <u>630,177</u> |
| Less amounts due within one year | 13,354 | 41,463 |
| | <u>\$552,873</u> | <u>\$588,714</u> |

During October 2003, we entered into a new \$210.0 million senior credit facility (the Credit Facility). The Credit Facility consists of a five-year \$135.0 million term loan facility and a four-year \$75.0 million revolving credit facility. The revolving credit facility will be available for general corporate purposes and up to \$55.0 million for the issuance of letters of credit. The term loan facility is fully drawn and we are utilizing \$41.3 million of the revolving credit facility for letters of credit at December 31, 2003. The Credit Facility currently bears interest at the prime lending rate plus 2.25%, or the Eurodollar rate plus 3.25%, at our option. These rates may be adjusted quarterly based on the senior secured leverage ratio calculation. The revolving credit facility is secured by first priority liens on 79 nursing facilities (5,950 beds) with an aggregate carrying value of \$111.3 million at December 31, 2003, has a security interest in certain patient accounts receivable, is guaranteed by substantially all of our present and future subsidiaries and imposes on us certain financial tests and restrictive covenants.

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Concurrently with the Credit Facility transaction, we issued through a public offering \$115.0 million of 2.75% convertible subordinated notes due 2033 (the Convertible Notes). The Convertible Notes are subordinated in right of payment to all of our existing and future senior debt. The Convertible Notes are

Table of Contents

BEVERLY ENTERPRISES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Years ended December 31, 2003, 2002 and 2001

9. Long-term Debt (Continued)

convertible into shares of our common stock at an initial conversion price of \$7.45 per share, at the option of the holder, if any of the following conditions are met:

during any fiscal quarter, if the market price of our common stock is at least \$8.94 for at least 20 consecutive trading days during the 30 consecutive trading day period ending on the last day of the preceding fiscal quarter;

during the five business day period following any 10 consecutive trading day period in which (a) the trading price of a note for each day of such period is less than 105% of the conversion value and (b) the conversion value for each day of such period is less than 95% of the principal amount of a Convertible Note;

if we call the Convertible Notes for redemption; or

upon the occurrence of certain corporate transactions specified in the agreement.

As of December 31, 2003, none of the conversion conditions had been met and therefore, the common shares into which the Convertible Notes may be converted were not included in the calculation of our diluted earnings per share. Assuming the Convertible Notes had been converted into shares of our common stock effective January 1, 2003, our unaudited pro forma diluted net income per share for the year ended December 31, 2003, would have been reduced by \$0.09 per share to \$0.66 per share diluted, based on a total number of shares outstanding of approximately 122,352,000.

The net proceeds from these transactions were used as follows:

to redeem all \$180.0 million of our outstanding 9% Senior Notes due 2006 and to pay the applicable premium of \$2.7 million;

to redeem \$31.0 million of our industrial development revenue and first mortgage bonds;

to repay \$18.6 million of our mortgage obligations; and

to pay transaction fees and expenses, and for general corporate purposes.

The 9 5/8% Senior Notes are unsecured obligations guaranteed by substantially all of our present and future subsidiaries (the Subsidiary Guarantors) and impose on us certain restrictive covenants. Separate financial statements of the Subsidiary Guarantors are not considered to be material to holders of our Senior Notes since the guaranty of each of the Subsidiary Guarantors is joint and several and full and unconditional (except that liability thereunder is limited to an aggregate amount equal to the largest amount that would not render its obligations thereunder subject to avoidance under Section 548 of the Bankruptcy Code of 1978, as amended, or any comparable provisions of applicable state law), and Beverly Enterprises, Inc., the parent, has no operations or material assets separate from its investments in its subsidiaries.

Table of Contents**BEVERLY ENTERPRISES, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****Years ended December 31, 2003, 2002 and 2001****9. Long-term Debt (Continued)**

Maturities and sinking fund requirements of long-term debt, including capital leases, for the years ended December 31 are estimated as follows (in thousands):

| | <u>2004</u> | <u>2005</u> | <u>2006</u> | <u>2007</u> | <u>2008</u> | <u>Thereafter</u> | <u>Total</u> |
|--|------------------|------------------|------------------|------------------|-------------------|-------------------|-------------------|
| Future minimum lease payments | \$ 887 | \$ 712 | \$ 503 | \$ 461 | \$ 440 | \$ 4,623 | \$ 7,626 |
| Less interest | (375) | (335) | (304) | (288) | (273) | (1,635) | (3,210) |
| Net present value of future minimum lease payments | 512 | 377 | 199 | 173 | 167 | 2,988 | 4,416 |
| Notes, mortgages and bonds | 12,842 | 13,044 | 11,031 | 49,009 | 106,408 | 369,477 | 561,811 |
| | <u>\$ 13,354</u> | <u>\$ 13,421</u> | <u>\$ 11,230</u> | <u>\$ 49,182</u> | <u>\$ 106,575</u> | <u>\$ 372,465</u> | <u>\$ 566,227</u> |

Most of our capital leases, as well as our operating leases, have original terms from ten to fifteen years and contain at least one renewal option (which could extend the terms of the leases by five to fifteen years), purchase options, escalation clauses and provisions for payments by us of real estate taxes, insurance and maintenance costs.

10. Commitments and Contingencies

Our future minimum rental commitments required by all noncancelable operating leases with initial or remaining terms in excess of one year as of December 31, 2003, are estimated as follows (in thousands):

| <u>Year Ending December 31,</u> | |
|-------------------------------------|-------------------|
| 2004 | \$ 43,504 |
| 2005 | 33,927 |
| 2006 | 16,274 |
| 2007 | 10,517 |
| 2008 | 9,647 |
| Thereafter | 20,133 |
| | <u>\$ 134,002</u> |

Our total future minimum rental commitments are net of approximately \$5.1 million of minimum sublease rental income due in the future under noncancelable subleases. The following table summarizes certain information relative to our operating leases, including operating leases for discontinued operations, for the years ended December 31 (in thousands):

| <u>2003</u> | <u>2002</u> | <u>2001</u> |
|-------------|-------------|-------------|
|-------------|-------------|-------------|

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| | | | |
|--|----------|----------|-----------|
| Rent expense, net of sublease rent income | \$70,132 | \$87,852 | \$106,814 |
| Sublease rent income | 1,143 | 2,036 | 2,248 |
| Estimated contingent rent expense, based primarily on revenues | 1,000 | 2,000 | 7,000 |

Our management information systems data processing functions have been outsourced under an agreement which was renegotiated during 2002 and expires in 2007. Our future minimum commitments as of December 31, 2003, under this agreement are estimated as follows: 2004 \$2.4 million; 2005 \$2.4 million; 2006 \$2.5 million; 2007 \$762,000. We incurred approximately \$2.3 million, \$2.9 million and \$3.4 million under this agreement during the years ended December 31, 2003, 2002 and 2001, respectively.

Table of Contents

BEVERLY ENTERPRISES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Years ended December 31, 2003, 2002 and 2001

10. Commitments and Contingencies (Continued)

We are contingently liable for approximately \$13.1 million of long-term debt maturing on various dates through 2019, as well as annual interest. These contingent liabilities principally arose from our sale of nursing facilities and assisted living centers. We operate two facilities related to approximately \$2.8 million of the principal amount for which we are contingently liable, pursuant to long-term agreements accounted for as operating leases. We guarantee certain third-party operating leases. These guarantees arose from our dispositions of leased facilities and the underlying leases have approximately \$46.6 million of minimum rental commitments remaining through the initial lease terms, with the latest termination date being February 2019. In accordance with the FASB's Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others* (FIN 45), we have recorded approximately \$531,000, included in Other accrued liabilities on the consolidated balance sheet, as the estimated fair value of 2003 guarantees.

In 2002, we notified federal and California healthcare regulatory authorities (CMS, Office of Inspector General (the OIG), the California Attorney General's office and the California Department of Health) of our intent to conduct an internal investigation of past billing practices relating to MK Medical, our former medical equipment business unit based in Fresno, California. An independent accounting firm has reviewed MK Medical's government payor billings since October 1, 1998, the date Beverly acquired the business unit. Deficiencies identified by the accounting firm primarily relate to inadequate documentation supporting Medicare and Medi-Cal claims for reimbursement for drugs, wheelchairs, and other durable medical equipment distributed by MK Medical. Specifically, the review identified instances of missing or incomplete certificates of medical necessity, treatment authorization requests, prescriptions and other documentation MK Medical is required to maintain in order to be entitled to reimbursement from government payors. Based on the results of the accounting firm's review, we established a reserve in 2002, included in Other accrued liabilities on the consolidated balance sheets in the amount of \$18.0 million to cover potential overpayments from government payors for the period from October 1, 1998 to 2002. We have advised regulatory authorities of the results of the accounting firm's review. On September 15, 2003, we received a subpoena from the United States Attorney's Office in Oakland, California, requesting the production of additional documents relating to MK Medical's operations and our review of MK Medical's claims. We have produced documents in response to this subpoena and continue to cooperate with the government's request for information. Our liability with respect to this matter could exceed the reserved amount, which continues to be our best estimate of our exposure on this matter. We can give no assurance of the final outcome of this matter or its impact on our financial position, results of operations and cash flows.

On February 3, 2000, we entered into a series of separate agreements with the U.S. Department of Justice and the OIG. These agreements settled the federal government's investigations of the Company relating to our allocation to the Medicare program of certain nursing labor costs in our skilled nursing facilities from 1990 to 1998 (the Allocation Investigations).

Under the Civil Settlement Agreement, we paid the federal government \$25.0 million during 2000 and are reimbursing the federal government an additional \$145.0 million through withholdings from our biweekly Medicare periodic interim payments in equal installments through the first quarter of 2008. The present value of the remaining obligation included as liabilities on our consolidated balance sheets was \$61.9 million and \$73.9 million at December 31, 2003 and 2002, respectively. In addition, we agreed to resubmit certain Medicare filings to reflect reduced labor costs allocated to the Medicare program. The adjustments for these resubmitted filings were part of the settlement agreement with CMS. (See Note 4.)

Under the Corporate Integrity Agreement, we are required to monitor, on an ongoing basis, our compliance with the requirements of the federal healthcare programs. This agreement addresses our

Table of Contents

BEVERLY ENTERPRISES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Years ended December 31, 2003, 2002 and 2001

10. Commitments and Contingencies (Continued)

obligations to ensure that we comply with the requirements for participation in the federal healthcare programs. It also includes functional and training obligations, audit and review requirements, recordkeeping and reporting requirements, as well as penalties for breach or noncompliance of the agreement. We believe that we are generally in compliance with the requirements of the Corporate Integrity Agreement.

On October 31, 2002, a shareholder derivative action entitled *Paul Dunne and Helene Dunne, derivatively on behalf of nominal defendant Beverly Enterprises, Inc. v. Beryl F. Anthony, Jr., et. al.* was filed in the Circuit Court of Sebastian County, Arkansas, Fort Smith Division (No. CIV-2002-1241). This case was purportedly brought derivatively on behalf of the Company against various current and former officers and directors. The complaint alleges causes of action for breach of fiduciary duty against the defendants based on: (1) allegations that defendants failed to establish and maintain adequate accounting controls such that the Company failed to record adequate reserves for patient care liability costs; and (2) allegations that certain defendants sold Company stock while purportedly in possession of material non-public information.

On May 16, 2003, two additional derivative complaints (*Holcombe v. Floyd, et. al.* and *Flowers v. Floyd, et. al.*) were filed and subsequently transferred to the Circuit Court of Sebastian County, Arkansas, Fort Smith Division and consolidated with the Dunne action as *Holcomb v. Beverly Enterprises, Inc.* The Dunnes were subsequently dismissed as plaintiffs. On June 9, 2003, pursuant to a stipulation of the parties, the Court entered a scheduling order providing, among other things, that plaintiffs will have thirty days from a ruling on the motion to dismiss filed by defendants in the related securities class action in federal court, *In re Beverly Enterprises, Inc. Securities Litigation* (Case No. 2:02 cv 2190), to file an amended complaint and that defendants shall have thirty days thereafter to respond to the complaint. The court entered a ruling on the defendants' motion to dismiss in the federal securities class action on December 23, 2003, and the plaintiffs filed a notice of appeal on January 22, 2004. In light of the plaintiffs' appeal, the parties have agreed to a further stay of this derivative action pending resolution of the appeal. The dismissal of the appeal on April 19, 2004, described in paragraph below, began the thirty-day period for plaintiffs to file an amended complaint in the derivative action, which they declined to do. Defendants' response to the complaint is currently due on June 19, 2004. Due to the preliminary state of this action, we are unable to assess the probable outcome of the case and can give no assurance of the ultimate impact on our financial position, results of operations and cash flows.

On August 16, 2002, August 26, 2002, and September 26, 2002, respectively, *Ernest Baer v. Beverly Enterprises, Inc., et. al.* (CIV. No. 02-2190), *Stanley V. Kensic v. Beverly Enterprises, Inc., et. al.* (CIV. No. 02-2193) and *Charles Krebs v. Beverly Enterprises, Inc., et. al.* (CIV. No. 02-2222) were filed in the United States District Court, Western District of Arkansas, Fort Smith Division. These cases were filed as purported securities fraud class actions under Sections 10(b) and 20(a) of the Securities Exchange Act of 1934 and Rule 10b-5 promulgated thereunder.

These cases separately name Beverly Enterprises, Inc. as a defendant along with various current officers and our independent auditors. In all three cases, the purported class period runs from October 16, 2000 to and including July 19, 2002. Plaintiffs claim that the defendants, during the purported class period, made multiple false and misleading statements. In early March 2003, these cases were consolidated as *In re Beverly Enterprises, Inc. Securities Litigation*. On April 30, 2003, plaintiffs filed an amended complaint. On May 30, 2003, the defendants filed a motion to dismiss the amended complaint. Briefing on the motion to dismiss was completed July 11, 2003. The court heard oral arguments on the defendants' motion on August 28, 2003. On December 23, 2003, the court granted defendants' motions to dismiss with prejudice and denied plaintiffs' motion to amend the complaint. Plaintiffs filed a notice of appeal on January 22, 2004. On April 2, 2004,

Table of Contents

BEVERLY ENTERPRISES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Years ended December 31, 2003, 2002 and 2001

10. Commitments and Contingencies (Continued)

plaintiffs and defendants jointly moved to dismiss the appeal with prejudice and on April 19, 2004, the court dismissed the action.

In addition, since July 29, 1999, several derivative lawsuits have been filed in the state courts of Arkansas, California and Delaware, as well as the federal district court in Arkansas, assertedly on behalf of the Company (collectively, the Derivative Actions). The parties have agreed on a settlement in principle for these actions, which provides that we will incorporate various corporate governance practices that are consistent with our policies. In addition, the directors and officers' liability insurance carriers, on behalf of the individual defendants, will pay no more than \$375,000 for plaintiffs' attorneys' fees.

We are party to various legal matters relating to patient care, including claims that our services have resulted in injury or death to residents of our facilities. We have experienced an increasing trend in the number and severity of the claims asserted against us. (See Note 2.) We believe that there has been, and will continue to be, an increase in governmental investigations of long-term care providers. Adverse determinations in legal proceedings or governmental investigations, whether currently asserted or arising in the future, could have a material adverse effect on us.

There are various other lawsuits and regulatory actions pending against the Company arising in the normal course of business, some of which seek punitive damages that are generally not covered by insurance. We do not believe that the ultimate resolution of such other matters will have a material adverse effect on our consolidated financial position, results of operations or cash flows.

11. Stockholders' Equity

We have 300,000,000 shares of authorized \$.10 par value common stock. We are subject to certain restrictions under our long-term debt agreements related to the payment of cash dividends on, and the repurchase of, our common stock. During 2003 and 2002, we did not pay any cash dividends on, or repurchase any of, our common stock. We have 25,000,000 shares of authorized \$1 par value preferred stock, all of which remains unissued. The Board of Directors has authority, without further stockholder action, to set rights, privileges and preferences for any unissued shares of preferred stock.

In November 2003, the Board of Directors authorized a stock repurchase program whereby we may repurchase, from time to time on the open market, up to \$20.0 million of our outstanding common stock, effective December 1, 2003 and remaining in effect for one year. As of December 31, 2003, no shares had been repurchased under this authorization and any such repurchases will occur during open trading windows, if at all.

In April 2003, we issued 2.5 million shares of restricted stock to certain officers and other employees. These shares vest one-third per year over the three years following the grant date. These restricted stock grants were made, along with certain cash incentives, as part of a program designed to retain key associates. If these additional shares had been issued prior to January 1, 2003, there would have been no material impact on the Company's net income per share for the year ended December 31, 2003. We recognize compensation expense for our restricted stock grants at the fair market value of our common stock on the date of grant, amortized over the respective vesting periods on a straight-line basis. The total charges to our consolidated statements of operations for the years ended December 31, 2003, 2002 and 2001 related to restricted stock grants were approximately \$1.8 million, \$1.3 million and \$1.7 million, respectively.

In January 2001, we filed a registration statement under Form S-8 with the Securities and Exchange Commission registering 1,174,500 shares of our common stock. These shares were previously repurchased by the Company and held in treasury. They may be issued under the Beverly Enterprises, Inc. Stock Grant Plan

Table of Contents

BEVERLY ENTERPRISES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Years ended December 31, 2003, 2002 and 2001

11. Stockholders Equity (Continued)

(the Stock Grant Plan) to holders of restricted stock who, by virtue of the terms of their employment contracts, severance agreements or other similar arrangements, are entitled to the immediate vesting of their restricted stock. In conjunction with ongoing operational reorganizations (as discussed in Note 5), 777,984 shares of our common stock under the Stock Grant Plan have been issued to various officers in exchange for shares of restricted stock held by them, which have been cancelled. Pre-tax workforce reduction charges of \$84,000, \$500,000 and \$4.5 million were recorded in 2003, 2002 and 2001, respectively, in connection with the issuance of these shares.

During 1997, the New Beverly 1997 Long-Term Incentive Plan was approved (the 1997 Long-Term Incentive Plan). The plan became effective December 3, 1997 and remains in effect until December 31, 2006, subject to early termination by the Board of Directors. The Compensation Committee of the Board of Directors (the Committee) is responsible for administering the 1997 Long-Term Incentive Plan and has complete discretion in determining the number of shares or units to be granted, in setting performance goals and in applying other restrictions to awards, as needed, under the plan. The 1997 Long-Term Incentive Plan was originally authorized to issue 10,000,000 shares of our common stock, subject to certain adjustments, in the form of nonqualified stock options, incentive stock options, stock appreciation rights, restricted stock, restricted stock units, performance awards, bonus stock and other stock unit awards. In May 2001, our stockholders approved an amendment to this plan which authorized the issuance of an additional 5,000,000 shares.

In general, nonqualified and incentive stock options must be granted at a purchase price equal to the fair market value of our common stock on the date of grant. Options issued at fair market value do not currently require the recording of compensation expense upon issuance. Options shall be exercisable at such times and be subject to such restrictions and conditions as the Committee shall determine and expire no later than 10 years from the grant date. Stock appreciation rights may be granted alone, in tandem with an option or in addition to an option. Stock appreciation rights shall be exercisable at such times and be subject to such restrictions and conditions as the Committee shall determine and expire no later than 10 years from the grant date. Restricted stock awards are outright stock grants which have a minimum vesting period of one year for performance-based awards and three years for other awards. Performance awards, bonus stock and other stock unit awards may be granted based on the achievement of certain performance or other goals and will carry certain restrictions, as defined. The issuance of restricted stock and other stock awards usually require the recognition of compensation expense measured by the fair value of the stock on the date of grant.

During 1997, the New Beverly Non-Employee Directors Stock Option Plan was approved (the Non-Employee Directors Stock Option Plan). The plan became effective December 3, 1997 and remains in effect until December 31, 2007, subject to early termination by the Board of Directors. We have 450,000 shares of our common stock authorized for issuance, subject to certain adjustments, under the Non-Employee Directors Stock Option Plan. The Non-Employee Directors Stock Option Plan was amended by the Board of Directors on March 28, 2001, to provide that each non-employee director be granted an option to purchase 11,000 shares of our common stock on June 1 of each year until the plan is terminated, subject to the availability of shares. These options are granted at a purchase price equal to the fair market value of our common stock on the date of grant, become exercisable one year after the date of grant and expire 10 years after the date of grant.

Table of Contents**BEVERLY ENTERPRISES, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****Years ended December 31, 2003, 2002 and 2001****11. Stockholders Equity (Continued)**

The following table summarizes stock option and restricted stock data relative to our long-term incentive plans for the years ended December 31:

| | 2003 | | 2002 | | 2001 | |
|---|------------------|---------------------------------|------------------|---------------------------------|------------------|---------------------------------|
| | Number of Shares | Weighted-Average Exercise Price | Number of Shares | Weighted-Average Exercise Price | Number of Shares | Weighted-Average Exercise Price |
| Options outstanding at beginning of year | 8,882,635 | \$6.62 | 5,808,260 | \$6.46 | 3,790,326 | \$5.02 |
| Changes during the year: | | | | | | |
| Granted | 103,000 | 3.96 | 4,749,460 | 6.43 | 3,914,323 | 7.77 |
| Exercised | (234,850) | 5.37 | (512,612) | 3.72 | (943,608) | 3.93 |
| Cancelled | (970,582) | 5.98 | (1,162,473) | 6.30 | (952,781) | 8.59 |
| Options outstanding at end of year | 7,780,203 | 6.70 | 8,882,635 | 6.62 | 5,808,260 | 6.46 |
| Options exercisable at end of year | 3,580,102 | 6.86 | 2,274,231 | 7.09 | 1,289,677 | 7.19 |
| Options available for grant at end of year | 1,967,432 | | 2,933,703 | | 6,465,204 | |
| Restricted stock outstanding at beginning of year | 1,122,402 | | 1,290,572 | | 2,354,873 | |
| Changes during the year: | | | | | | |
| Granted | 2,503,125 | | 175,000 | | 205,360 | |
| Vested | (131,550) | | (112,684) | | (75,709) | |
| Forfeited | (352,971) | | (230,486) | | (1,193,952) | |
| Restricted stock outstanding at end of year | 3,141,006 | | 1,122,402 | | 1,290,572 | |

Exercise prices for options outstanding as of December 31, 2003, ranged from \$2.33 to \$14.38. The weighted-average remaining contractual life of these options is approximately seven years. The following table provides certain information with respect to stock options outstanding and exercisable at December 31, 2003:

| Options | Options Outstanding | | Options Exercisable | |
|---------|---------------------|---------------------------|---------------------|---------------------------|
| | Options | Weighted-Average Exercise | Options | Weighted-Average Exercise |
| | | Remaining | | |

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| Range of Exercise Prices | | Outstanding | Price | Contractual Life | Exercisable | Price |
|--------------------------|---------|-------------|---------|------------------|-------------|---------|
| \$ 2.33 | \$ 6.85 | 3,782,276 | \$ 5.20 | 7.53 | 1,521,893 | \$ 4.71 |
| \$ 7.00 | \$ 9.80 | 3,582,592 | 7.73 | 7.26 | 1,655,000 | 7.68 |
| \$10.46 | \$11.76 | 364,710 | 11.29 | 7.28 | 352,584 | 11.29 |
| \$12.88 | \$14.38 | 50,625 | 13.58 | 4.17 | 50,625 | 13.58 |
| \$ 2.33 | \$14.38 | 7,780,203 | 6.70 | 7.39 | 3,580,102 | 6.86 |

SFAS No. 148, issued on December 31, 2002, provides companies alternative methods of transitioning to SFAS No. 123's fair value method of accounting for stock-based employee compensation, and amends certain

Table of Contents

BEVERLY ENTERPRISES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Years ended December 31, 2003, 2002 and 2001

11. Stockholders Equity (Continued)

disclosure requirements. SFAS No. 148 does not mandate fair value accounting for stock-based employee compensation, but does require all companies to meet the disclosure provisions. We currently do not recognize compensation expense for our stock option grants, which are issued at fair market value on the date of grant, and are accounted for under the intrinsic value method. We are in compliance with the current accounting rules surrounding stock-based compensation.

On March 31, 2004, the Financial Accounting Standards Board (FASB) issued an Exposure Draft, Share-Based Payment, which is a proposed amendment to SFAS No. 123. The Exposure Draft would require all share-based payments to employees, including grants of employee stock options, to be expensed in the statements of income based on their fair values. Public comments on the Exposure Draft are due by June 30, 2004, and the FASB expects the new standard will be effective beginning in 2005.

Pro forma information regarding net income (loss) and diluted net income (loss) per share has been determined as if we accounted for our stock option grants under the fair market value method described in SFAS No. 123. The fair market value of our stock options was estimated at the date of grant using a Black-Scholes option pricing model with the following weighted-average assumptions for the years ended December 31, 2003, 2002 and 2001, respectively:

risk-free interest rates of 3.0%, 4.8% and 4.3%;

volatility factors of the expected market price of our common stock of .81, .74 and .59; and

expected option lives of five years.

We do not currently pay cash dividends on our common stock and no future dividends are currently planned. The weighted-average assumptions resulted in a weighted average estimated fair market value of options granted during 2003, 2002 and 2001 of \$2.61 per share, \$3.55 per share and \$4.25 per share, respectively.

The Black-Scholes option valuation model was developed for use in estimating the fair market value of traded options that have no vesting restrictions and are fully transferable. In addition, option valuation models require the input of highly subjective assumptions including the expected stock price volatility. Because our stock options have characteristics significantly different from those of traded options, and because changes in the subjective input assumptions can materially affect the fair market value estimates, in management's opinion, the existing models do not necessarily provide a reliable single measure of the fair market value of our stock options.

Table of Contents**BEVERLY ENTERPRISES, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****Years ended December 31, 2003, 2002 and 2001****11. Stockholders Equity (Continued)**

For purposes of pro forma disclosures, the estimated fair market value of all outstanding stock options is amortized to expense over their respective vesting periods. The pro forma effects are not necessarily indicative of the effects on future years. The following table summarized our pro forma net income (loss) and diluted net income (loss) per share, assuming we accounted for our stock option grants in accordance with SFAS No. 123, for the years ended December 31 (in thousands, except per share amounts):

| | <u>2003</u> | <u>2002</u> | <u>2001</u> |
|---|-----------------|--------------------|--------------------|
| Reported net income (loss) ^(a) | \$80,468 | \$(146,090) | \$(301,272) |
| Stock option compensation expense | 6,865 | 6,218 | 2,708 |
| Pro forma net income (loss) | <u>\$73,603</u> | <u>\$(152,308)</u> | <u>\$(303,980)</u> |
| Reported diluted net income (loss) per share | \$ 0.75 | \$ (1.39) | \$ (2.90) |
| Pro forma diluted net income (loss) per share | <u>\$ 0.69</u> | <u>\$ (1.45)</u> | <u>\$ (2.92)</u> |

(a) Includes total charges to our consolidated statements of operations related to restricted stock grants of \$1.8 million, \$1.3 million and \$1.7 million for the years ended December 31, 2003, 2002 and 2001, respectively.

The Beverly Enterprises 1988 Employee Stock Purchase Plan (as amended and restated) enables all full-time employees having completed one year of continuous service to purchase shares of our common stock at the current market price through payroll deductions. Effective January 1, 2003, we eliminated our matching contributions to this plan. Each participant specifies the amount to be withheld from earnings per pay period, subject to certain limitations. During 2002 and 2001 we matched 15% of each participant's contribution. The total charges to our consolidated statements of operations for the years ended December 31, 2002 and 2001 related to this plan were approximately \$300,000 and \$500,000, respectively.

12. Income Taxes

The provision for (benefit from) income taxes, including taxes allocated to discontinued operations of \$3.4 million in 2003 and \$1.3 million in 2001, consists of the following for the years ended December 31 (in thousands):

| | <u>2003</u> | <u>2002</u> | <u>2001</u> |
|----------|-----------------|-----------------|-----------------|
| Federal: | | | |
| Current | \$(11,122) | \$ (8,345) | \$ 1,487 |
| Deferred | 12,702 | 10,447 | 56,831 |
| State: | | | |
| Current | 6,867 | 3,835 | 5,000 |
| Deferred | | 148 | (1,930) |
| | <u>\$ 8,447</u> | <u>\$ 6,085</u> | <u>\$61,388</u> |

Table of Contents**BEVERLY ENTERPRISES, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****Years ended December 31, 2003, 2002 and 2001****12. Income Taxes (Continued)**

A reconciliation of our income tax provision (benefit), including taxes allocated to discontinued operations computed at the statutory federal income tax rate to our actual provision for (benefit from) income taxes is summarized as follows for the years ended December 31 (in thousands):

| | <u>2003</u> | <u>2002</u> | <u>2001</u> |
|--|-----------------|-----------------|------------------|
| Tax (benefit) at statutory rate | \$ 31,121 | \$ (49,002) | \$ (83,959) |
| General business tax credits | (968) | (2,090) | (5,987) |
| State tax provision (benefit), net | 8,423 | 2,593 | (10,666) |
| Impairment charges | | 12,685 | 7,090 |
| Increase (decrease) in valuation allowance | (30,141) | 45,520 | 153,697 |
| Other | 12 | (3,621) | 1,213 |
| | <u>\$ 8,447</u> | <u>\$ 6,085</u> | <u>\$ 61,388</u> |

Deferred income taxes reflect the impact of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes. The tax effects of temporary differences giving rise to our deferred tax assets and liabilities at December 31, 2003 and 2002 are as follows (in thousands):

| | <u>December 31, 2003</u> | | <u>December 31, 2002</u> | |
|--|--------------------------|------------------|--------------------------|------------------|
| | <u>Asset</u> | <u>Liability</u> | <u>Asset</u> | <u>Liability</u> |
| Insurance reserves | \$ 70,838 | \$ | \$ 79,071 | \$ |
| General business tax credit carryforwards | 37,708 | | 28,742 | |
| Alternative minimum tax credit carryforwards | 21,279 | | 19,124 | |
| Provision for dispositions | 3,539 | 16,016 | 66,768 | 8,387 |
| Provision for Medicare repayment | 26,574 | | 31,735 | |
| Depreciation and amortization | 21,572 | 55,687 | 28,399 | 113,228 |
| Operating supplies | | 9,538 | | 11,489 |
| Federal net operating loss carryforwards | 34,183 | | 55,659 | |
| Other | 29,767 | 18,440 | 29,279 | 17,051 |
| | <u>245,460</u> | <u>99,681</u> | <u>338,777</u> | <u>150,155</u> |
| Valuation allowances: | | | | |
| Federal | (155,692) | | (179,625) | |
| State | (13,384) | | (19,592) | |
| | <u>\$ 76,384</u> | <u>\$99,681</u> | <u>\$ 139,560</u> | <u>\$150,155</u> |

At December 31, 2003, for federal income tax purposes, we had federal net operating loss carryforwards of \$93.2 million that expire in years 2018 through 2023; general business tax credit carryforwards of \$37.7 million that expire in years 2006 through 2023; and alternative minimum tax credit carryforwards of \$21.3 million that do not expire. Under the guidance of SFAS No. 109, based upon our operating results in

recent years, our reported cumulative losses, and the inherent uncertainty associated with the realization of future income in the near term, we have provided a valuation allowance on our net deferred tax assets as of December 31, 2003 and 2002.

Table of Contents**BEVERLY ENTERPRISES, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****Years ended December 31, 2003, 2002 and 2001****13. Fair Values of Financial Instruments**

Financial Accounting Standards Statement No. 107, *Disclosures about Fair Value of Financial Instruments*, (SFAS No. 107) requires disclosure of fair value information about financial instruments, whether or not recognized in the balance sheet, for which it is practicable to estimate that value. In cases where quoted market prices are not available, fair values are based on estimates using present value or other valuation techniques. Those techniques are significantly affected by the assumptions used, including the discount rate and estimates of future cash flows. In that regard, the derived fair value estimates cannot be substantiated by comparison to independent markets and, in many cases, could not be realized in immediate settlement of the instrument. SFAS No. 107 excludes certain financial instruments and all nonfinancial instruments from its disclosure requirements. Accordingly, the aggregate fair value amounts presented do not represent our underlying value.

The carrying amounts and estimated fair values of our financial instruments at December 31, 2003 and 2002 are as follows (in thousands):

| | 2003 | | 2002 | |
|--|-----------------|------------|-----------------|------------|
| | Carrying Amount | Fair Value | Carrying Amount | Fair Value |
| Cash and cash equivalents | \$258,815 | \$258,815 | \$115,445 | \$115,445 |
| Notes receivable, net (including current portion) | 27,873 | 27,873 | 24,997 | 24,997 |
| Beverly Indemnity funds | 11,809 | 11,809 | 2,809 | 2,809 |
| Long-term debt (including current portion) | 566,227 | 640,723 | 630,177 | 585,657 |
| Federal government settlements (including current portion) | 61,888 | 61,888 | 73,891 | 73,891 |

At December 31, 2003 and 2002, we had outstanding defeased long-term debt with aggregate carrying values of \$6.3 million and \$4.6 million, respectively. The fair value of such defeased debt was approximately \$6.4 million and \$4.6 million at December 31, 2003 and 2002, respectively. The fair value was estimated using discounted cash flow analyses, based on our incremental borrowing rates for similar types of borrowing arrangements.

In order to consummate certain dispositions and other transactions, we have agreed to guarantee the debt assumed or acquired by the purchaser or the performance under a lease, by the lessee. In accordance with FIN 45, we have recorded approximately \$531,000, included in Other accrued liabilities on the 2003 consolidated balance sheet, as the estimated fair value of 2003 guarantees.

We used the following methods and assumptions in estimating our fair value disclosures for financial instruments:

Cash and Cash Equivalents

The carrying amount reported in the consolidated balance sheets for cash and cash equivalents approximates its fair value.

Notes Receivable, Net (Including Current Portion)

For variable-rate notes that reprice frequently and with no significant change in credit risk, fair values are based on carrying values. For fixed-rate notes, the fair values are estimated using discounted cash flow analyses, using interest rates currently being offered for loans with similar terms to borrowers of similar credit quality.

Table of Contents

BEVERLY ENTERPRISES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Years ended December 31, 2003, 2002 and 2001

13. Fair Values of Financial Instruments (Continued)

Beverly Indemnity Funds

The carrying amount reported in the consolidated balance sheets for the Beverly Indemnity funds approximates its fair value and is included in the consolidated balance sheet caption Prepaid expenses and other.

Long-term Debt (Including Current Portion)

The carrying amounts of our variable-rate borrowings approximate their fair values. The fair values of the remaining long-term debt are estimated using discounted cash flow analyses, based on our incremental borrowing rates for similar types of borrowing arrangements.

Federal Government Settlements (Including Current Portion)

The present value of our obligations to the federal government resulting from the settlements of the Allocation Investigations is included in the consolidated balance sheet captions Federal government settlement obligations and Other liabilities and deferred items. These obligations are non-interest bearing, and as such, were imputed at their approximate fair market rate of 9% for accounting purposes. The carrying amounts of these obligations approximate their fair values.

14. Segment Information

Statement of Financial Accounting Standards No. 131, *Disclosures about Segments of an Enterprise and Related Information*, provides disclosure guidelines for segments of a company based on a management approach to defining operating segments.

Description of the Types of Services from which each Operating Segment Derives its Revenues

Our operations are currently organized into three primary segments:

Nursing Facilities, which provide long-term healthcare through the operation of skilled nursing homes and assisted living centers;

Aegis Therapies, which provides rehabilitation therapy services under contract to our nursing facilities and third-party nursing facilities; and

Home Care, which primarily provides hospice services.

Measurement of Segment Income or Loss and Segment Assets

The accounting policies of the operating segments are the same as those described in the summary of significant accounting policies (see Note 1). We evaluate financial performance and allocate resources primarily based on income or loss from operations before income taxes, excluding any unusual items.

Factors Management Used to Identify Our Operating Segments

Our operating segments are strategic business units that offer different services within the healthcare continuum. Business in each operating segment is conducted by one or more entities. The entities comprising each operating segment also have separate boards of directors or managers.

Table of Contents**BEVERLY ENTERPRISES, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****Years ended December 31, 2003, 2002 and 2001****14. Segment Information (Continued)**

The following table summarizes certain information for each of our operating segments (in thousands):

| | <u>Nursing Facilities</u> | <u>Aegis⁽¹⁾</u> | <u>Home Care</u> | <u>All Other⁽²⁾</u> | <u>Total</u> | <u>Discontinued Operations⁽³⁾</u> |
|---|-------------------------------|----------------------------|------------------|--------------------------------|--------------|--|
| <i>Year ended December 31, 2003</i> | | | | | | |
| Revenues from external customers | \$ 1,857,030 | \$ 77,007 | \$ 39,164 | \$ 6,558 | \$ 1,979,759 | \$ 377,126 |
| Intercompany revenues | 1,121 | 153,140 | | 1,322 | 155,583 | |
| Interest income | 2,941 | 25 | 1 | 2,398 | 5,365 | 159 |
| Interest expense | 12,231 | | 8 | 51,665 | 63,904 | 2,394 |
| Depreciation and amortization | 50,233 | 831 | 547 | 7,707 | 59,318 | 10,345 |
| Pre-tax income (loss) | 61,655 | 46,892 | 5,030 | (85,454) | 28,123 | 60,792 |
| Goodwill | 45,272 | | 11,723 | 107 | 57,102 | 332 |
| Total assets | 953,244 | 21,015 | 22,577 | 346,087 | 1,342,923 | 3,498 |
| Capital expenditures | 28,892 | 1,434 | 387 | 9,785 | 40,498 | 3,486 |
| <i>Year ended December 31, 2002</i> | | | | | | |
| Revenues from external customers | \$ 1,852,479 | \$ 52,871 | \$ 34,315 | \$ 1,648 | \$ 1,941,313 | \$ 578,154 |
| Intercompany revenues | | 154,306 | | 626 | 154,932 | |
| Interest income | 1,567 | 42 | 13 | 3,068 | 4,690 | 59 |
| Interest expense | 13,387 | | 23 | 49,816 | 63,226 | 3,603 |
| Depreciation and amortization | 57,284 | 710 | 724 | 7,209 | 65,927 | 23,018 |
| Pre-tax income (loss) | 105,994 | 35,569 | (1,633) | (171,033) | (31,103) | (31,731) |
| Goodwill | 44,808 | | 11,724 | (159) | 56,373 | 7,004 |
| Total assets | 918,298 | 15,966 | 20,873 | 137,907 | 1,093,044 | 256,851 |
| Capital expenditures | 77,952 | 1,676 | 258 | 7,778 | 87,664 | 12,439 |
| <i>Year ended December 31, 2001</i> | | | | | | |
| Revenues from external customers | \$ 2,063,698 | \$ 17,366 | \$ 45,389 | \$ 1,342 | \$ 2,127,795 | \$ 604,305 |
| Intercompany revenues | | 170,705 | | 11,360 | 182,065 | |
| Interest income | 127 | 4 | | 2,785 | 2,916 | 161 |
| Interest expense | 21,608 | | 74 | 53,354 | 75,036 | 4,337 |
| Depreciation and amortization | 58,286 | 278 | 1,472 | 6,916 | 66,952 | 26,050 |
| Pre-tax income (loss) | 64,845 | 48,322 | (425) | (325,826) | (213,084) | (26,800) |
| Goodwill | 28,550 | | 13,397 | (223) | 41,724 | 103,160 |
| Total assets | 1,113,194 | 8,575 | 30,442 | 141,481 | 1,293,692 | 387,378 |
| Capital expenditures | 65,908 | 1,200 | 118 | 3,127 | 70,353 | 19,048 |

(1) Pre-tax income includes profit on intercompany revenues which is eliminated in All Other.

(2)

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Consists of the operations of our corporate headquarters and related overhead, as well as certain non-operating revenues and expenses. These amounts also include special pre-tax charges and adjustments totaling approximately \$4.7 million, \$73.9 million and \$259.5 million for 2003, 2002 and 2001, respectively. These pre-tax charges primarily related to asset impairments, workforce reductions and other unusual items, special charges and adjustments related to federal government investigation settlements and increasing reserves for patient care liability costs in 2002.

- (3) The results of operations of 2003 disposed facilities, clinics and other assets as well as dispositions during the three months ended March 31, 2004 have been reported as discontinued operations, for all periods presented. Pre-tax income (loss) includes net gains on sales, exit costs, asset impairments and other unusual items of \$62.4 million for 2003; net losses on sales, exit costs, asset impairments and other unusual items of \$31.1 million in 2002; and \$56.1 million of asset impairments and other unusual items in 2001. (See Note 6.)

Table of Contents

BEVERLY ENTERPRISES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Years ended December 31, 2003, 2002 and 2001

15. Subsequent Events

On June 9, 2004, we commenced a cash tender offer to purchase any and all of our \$200.0 million in aggregate principal amount of 9 5/8% senior notes due 2009 at an offer price of \$1,190 per \$1,000 principal amount tendered, plus accrued and unpaid interest, and a solicitation of consents to amend the indenture under which the 9 5/8% senior notes were issued. The consummation of the tender offer is conditioned upon, among other things, the consummation of our private placement of up to \$225.0 million senior subordinated notes due 2014 on terms acceptable to us. The tender offer is scheduled to expire on July 8, 2004, unless extended or earlier terminated. We intend to use the net proceeds of the \$225.0 million senior subordinated notes offering, together with cash on hand, to purchase the 9 5/8% senior notes validly tendered pursuant to the tender offer.

On May 27, 2004, we signed a definitive agreement to purchase the assets of Hospice USA, LLC, a privately held company providing hospice services in Mississippi, Alabama and Tennessee, for cash of approximately \$77.0 million. Hospice USA, LLC currently operates 18 hospice agencies and has an additional 16 agencies under development. The transaction is subject to customary conditions, including normal licensure and government approvals, and is expected to close in late July.

The results of operations of the following facilities and business disposed of during the three months ended March 31, 2004 are reflected as discontinued operations for all periods presented in the accompanying consolidated statements of operations:

four nursing facilities (353 beds) for cash proceeds totaling \$8.4 million; and

a home medical equipment business of our Home Care segment for cash proceeds totaling \$165,000.

In April 2004, revisions were made to our Corporate Integrity Agreement to extend the services of the quality monitor to all of our nursing facilities and to reflect a modification of the requirements under the agreement with respect to training and education. We believe that we are generally in compliance with the requirements of our Corporate Integrity Agreement and file annual reports with the OIG documenting our compliance. If we fail to comply with our Corporate Integrity Agreement, we may be subject to penalties or exclusion from the Medicare and Medicaid programs, which could have an adverse effect on our financial condition and results of operations.

Table of Contents**BEVERLY ENTERPRISES, INC.****SUPPLEMENTARY DATA (Unaudited)****QUARTERLY FINANCIAL DATA
(In thousands, except per share data)**

The following is a summary of our quarterly results of operations for the years ended December 31, 2003 and 2002:

| | 2003 | | | | | 2002 | | | | |
|--|------------|------------|------------|------------|--------------|-------------|-------------|------------|-------------|--------------|
| | 1st | 2nd | 3rd | 4th | Total | 1st | 2nd | 3rd | 4th | Total |
| Revenues | \$ 476,233 | \$ 485,333 | \$ 502,607 | \$ 515,586 | \$ 1,979,759 | \$ 472,600 | \$ 495,750 | \$ 487,027 | \$ 485,936 | \$ 1,941,313 |
| Income (loss) before provision for income taxes, discontinued operations and cumulative effect of change in accounting | \$ 1,393 | \$ 5,529 | \$ 8,797 | \$ 12,404 | \$ 28,123 | \$ 13,946 | \$ (18,212) | \$ 16,130 | \$ (42,967) | \$ (31,103) |
| Provision for income taxes | 1,236 | 1,201 | 1,853 | 779 | 5,069 | 1,079 | 1,331 | 1,021 | 2,654 | 6,085 |
| Income (loss) before discontinued operations and cumulative effect of change in accounting | 157 | 4,328 | 6,944 | 11,625 | 23,054 | 12,867 | (19,543) | 15,109 | (45,621) | (37,188) |
| Discontinued operations, net of taxes | 12,031 | 13,163 | 3,039 | 29,181 | 57,414 | 7,637 | 5,529 | 469 | (45,366) | (31,731) |
| Cumulative effect of change in accounting, net of taxes | | | | | | (77,171) | | | | (77,171) |
| Net income (loss) | \$ 12,188 | \$ 17,491 | \$ 9,983 | \$ 40,806 | \$ 80,468 | \$ (56,667) | \$ (14,014) | \$ 15,578 | \$ (90,987) | \$ (146,090) |
| Income (loss) per share of common stock: | | | | | | | | | | |
| Basic and diluted: | | | | | | | | | | |
| Before discontinued operations and cumulative effect of change in accounting | \$ | \$ 0.04 | \$ 0.06 | \$ 0.11 | \$ 0.22 | \$ 0.12 | \$ (0.19) | \$ 0.14 | \$ (0.44) | \$ (0.36) |
| Discontinued operations, net of taxes | 0.12 | 0.12 | 0.03 | 0.27 | 0.53 | 0.08 | 0.06 | 0.01 | (0.43) | (0.29) |
| Cumulative effect of change in accounting, net of taxes | | | | | | (0.74) | | | | (0.74) |
| Net income (loss) | \$ 0.12 | \$ 0.16 | \$ 0.09 | \$ 0.38 | \$ 0.75 | \$ (0.54) | \$ (0.13) | \$ 0.15 | \$ (0.87) | \$ (1.39) |
| | 104,743 | 107,156 | 107,142 | 107,201 | 106,582 | 104,441 | 104,731 | 104,865 | 104,861 | 104,726 |

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Shares used to compute basic net income (loss) per share amounts

Shares used to compute diluted net income (loss) per share amounts

Common stock price range:

| | | | | | | | | |
|------|---------|---------|---------|---------|---------|---------|---------|---------|
| High | \$ 3.00 | \$ 4.30 | \$ 6.99 | \$ 8.60 | \$ 9.50 | \$ 9.18 | \$ 7.95 | \$ 3.89 |
| Low | \$ 1.63 | \$ 1.80 | \$ 3.71 | \$ 5.06 | \$ 5.66 | \$ 6.95 | \$ 1.90 | \$ 1.60 |

We recorded provisions for income taxes, including taxes allocated to discontinued operations, at 9.5% and 4% for the years ended December 31, 2003 and 2002, respectively, primarily due to state income taxes.

The operations of Matrix, MK Medical, Care Focus, 84 nursing facilities, seven assisted living centers and certain other assets, including four nursing facilities and a home medical equipment business disposed of during the three months ended March 31, 2004, have been reported as discontinued operations for all periods presented since they met the criteria under SFAS No. 144 and therefore, the results above differ from amounts previously reported in our Form 10-Qs. In addition, we recorded a cumulative effect for the change in accounting for goodwill as of January 1, 2002, which had not been included in the first quarter 2002 Form 10-Q.

Table of Contents

ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE.

None.

ITEM 9A. CONTROLS AND PROCEDURES.

The Company maintains disclosure controls and procedures which are designed to ensure that information required to be disclosed in the Company's Exchange Act reports is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms. Such information is accumulated and communicated to the Company's management, including its Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure. In designing and evaluating the disclosure controls and procedures, the Company's management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives, and the Company's management is required to apply its judgment in evaluating the cost-benefit relationship of possible controls and procedures.

As required by SEC Rule 13a-15(b), the Company has carried out an evaluation as of December 31, 2003, the end of the period covered by this report, under the supervision and with the participation of the Company's management, including the Company's Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of the Company's disclosure controls and procedures. Based upon their evaluation and subject to the foregoing, the Chief Executive Officer and Chief Financial Officer concluded that the Company's disclosure controls and procedures were effective at the reasonable assurance level.

There has been no change in the Company's internal controls over financial reporting during the Company's fourth fiscal quarter ended December 31, 2003, that has materially affected, or is reasonably likely to materially affect, the Company's internal controls over financial reporting.

Table of Contents

PART III

ITEM 10. DIRECTORS AND EXECUTIVE OFFICERS OF THE COMPANY.

The information contained in our proxy with respect to directors, executive officers, code of ethics, audit committee and audit committee financial experts is incorporated herein by reference from our definitive proxy statement for the Annual Stockholders Meeting held on May 20, 2004, filed pursuant to Regulation 14a.

ITEM 11. EXECUTIVE COMPENSATION.

Incorporated herein by reference from our definitive proxy statement for the Annual Stockholders Meeting held on May 20, 2004, filed pursuant to Regulation 14A.

ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS.

Incorporated herein by reference from our definitive proxy statement for the Annual Stockholders Meeting held on May 20, 2004, filed pursuant to Regulation 14A.

ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS.

Incorporated herein by reference from our definitive proxy statement for the Annual Stockholders Meeting held on May 20, 2004, filed pursuant to Regulation 14A.

ITEM 14. PRINCIPAL ACCOUNTANT FEES AND SERVICES.

Incorporated herein by reference from our definitive proxy statement for the Annual Stockholders Meeting held on May 20, 2004, filed pursuant to Regulation 14A.

Table of Contents

PART IV

ITEM 15. EXHIBITS, FINANCIAL STATEMENT SCHEDULES AND REPORTS ON FORM 8-K.

(a) 1 and 2. The Consolidated Financial Statements and Consolidated Financial Statement Schedule

The consolidated financial statements and consolidated financial statement schedule listed in the accompanying index to consolidated financial statements and financial statement schedules are filed as part of this annual report.

3. Exhibits

The exhibits listed in the accompanying index to exhibits are incorporated by reference herein or are filed as part of this annual report.

(b) Reports on Form 8-K

On December 22, 2003, we filed a report on Form 8-K under Item 9, which included a press release announcing that Larry Deans has joined the Company as Senior Vice President Human Resources.

On December 15, 2003, we filed a report on Form 8-K under Item 9, which included a press release announcing the election of Cindy Susienka as Executive Vice President and the election of Steve Brigance as Senior Vice President Litigation and Assistant Chief Legal Officer.

On December 3, 2003, we filed a report on Form 8-K under Item 9, which included a press release announcing the sale of 21 skilled nursing operations in California, Washington and Arizona.

On November 13, 2003, we filed a Form 8-K under Items 9 and 12, which included a press release announcing our operating results for the 2003 third quarter. We also announced that our Board of Directors has authorized us to purchase up to \$20.0 million of outstanding shares of our common stock, effective December 1, 2003 and remaining in effect for one year.

On November 4, 2003, we filed a report on Form 8-K under Item 9, which included a press release announcing the all-cash sale of nine skilled nursing operations in Southern California.

On October 23, 2003, we filed a report on Form 8-K including a press release dated October 17, 2003, announcing that the underwriters of our previously announced public offering of \$100.0 million principal amount of 2.75% Convertible Subordinated Notes due 2033 (the Notes) had exercised their over-allotment option in full to purchase an additional \$15.0 million in principal amount of the Notes. Also included was a press release dated October 22, 2003, announcing that, as a result of our sale of an additional \$15.0 million in principal amount of the Notes to cover over-allotments, we had decided to reduce the \$150.0 million term loan portion of our new senior credit facility to \$135.0 million.

On October 17, 2003, we filed a report on Form 8-K under Items 5, 7 and 9, announcing our agreement to sell \$100.0 million of 2.75% Convertible Subordinated Notes due 2033 pursuant to the previously announced public offering. The underwriting agreement relating to the Notes, the Prospectus Supplement and a press release all dated October 16, 2003, were also included in the Form 8-K.

On October 14, 2003, we filed a report on Form 8-K under Items 5, 7 and 9, announcing the appointment of The Bank of New York as trustee in connection with our proposed offering of \$100.0 million of convertible subordinated notes. A copy of the T-1 and a press release dated October 13, 2003, were also included in the Form 8-K.

On October 2, 2003, we filed a report on Form 8-K under Item 9, which included a press release announcing the all-cash sale of 12 skilled nursing operations and one assisted living center in Southern California.

Table of Contents

(c) Exhibits

See the accompanying index to exhibits referenced in Item 15(a)(3) above for a list of exhibits incorporated herein by reference or filed as part of this annual report.

(d) Financial Statement Schedule

See the accompanying index to consolidated financial statements and financial statement schedules referenced in Item 15(a)1 and 2, above.

Table of Contents**BEVERLY ENTERPRISES, INC.****INDEX TO CONSOLIDATED FINANCIAL STATEMENTS AND****FINANCIAL STATEMENT SCHEDULES****(Item 15(a))**

| | Page |
|---|-------------|
| 1. Consolidated financial statements: | |
| Report of Ernst & Young LLP, Independent Registered Public Accounting Firm | 47 |
| Consolidated Balance Sheets at December 31, 2003 and 2002 | 48 |
| Consolidated Statements of Operations for each of the three years in the period ended December 31, 2003 | 49 |
| Consolidated Statements of Stockholders' Equity for each of the three years in the period ended December 31, 2003 | 50 |
| Consolidated Statements of Cash Flows for each of the three years in the period ended December 31, 2003 | 51 |
| Notes to Consolidated Financial Statements | 52 |
| Supplementary Data (Unaudited) - Quarterly Financial Data | 84 |
| 2. Consolidated financial statement schedule for each of the three years in the period ended December 31, 2003: | |
| Schedule II - Valuation and Qualifying Accounts | 90 |

All other schedules are omitted because they are either not applicable or the items do not meet the various disclosure requirements.

Table of Contents**BEVERLY ENTERPRISES, INC.****SCHEDULE II VALUATION AND QUALIFYING ACCOUNTS**

Years ended December 31, 2003, 2002 and 2001

(In thousands)

| Description | Balance at Beginning of Year | Charged (Credited) to Operations | (Write-offs) Recoveries | Due to Acquisitions, Dispositions and Discontinued Operations | Other | Balance at End of Year |
|--|------------------------------|----------------------------------|---------------------------|---|-----------------|------------------------|
| Year ended December 31, 2003: | | | | | | |
| Allowance for doubtful accounts: | | | | | | |
| Account receivable patient | \$ 43,189 | \$ 22,515 | \$(30,287) | \$(3,478) | \$ (1,891) | \$ 30,048 |
| Account receivable nonpatient | 1,477 | 228 | (20) | (4) | 16 | 1,697* |
| Notes receivable | 7,761 | (1,138) | (4,085) | 682 | 2,106 | 5,326 |
| | <u>\$ 52,427</u> | <u>\$ 21,605</u> | <u>\$(34,392)</u> | <u>\$(2,800)</u> | <u>\$ 231</u> | <u>\$ 37,071</u> |
| Valuation allowance on deferred tax assets | \$199,217 | \$(30,141) | \$ | \$ | \$ | \$169,076 |
| Year ended December 31, 2002: | | | | | | |
| Allowance for doubtful accounts: | | | | | | |
| Account receivable patient | \$ 51,400 | \$ 53,692 | \$(59,385) | \$(4,207) | \$ 1,689 | \$ 43,189 |
| Account receivable nonpatient | 1,074 | 866 | (615) | (14) | 166 | 1,477* |
| Notes receivable | 4,941 | 1,012 | (39) | 181 | 1,666 | 7,761 |
| | <u>\$ 57,415</u> | <u>\$ 55,570</u> | <u>\$(60,039)</u> | <u>\$(4,040)</u> | <u>\$ 3,521</u> | <u>\$ 52,427</u> |
| Valuation allowance on deferred tax assets | \$153,697 | \$ 45,520 | \$ | \$ | \$ | \$199,217 |
| Year ended December 31, 2001: | | | | | | |
| Allowance for doubtful accounts: | | | | | | |
| Account receivable patient | \$ 91,636 | \$ 43,658 | \$(95,214) ^(A) | \$ 4,022 | \$ 7,298 | \$ 51,400 |
| Account receivable nonpatient | 1,372 | 89 | (477) | | 90 | 1,074* |
| Notes receivable | 3,573 | 504 | 93 | 107 | 664 | 4,941 |
| | <u>\$ 96,581</u> | <u>\$ 44,251</u> | <u>\$(95,598)</u> | <u>\$ 4,129</u> | <u>\$ 8,052</u> | <u>\$ 57,415</u> |
| | \$ | \$ 52,100 | \$ | \$ | \$101,597(B) | \$153,697 |

Valuation allowance on
deferred tax assets

- (A) Includes the write-off of \$39.0 million of Medicare cost report related receivables against a related reserve established in conjunction with the OIG settlement (see Item 8 Note 4).
- (B) Represents a full valuation allowance on our net deferred tax assets.
- * Includes amounts classified in long-term other assets as well as current assets.

90

Table of Contents**BEVERLY ENTERPRISES, INC.****INDEX TO EXHIBITS****(ITEM 15(a)(3))**

| Exhibit Number | Description |
|-------------------|---|
| 3.1 | Form of Restated Certificate of Incorporation of New Beverly Holdings, Inc. (incorporated by reference to Exhibit 3.1 to Beverly Enterprises, Inc. s Annual Report on Form 10-K for the year ended December 31, 1997) |
| 3.2 | Form of Certificate of Amendment of Certificate of Incorporation of New Beverly Holdings Inc., changing its name to Beverly Enterprises, Inc. (incorporated by reference to Exhibit 3.2 to Beverly Enterprises, Inc. s Annual Report on Form 10-K for the year ended December 31, 1997) |
| 3.3 | By-Laws of Beverly Enterprises, Inc. (incorporated by reference to Exhibit 3.4 to Beverly Enterprises, Inc. s Registration Statement on Form S-1 filed on June 4, 1997 (File No. 333-28521)) |
| 4.1 | Indenture, dated as of April 25, 2001, between Beverly Enterprises, Inc., and The Bank of New York, as Trustee, with respect to Beverly Enterprises, Inc. s 9 5/8% Senior Notes due 2009 (incorporated by reference to Exhibit 4.3 to Beverly Enterprises, Inc. s Annual Report on Form 10-K for the year ended December 31, 2001) |
| 4.2 | Trust Indenture, dated as of December 1, 1994, from Beverly Funding Corporation, as Issuer, to Chemical Bank, as Trustee (the Chemical Indenture) (incorporated by reference to Exhibit 10.45 to Beverly Enterprises, Inc. s Registration Statement on Form S-4 filed on February 13, 1995 (File No. 33-57663)) |
| 4.3 | First Amendment and Restatement, dated as of June 1, 1999, of Trust Indenture, dated as of December 1, 1994, from Beverly Funding Corporation, as Issuer, to The Chase Manhattan Bank, as Trustee (incorporated by reference to Exhibit 10.2 to Beverly Enterprises, Inc. s Quarterly Report on Form 10-Q for the quarter ended September 30, 1999) |
| 4.4 | Series Supplement, dated as of December 1, 1994, to the Chemical Indenture (incorporated by reference to Exhibit 10.46 to Beverly Enterprises, Inc. s Registration Statement on Form S-4 filed on February 13, 1995 (File No. 33-57663)) |
| 4.5 | Series Supplement, dated as of June 1, 1999, by and between Beverly Funding Corporation and The Chase Manhattan Bank (1999-1 Series Supplement) (incorporated by reference to Exhibit 10.3 to Beverly Enterprises, Inc. s Quarterly Report on Form 10-Q for the quarter ended September 30, 1999) |
| 4.6 | First Amendment, dated as of July 14, 1999, to the 1999-1 Series Supplement (incorporated by reference to Exhibit 10.4 to Beverly Enterprises, Inc. s Quarterly Report on Form 10-Q for the quarter ended September 30, 1999). In accordance with item 601 (b) (4) (iii) of Regulation S-K, certain instruments pertaining to Beverly Enterprises, Inc. s long-term obligations have not been filed; copies thereof will be furnished to the Securities and Exchange Commission upon request. |
| 10.1* | Beverly Enterprises, Inc. Annual Incentive Plan (incorporated by reference to Exhibit 10.1 to Beverly Enterprises, Inc. s Annual Report on Form 10-K for the year ended December 31, 2001) |
| 10.2* | 1997 Long-Term Incentive Plan, as amended and restated as of June 1, 2001 (the 1997 LTIP) (incorporated by reference to Exhibit 10.2 to Beverly Enterprises, Inc. s Annual Report on Form 10-K for the year ended December 31, 2001) |

Table of Contents

| Exhibit Number | Description |
|-------------------|--|
| 10.3* | Beverly Enterprises, Inc. Non-Employee Directors Stock Option Plan, as amended and restated as of June 1, 2001 (the Directors Option Plan) (incorporated by reference to Exhibit 10.3 to Beverly Enterprises, Inc. s Annual Report on Form 10-K for the year ended December 31, 2001) |
| 10.4* | Beverly Enterprises, Inc. Stock Grant Plan (incorporated by reference to Exhibit 10.6 to Beverly Enterprises, Inc. s Annual Report on Form 10-K for the year ended December 31, 2000) |
| 10.5* | Executive Medical Reimbursement Plan (incorporated by reference to Exhibit 10.5 to Beverly Enterprises, Inc. s Annual Report on Form 10-K for the year ended December 31, 1987) |
| 10.6* | Form of the Beverly Enterprises, Inc. Executive Life Insurance Plan Split Dollar Agreement (incorporated by reference to Exhibit 10.8 to Beverly Enterprises, Inc. s Annual Report on Form 10-K for the year ended December 31, 2000) |
| 10.7* | Executive Physicals Policy (incorporated by reference to Exhibit 10.8 to Beverly Enterprises, Inc. s Quarterly Report on Form 10-Q for the quarter ended June 30, 1993) |
| 10.8* | Amended and Restated Deferred Compensation Plan effective July 18, 1991 (incorporated by reference to Exhibit 10.6 to Beverly Enterprises, Inc. s Annual Report on Form 10-K for the year ended December 31, 1991) |
| 10.9* | Amendment No. 1, effective September 29, 1994, to the Deferred Compensation Plan (incorporated by reference to Exhibit 10.13 to Beverly Enterprises, Inc. s Registration Statement on Form S-4 filed on February 13, 1995 (File No. 33-57663)) |
| 10.10* | Executive Retirement Plan (incorporated by reference to Exhibit 10.9 to Beverly Enterprises, Inc. s Annual Report on Form 10-K for the year ended December 31, 1987) |
| 10.11* | Amendment No. 1, effective as of July 1, 1991, to the Executive Retirement Plan (incorporated by reference to Exhibit 10.8 to Beverly Enterprises, Inc. s Annual Report on Form 10-K for the year ended December 31, 1991) |
| 10.12* | Amendment No. 2, effective as of December 12, 1991, to the Executive Retirement Plan (incorporated by reference to Exhibit 10.9 to Beverly Enterprises, Inc. s Annual Report on Form 10-K for the year ended December 31, 1991) |
| 10.13* | Amendment No. 3, effective as of July 31, 1992, to the Executive Retirement Plan (incorporated by reference to Exhibit 10.10 to Beverly Enterprises, Inc. s Annual Report on Form 10-K for the year ended December 31, 1992) |
| 10.14* | Amendment No. 4, effective as of January 1, 1993, to the Executive Retirement Plan (incorporated by reference to Exhibit 10.18 to Beverly Enterprises, Inc. s Annual Report on Form 10-K for the year ended December 31, 1994) |
| 10.15* | Amendment No. 5, effective as of September 29, 1994, to the Executive Retirement Plan (incorporated by reference to Exhibit 10.19 to Beverly Enterprises, Inc. s Annual Report on Form 10-K for the year ended December 31, 1994) |
| 10.16* | Amendment No. 6, effective as of January 1, 1996, to the Executive Retirement Plan (incorporated by reference to Exhibit 10.18 to Beverly Enterprises, Inc. s Annual Report on Form 10-K for the year ended December 31, 1997) |
| 10.17* | Amendment No. 7, effective as of September 1, 1997, to the Executive Retirement Plan (incorporated by reference to Exhibit 10.19 to Beverly Enterprises, Inc. s Annual Report on Form 10-K for the year ended December 31, 1997) |

Table of Contents

| Exhibit Number | Description |
|-------------------|---|
| 10.18* | Amendment No. 8, dated as of December 11, 1997, to the Executive Retirement Plan, changing its name to the Executive SavingsPlus Plan (incorporated by reference to Exhibit 10.20 to Beverly Enterprises, Inc. s Annual Report on Form 10-K for the year ended December 31, 1997) |
| 10.19* | Beverly Enterprises, Inc. Amended and Restated Supplemental Executive Retirement Plan effective as of April 1, 2000 (incorporated by reference to Exhibit 10.21 to Beverly Enterprises, Inc. s Annual Report on Form 10-K for the year ended December 31, 2000) |
| 10.20* | Amendment Number One to the Beverly Enterprises, Inc. Supplemental Executive Retirement Plan (incorporated by reference to Exhibit 10.5 to Beverly Enterprises, Inc. s Quarterly Report on Form 10-Q for the quarter ended June 30, 2002) |
| 10.21* | Beverly Enterprises, Inc. Amended and Restated Executive Deferred Compensation Plan effective July 1, 2000 (incorporated by reference to Exhibit 10.22 to Beverly Enterprises, Inc. s Annual Report on Form 10-K for the year ended December 31, 2000) |
| 10.22* | Beverly Enterprises, Inc. Executive Deferred Compensation Plan effective December 31, 2002 (incorporated by reference to Exhibit 10.22 to Beverly Enterprises, Inc. s Annual Report on Form 10-K for the year ended December 31, 2002) |
| 10.23* | Beverly Enterprises, Inc. Non-Employee Director Deferred Compensation Plan (the Directors Plan) (incorporated by reference to Exhibit 10.1 to Beverly Enterprises, Inc. s Quarterly Report on Form 10-Q for the quarter ended June 30, 1997) |
| 10.24* | Amendment No. 1, effective as of December 3, 1997, to the Directors Plan (incorporated by reference to Exhibit 10.26 to Beverly Enterprises, Inc. s Annual Report on Form 10-K for the year ended December 31, 1997) |
| 10.25* | Beverly Enterprises, Inc. s Supplemental Long-Term Disability Plan (incorporated by reference to Exhibit 10.24 to Beverly Enterprises, Inc. s Annual Report on Form 10-K for the year ended December 31, 1996) |
| 10.26* | Form of Indemnification Agreement between Beverly Enterprises, Inc. and its officers, directors and certain of its employees (incorporated by reference to Exhibit 19.14 to Beverly Enterprises, Inc. s Quarterly Report on Form 10-Q for the quarter ended June 30, 1987) |
| 10.27* | Form of request by Beverly Enterprises, Inc. to certain of its officers or directors relating to indemnification rights (incorporated by reference to Exhibit 19.5 to Beverly Enterprises, Inc. s Quarterly Report on Form 10-Q for the quarter ended September 30, 1987) |
| 10.28* | Form of request by Beverly Enterprises, Inc. to certain of its officers or employees relating to indemnification rights (incorporated by reference to Exhibit 19.6 to Beverly Enterprises, Inc. s Quarterly Report on Form 10-Q for the quarter ended September 30, 1987) |
| 10.29* | Agreement dated December 29, 1986 between Beverly Enterprises, Inc. and Stephens Inc. (incorporated by reference to Exhibit 10.20 to Beverly Enterprises, Inc. s Registration Statement on Form S-1 filed on January 18, 1990 (File No. 33-33052)) |
| 10.30* | Severance Agreement and Release of Claims between Beverly Enterprises, Inc. and David R. Banks (incorporated by reference to Exhibit 10.28 to Beverly Enterprises, Inc. s Annual Report on Form 10-K for the year ended December 31, 2001) |

Table of Contents

| Exhibit Number | Description |
|-------------------|--|
| 10.31* | Employment Contract, made as of April 10, 2000, between Beverly Enterprises, Inc. and William R. Floyd (incorporated by reference to Exhibit 10.31 to Beverly Enterprises, Inc. s Annual Report on Form 10-K for the year ended December 31, 2000) |
| 10.32* | Employment Contract, made as of December 6, 2001, between Beverly Enterprises, Inc. and William R. Floyd (incorporated by reference to Exhibit 10.32 to Beverly Enterprises, Inc. s Annual Report on Form 10-K for the year ended December 31, 2002) |
| 10.33* | Employment and Severance Agreement, made as of June 1, 2001, between Beverly Enterprises, Inc. and David R. Devereaux (incorporated by reference to Exhibit 10.33 to Beverly Enterprises, Inc. s Annual Report on Form 10-K for the year ended December 31, 2002) |
| 10.34* | Severance Agreement and Release of Claims made as of October 5, 2002, between Beverly Enterprises, Inc. and Bobby W. Stephens (incorporated by reference to Exhibit 10.34 to Beverly Enterprises, Inc. s Annual Report on Form 10-K for the year ended December 31, 2002) |
| 10.35* | Employment Contract, made as of April 1, 2000, between Beverly Enterprises, Inc. and Douglas J. Babb (incorporated by reference to Exhibit 10.35 to Beverly Enterprises, Inc. s Annual Report on Form 10-K for the year ended December 31, 2002) |
| 10.36* | Severance Agreement and Release of Claims made as of October 11, 2002, between Beverly Enterprises, Inc. and Michael J. Matheny (incorporated by reference to Exhibit 10.36 to Beverly Enterprises, Inc. s Annual Report on Form 10-K for the year ended December 31, 2002) |
| 10.37* | Severance Agreement and Release of Claims made as of December 31, 2001, between Beverly Enterprises, Inc. and T. Jerald Moore (incorporated by reference to Exhibit 10.37 to Beverly Enterprises, Inc. s Annual Report on Form 10-K for the year ended December 31, 2002) |
| 10.38* | Employment Agreement, dated February 15, 2001 between Beverly Enterprises, Inc. and William A. Mathies (incorporated by reference to Exhibit 10.1 to Beverly Enterprises, Inc. s Quarterly Report on Form 10-Q for the quarter ended June 30, 2001) |
| 10.39* | Form of Employment Contract, made as of August 22, 1997, between New Beverly Holdings, Inc. and certain of its officers (incorporated by reference to Exhibit 10.20 to Amendment No. 2 to Beverly Enterprises, Inc. s Registration Statement on Form S-1 filed on September 22, 1997 (File No. 333-28521)) |
| 10.40* | Form of Irrevocable Trust Agreement for the Beverly Enterprises, Inc. Executive Benefits Plan (incorporated by reference to Exhibit 10.55 to Beverly Enterprises, Inc. s Registration Statement of Form S-4 filed on February 13, 1995 (File No. 33-57663)) |
| 10.41* | Retention Stock Option Agreement, effective as of June 1, 2001, between Beverly Enterprises, Inc. and David R. Devereaux (incorporated by reference to Exhibit 10.1 to Beverly Enterprises, Inc. s Quarterly Report on Form 10-Q for the quarter ended September 30, 2002) |
| 10.42* | Description of Non-Employee Directors Group Term Life Insurance Plan (incorporated by reference to Exhibit 10.4 to Beverly Enterprises, Inc. s Quarterly Report on Form 10-Q for the quarter ended June 30, 2002) |

Table of Contents

| Exhibit Number | Description |
|-------------------|--|
| 10.43* | Performance based Stock Option Award to Jeffrey P. Freimark pursuant to Process Improvement Team Awards Program (incorporated by reference to Exhibit 10.6 to Beverly Enterprises, Inc. s Quarterly Report on Form 10-Q for the quarter ended June 30, 2002) |
| 10.44* | Performance based Stock Option Award to L. Darlene Burch pursuant to Process Improvement Team Awards Program (incorporated by reference to Exhibit 10.7 to Beverly Enterprises, Inc. s Quarterly Report on Form 10-Q for the quarter ended June 30, 2002) |
| 10.45* | Description of Long Term Disability Policy for William R. Floyd (incorporated by reference to Exhibit 10.8 to Beverly Enterprises, Inc. s Quarterly Report on Form 10-Q for the quarter ended June 30, 2002) |
| 10.46* | Employment Agreement, made as of December 31, 2001, between Beverly Enterprises, Inc. and Jeffrey P. Freimark (incorporated by reference to Exhibit 10.9 to Beverly Enterprises, Inc. s Quarterly Report on Form 10-Q for the quarter ended June 30, 2002) |
| 10.47* | Demand Promissory Note, made as of April 1, 2002, by Richard D. Skelly, Jr. for the benefit of Beverly Enterprises, Inc. (incorporated by reference to Exhibit 10.10 to Beverly Enterprises, Inc. s Quarterly Report on Form 10-Q for the quarter ended June 30, 2002) |
| 10.48 | Master Lease Document – General Terms and Conditions, dated December 30, 1985, for Leases between Beverly California Corporation and various subsidiaries thereof as lessees and Beverly Investment Properties, Inc. as lessor (incorporated by reference to Exhibit 10.12 to Beverly California Corporation s Annual Report on Form 10-K for the year ended December 31, 1985) |
| 10.49 | Agreement, dated as of December 29, 1986, among Beverly California Corporation, Beverly Enterprises Texas, Inc., Stephens Inc. and Real Properties, Inc. (incorporated by reference to Exhibit 28 to Beverly California Corporation s Current Report on Form 8-K dated December 30, 1986) and letter agreement, dated as of July 31, 1987, among Beverly Enterprises, Inc., Beverly California Corporation, Beverly Enterprises Texas, Inc. and Stephens Inc. with reference thereto (incorporated by reference to Exhibit 19.13 to Beverly Enterprises, Inc. s Quarterly Report on Form 10-Q for the quarter ended June 30, 1987) |
| 10.50 | Agreement to Sale of Nursing Home Properties, dated as of July 13, 2001, among Beverly Enterprises Florida, Inc., Beverly Health and Rehabilitation Services, Inc., Beverly Savana Cay Manor, Inc., Vantage Healthcare Corporation, Peterson Health Care, Inc. and NMC of Florida, LLC (the Florida Sale Agreement) (incorporated by reference to Exhibit 10.36 to Beverly Enterprises, Inc. s Annual Report on Form 10-K for the year ended December 31, 2001) |
| 10.51 | First Amendment to Florida Sale Agreement, dated as of August 30, 2001 (incorporated by reference to Exhibit 10.37 to Beverly Enterprises, Inc. s Annual Report on Form 10-K for the year ended December 31, 2001) |
| 10.52 | Second Amendment to Florida Sale Agreement, dated as of October 29, 2001 (incorporated by reference to Exhibit 10.38 to Beverly Enterprises, Inc. s Annual Report on Form 10-K for the year ended December 31, 2001) |
| 10.53 | Amendment No. 5 to Amended and Restated Participation Agreement, dated as of December 20, 2002 (incorporated by reference to Exhibit 10.59 to Beverly Enterprises, Inc. s Annual Report on Form 10-K for the year ended December 31, 2002) |

Table of Contents

| Exhibit Number | Description |
|-------------------|--|
| 10.54 | Amendment No. 6 to Amended and Restated Participation Agreement, dated as of February 28, 2003 (incorporated by reference to Exhibit 10.60 to Beverly Enterprises, Inc. s Annual Report on Form 10-K for the year ended December 31, 2002) [Note: Confidential treatment has been requested for portions of this document.] |
| 10.55 | Master Services Agreement, dated as of September 18, 1997, by and between Alltel Information Services, Inc. and Beverly Enterprises, Inc. (incorporated by reference to Exhibit 10.41 to Beverly Enterprises, Inc. s Annual Report on Form 10-K for the year ended December 31, 1999) |
| 10.56 | Fifth Amendment to Master Services Agreement, dated as of January 1, 2003, by and between Alltel Information Services, Inc. and Beverly Enterprises, Inc. (incorporated by reference to Exhibit 10.62 to Beverly Enterprises, Inc. s Annual Report on Form 10-K for the year ended December 31, 2002). |
| 10.57 | Amendment No. 3 to the Credit Agreement, dated as of December 20, 2002 (incorporated by reference to Exhibit 10.65 to Beverly Enterprises, Inc. s Annual Report on Form 10-K for the year ended December 31, 2002). |
| 10.58 | Amendment No. 4 to the Credit Agreement, dated as of February 28, 2003 (incorporated by reference to Exhibit 10.66 to Beverly Enterprises, Inc. s Annual Report on Form 10-K for the year ended December 31, 2002) [Note: Confidential treatment has been requested for portions of this document.] |
| 10.59 | Corporate Integrity Agreement between the Office of Inspector General of the Department of Health and Human Services and Beverly Enterprises, Inc. (incorporated by reference to Exhibit 10.43 to Beverly Enterprises, Inc. s Annual Report on Form 10-K for the year ended December 31, 1999) |
| 10.60 | Plea Agreement (incorporated by reference to Exhibit 10.44 to Beverly Enterprises, Inc. s Annual Report on Form 10-K for the year ended December 31, 1999) |
| 10.61 | Addendum to Plea Agreement (incorporated by reference to Exhibit 10.45 to Beverly Enterprises, Inc. s Annual Report on Form 10-K for the year ended December 31, 1999) |
| 10.62 | Settlement Agreement between the United States of America, Beverly Enterprises, Inc. and Domenic Todarello (incorporated by reference to Exhibit 10.46 to Beverly Enterprises, Inc. s Annual Report on Form 10-K for the year ended December 31, 1999) |
| 10.63 | Agreement Regarding the Operations of Beverly Enterprises California, Inc. (incorporated by reference to Exhibit 10.47 to Beverly Enterprises, Inc. s Annual Report on Form 10-K for the year ended December 31, 1999) |
| 10.64 | Settlement Agreement, effective October 15, 2002, between the Centers for Medicare and Medicaid Services, United States Department of Health and Human Services and Beverly Enterprises, Inc. (incorporated by reference to Exhibit 10.2 to Beverly Enterprises, Inc. s Quarterly Report on Form 10-Q for the quarter ended September 30, 2002) |
| 10.65 | Permanent Injunction and Final Judgment, entered on August 1, 2002, in People of the State of California v. Beverly Enterprises, Inc.; Beverly Health and Rehabilitation Services, Inc.; Beverly Enterprises California, Inc.; and Beverly Healthcare California, Inc., Superior Court of the State of California For the County of Santa Barbara (incorporated by reference to Exhibit 10.1 to Beverly Enterprises, Inc. s Quarterly Report on Form 10-Q for the quarter ended June 30, 2002) |

Table of Contents

| Exhibit Number | Description |
|-------------------|---|
| 10.66 | Waiver of Constitutional Rights and Plea Form and Court Finding and Order, dated August 1, 2002, in The People of California v. Beverly Enterprises California, Inc., Superior Court of the State of California For the County of Santa Barbara (S.C. No. 1094923) (incorporated by reference to Exhibit 10.2 to Beverly Enterprises, Inc. s Quarterly Report on Form 10-Q for the quarter ended June 30, 2002) |
| 10.67 | Investigation Conclusion letter dated August 1, 2002, from the State of California Department of Justice (incorporated by reference to Exhibit 10.3 to Beverly Enterprises, Inc. s Quarterly Report on Form 10-Q for the quarter ended June 30, 2002) |
| 10.68 | Loan Agreement, dated as of December 24, 2002, between Beverly Enterprises Washington, Inc. and Bank of America, N.A. (incorporated by reference to Exhibit 10.76 to Beverly Enterprises, Inc. s Annual Report on Form 10-K for the year ended December 31, 2002) |
| 10.69 | Guaranty, dated December 24, 2002, between Beverly Enterprises, Inc. and Bank of America, N.A. (incorporated by reference to Exhibit 10.77 to Beverly Enterprises, Inc. s Annual Report on Form 10-K for the year ended December 31, 2002) |
| 10.70 | Credit Agreement, dated as of October 22, 2003, (the Credit Agreement) among Beverly Enterprises, Inc., Lehman Brothers Inc., Lehman Commercial Paper Inc., Bank of Montreal and General Electric Capital Corporation [Note: Confidential treatment has been requested for portions of this document.] (incorporated by reference to Exhibit 10.1 to Beverly Enterprises, Inc. s Quarterly Report on Form 10-Q for the quarter ended September 30, 2003) |
| 10.71 | Guaranty and Collateral Agreement (incorporated by reference to Exhibit 10.1 to Beverly Enterprises, Inc. s Quarterly Report on Form 10-Q for the quarter ended September 30, 2003) |
| 12.1 | Computation of Ratio of Earnings to Fixed Charges |
| 21.1 | Subsidiaries of Registrant |
| 23.1 | Consent of Ernst & Young LLP, Independent Registered Public Accounting Firm |
| 31.1 | Rule 13a-14(a)/15d-14(a) Certification of Chief Executive Officer |
| 31.2 | Rule 13a-14(a)/15d-14(a) Certification of Chief Financial Officer |
| 32.1 | Section 1350 Certification of Chief Executive Officer |
| 32.2 | Section 1350 Certification of Chief Financial Officer |

* Exhibits 10.1 through 10.47 are management contracts, compensatory plans, contracts and arrangements in which any director or named executive officer participates.

Filed herewith.

Previously filed.

*By:

/s/ JOHN G. ARENA

John G. Arena
Attorney-in-Fact