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ASSISTED LIVING CONCEPTS INC

Form 10-K

March 13, 2001

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UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20459

FORM 10-K

(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, 2000

OR

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

FOR THE TRANSITION PERIOD FROM \_\_\_\_\_ TO \_\_\_\_\_ .

COMMISSION FILE NUMBER 1-13498

ASSISTED LIVING CONCEPTS, INC.  
(EXACT NAME OF REGISTRANT AS SPECIFIED IN ITS CHARTER)

NEVADA  
(STATE OR OTHER JURISDICTION OF  
INCORPORATION OR ORGANIZATION)

93-1148702  
(IRS EMPLOYER  
IDENTIFICATION NO.)

11835 NE GLENN WIDING DRIVE, BUILDING E  
PORTLAND, OR 97220-9057  
(503) 252-6233

(ADDRESS, INCLUDING ZIP CODE, AND TELEPHONE NUMBER, INCLUDING AREA CODE, OF  
REGISTRANT'S PRINCIPAL EXECUTIVE OFFICES)

SECURITIES REGISTERED PURSUANT TO SECTION 12 (b) OF THE ACT:

TITLE OF EACH CLASS	NAME OF EACH EXCHANGE ON WHICH REGISTERED
COMMON STOCK, PAR VALUE \$.01	AMERICAN STOCK EXCHANGE
6.0% CONVERTIBLE SUBORDINATED DEBENTURES DUE NOVEMBER 2002	AMERICAN STOCK EXCHANGE
5.625% CONVERTIBLE SUBORDINATED DEBENTURES DUE MAY 2003	AMERICAN STOCK EXCHANGE

SECURITIES REGISTERED PURSUANT TO SECTION 12 (g) OF THE ACT:

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NONE.

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for at least the past 90 days. Yes [ ] 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: [ ]

The Registrant had 17,120,745 shares of common stock, \$.01 par value, outstanding at March 9, 2001. The aggregate market value of the voting stock held by non-affiliates of the registrant on such date was approximately \$13.5 million.

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## PART I

References in this report to "ALC," the "Company," "us" or "we" refer to Assisted Living Concepts, Inc. and its subsidiaries.

### ITEM 1. BUSINESS

#### OVERVIEW

We operate, own and lease free-standing assisted living residences. These residences are primarily located in small, middle-market, rural and suburban communities with a population typically ranging from 10,000 to 40,000. As of December 31, 2000 we had operations in 16 states.

We also provide personal care and support services and make available routine nursing services (as permitted by applicable law) designed to meet the personal and health care needs of our residents. We believe that this combination of residential, personal care, support and health care services provides a cost-efficient alternative to, and affords an independent lifestyle for, individuals who do not require the broader array of medical services that nursing facilities are required by law to provide.

We experienced significant and rapid growth between 1994 and 1998, primarily through the development of assisted living residences and, to a much lesser extent, through acquisition of assisted living residences. When we completed our initial public offering in November 1994 we had a base of five leased residences (137 units). We opened twenty residences (798 units) in 1999 and no new residences in 2000. As of December 31, 2000, we had 185 assisted living residences in operation representing an aggregate of 7,149 units. Of these residences, we owned 115 residences (4,515 units) and leased 70 residences (2,634 units). For the year ended December 31, 2000, our 165 Same Store Residences (those residences that had been operating in their entirety for both 1999 and 2000) had an average occupancy rate of 83.7% and an average monthly rental rate of \$1,985 per unit.

The principal elements of our business strategy are to:

- increase occupancy and improve operating efficiencies at our existing base of residences;

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- reduce overhead costs where possible; and
- establish necessary financing to meet maturing obligations.

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

Although we manage the mix of private paying tenants and Medicaid paying tenants residing in our facilities, any significant increase in our Medicaid population could have an adverse effect on our financial position, results of operations or cash flows, particularly if the states operating these programs continue to or more aggressively seek limits on reimbursement rates. See "Risk Factors -- We depend on reimbursement by third-party payors" included in Item 7.

Assisted Living Concepts, Inc. is a Nevada corporation. Our principal executive offices are located at 11835 NE Glenn Widing Drive, Building E, Portland, Oregon 97220-9057, and our telephone number is (503) 252-6233.

### RECENT DEVELOPMENTS

#### Securityholder Litigation Settlement

In September 2000, we reached an agreement to settle the class action litigation relating to the restatement of our financial statements for the years ended December 31, 1996 and 1997 and the first three

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fiscal quarters of 1998. This agreement received final court approval on November 30, 2000 and we were subsequently dismissed from the litigation with prejudice.

The total cost of the settlement was approximately \$10,020,000 (less \$1.0 million of legal fees and expenses reimbursed by our corporate liability insurance carriers and other reimbursements of approximately \$193,000). We made two payments of \$2.3 million each on October 23, 2000 and January 23, 2001 towards the settlement. The remaining amount due will be paid in two payments of \$2.3 million each, due on April 23, 2001 and July 23, 2001, and a final payment of \$1.0 million due within 90 days following the July 23, 2001 payment.

The settlement had been pending the approval of our corporate liability insurance carriers who had raised certain coverage issues that resulted in the filing of litigation between us and the carriers. These carriers consented to the settlement, and we and the carriers agreed to dismiss the litigation regarding coverage issues and to resolve those issues through binding arbitration. The arbitration proceeding is pending. To the extent that the carriers are successful, we and the carriers agreed that the carriers' recovery is not to exceed \$4.0 million. The parties further agreed that payment of any such amount awarded will not be due in any event until 90 days after we have satisfied our obligations to the plaintiffs in the class action, with any such amount to be subordinated to new or refinancing of existing obligations. We believe that we have strong defenses regarding this dispute and consequently have not recorded a liability in relation to this matter.

As a result of the class action settlement, we recorded a charge of

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approximately \$10,020,000, which was partially offset by a reduction in general, and administrative expenses of approximately \$1,193,000 as a result of the reimbursement of legal fees and expenses incurred in connection with the litigation. The settlement resulted in an increase in net loss of \$8,827,000 (or approximately \$0.52 per basic and diluted share) for the year ended December 31, 2000.

### Indiana Litigation Settlement

In a lawsuit filed in 2000, the Indiana State Department of Health ("ISDH") had alleged that we were operating our Logansport, Indiana facility known as McKinney House, as a residential care facility without a license. We believe our services have been consistent with those of a "Housing with Services Establishment" (which is not required to be licensed) pursuant to Indiana Code Section 12-10-15-1.

To avoid the expense and uncertainty of protracted litigation and, also because we wished to assure the State that we operate in a manner that is consistent with Indiana law, we agreed to the following settlement on behalf of all facilities owned and operated by us in the State of Indiana. The State and ALC agreed upon a Program Description that clarifies the services that we can provide without requiring licensure as a residential care facility. This Program Description provides guidelines regarding the physical and medical condition of the residents in our facilities and the services to be provided to them. We agreed that prior to March 20, 2001, we will provide in-service training regarding the Program Description throughout our Indiana facilities. Under the Program Description, we must discharge residents who require certain types or levels of care that we agreed not to provide in Indiana. We are currently implementing the Program Description and, while its full impact is not now known, we do not expect the impact to be material to our financial condition, results of operations, cash flow and liquidity. Without admitting liability, we paid a civil penalty of \$10,000. The State dismissed the lawsuit against us with prejudice.

### Management Changes

On March 3, 2000, our Board of Directors announced the appointment of Wm. James Nicol and John Gibbons to the Board, including the appointment of Mr. Nicol as Chairman of the Board. We also announced the formation of an Executive Committee of our Board of Directors comprised of Dr. Keren Brown Wilson, Mr. Nicol and Mr. Gibbons. On March 3, 2000, we also announced the resignation of James W. Cruckshank as our Chief Financial Officer and the appointment of Mr. Gibbons as Interim Chief Financial Officer. At that time, we entered into a Separation and Consulting Agreement with Mr. Cruckshank, pursuant to which Mr. Cruckshank's employment agreement with us was terminated, and Mr. Cruckshank agreed to provide us

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with consulting services through the end of 2000. See "Executive Compensation -- Agreements with Former Officers" included in Item 11.

On March 16, 2000, we announced the appointment of Drew Q. Miller as Senior Vice President, Chief Financial Officer and Treasurer and the resignation of Mr. Gibbons as Interim Chief Financial Officer.

On April 21, 2000, we eliminated the position of Vice President and Chief Operating Officer which had been held by Leslie Mahon. Keren Brown Wilson assumed these duties until her position of President and CEO was restructured in October, 2000.

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Effective October 19, 2000, Dr. Wilson resigned as President and Chief Executive Officer and from our Board. She will remain active with us, continuing to represent us at various assisted living industry events and providing consulting services to us, as requested, until December 31, 2001. We incurred a charge of \$800,000 in the fourth quarter of 2000 in connection with her resignation, such amount to be paid out over the fourteen-month period ending December 31, 2001.

Upon the resignation of Dr. Wilson, Mr. Nicol served as the Acting President and Chief Executive Officer until his permanent appointment. On November 8, 2000, our Board appointed Wm. James Nicol as President and Chief Executive Officer and Jill M. Krueger replaced Dr. Wilson on the Executive Committee.

In January, 2001, our Board determined the Executive Committee was no longer needed and discontinued it.

### Annual Meeting of Shareholders

On January 16, 2001, we held our annual shareholders' meeting. The sole purpose of this meeting was the re-election of two of our directors, Richard C. Ladd and Jill M. Krueger, and the election of four new directors, Wm. James Nicol (Chairman, President & Chief Executive Officer), John M. Gibbons, Leonard Tannenbaum and Bruce E. Toll. Following the meeting, Mr. Gibbons was appointed Vice Chairman of the Board.

### Modification and Amendment to Rights Agreement

On November 8, 2000, we modified and amended our Rights Agreement to provide that the acquisition of up to \$15.0 million in face value of our convertible debentures is not to be considered "beneficially owned," as defined under the Rights Agreement, for purposes of calculating whether a beneficial owner owns 15% or more of our common shares then outstanding, in which event certain rights as described in the Rights Agreement would arise.

### Amendment of Loan Documents

On March 12, 2001, we amended certain loan documents with U. S. Bank National Association ("U.S. Bank"). Pursuant to the amendment, we agreed to pay fees of \$34,700 in exchange for the following: the modification of certain financial covenants, and the waiver of U.S. Bank's right to declare an event of default for our failure to comply with certain financial covenants as of December 31, 2000 and for our anticipated failure to comply with certain financial covenants for the three months ending March 31, 2001. The amendment also provides the following: approval for us to repurchase for cash up to \$25.0 million in face value of our convertible debentures prior to maturity; a requirement that we deposit \$500,000 in cash collateral with U.S. Bank in the event certain regulatory actions are commenced with respect to the properties securing our obligations to U.S. Bank; and the requirement that U.S. Bank release such deposits to us upon satisfactory resolution of the regulatory action.

### Additional Financing

In November 2000, we entered into a short-term bridge loan with Red Mortgage Capital, Inc. ("Red Mortgage") in the amount of \$4.0 million secured by three previously unencumbered properties. This loan matures on August 1, 2001, requires monthly interest-only payments until maturity and bears interest at the

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greater of 10% or LIBOR plus 3.5%. We intend to replace this loan with long-term HUD financing prior to its maturity.

On March 2, 2001, we entered into an agreement with Heller Healthcare Finance, Inc. ("Heller") for a \$45.0 million line of credit, under which five wholly owned subsidiaries are the jointly and severally liable borrowers of any funds drawn. This line matures on August 31, 2002 and requires monthly interest-only payments until maturity. This line bears an interest rate of 3.85% over the three-month LIBOR rate floating monthly and will be secured by up to 32 properties owned by the borrowers and leased to another of our affiliates or us. We guaranteed the line. In addition to having paid a commitment fee of \$450,000, we are to pay funding fees of 0.5% of the principal amount funded at the time of funding and pay an exit fee of 1.0% of the principal being repaid. The borrowers may elect to exercise up to three six-month extensions of the maturity date, subject to the satisfaction of certain conditions. We intend to replace a substantial portion of this financing with long-term HUD financing to the extent the processing time and increasing limitations by HUD on submission of applications and amount financed permit. While the line remains outstanding, we have agreed that all of our remaining unencumbered properties, except one, will remain unencumbered, unless the net proceeds of such financing are used to repurchase our convertible debentures or pay off other indebtedness (if approved by Heller). Proceeds of the line may be used for the payment of our shareholders' litigation settlement, the repurchase of 16 of our leased properties and the repurchase of some of our convertible debentures. Our initial draw on this line was \$1.3 million on March 2, 2001.

### Option Cancellation

In November 2000, the Board of Directors, at the recommendation of the Compensation Committee, approved an offer (the "Offer") to holders of options under both the 1994 Stock Option Plan and the Non-Executive Employee Equity Participation Plan. We agreed to make lump sum payments of \$250 to each option holder who agreed to the cancellation of all of their options having an exercise price of \$5.00 or greater ("Eligible Options"), except that certain executive officers, directors, and consultants were asked to agree to the cancellation of their Eligible Options without any such payment. We completed the Offer in December 2000, paying approximately \$17,000 for the cancellation of options covering the issuance of 596,103 shares of common stock.

### SERVICES

Our residences offer residents a supportive, "home-like" setting and assistance with activities of daily living. Residents are individuals who, for a variety of reasons, cannot live alone, or elect not to do so, and do not need the 24-hour skilled medical care provided in nursing facilities. We design services provided to these residents to respond to their individual needs and to improve their quality of life. This individualized assistance is available 24 hours a day, to meet both anticipated and unanticipated needs, including routine health-related services, which are made available and are provided according to the resident's individual needs and state regulatory requirements. Available services include:

- General services, such as meals, laundry and housekeeping;
- Support services, such as assistance with medication, monitoring health status, coordination of transportation; and
- Personal care, such as dressing, grooming and bathing.

We also provide or arrange access to additional services beyond basic housing and related services, including physical therapy and pharmacy services.

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Although a typical package of basic services provided to a resident includes meals, housekeeping, laundry and personal care, we do not have a standard service package for all residents. Instead, we are able to accommodate the changing needs of our residents through the use of individual service plans and flexible staffing patterns. Our multi-tiered rate structure for services is based upon the acuity of, or level of services needed by, each resident. Supplemental and specialized health-related services for those residents requiring 24-hour supervision or more extensive assistance with activities of daily living are provided by third-party

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providers who are reimbursed directly by the resident or a third-party payor (such as Medicaid or long-term care insurance). Our policy is to assess the level of need of each resident regularly.

### OPERATIONS

Each residence has an on-site program director who is responsible for the overall day-to-day operation of the residence, including quality of care, marketing, social services and financial performance. The program director is assisted by professional and non-professional personnel, some of whom may be independent providers or part-time personnel, including nurses, personal service assistants, maintenance and kitchen personnel. The nursing hours vary depending on the residents' needs. We consult with outside providers, such as registered nurses, pharmacists, and dietitians, for purposes of medication review, menu planning and responding to any special dietary needs of residents. Personal service assistants who primarily are full-time employees are responsible for personal care, dietary services, housekeeping and laundry services. Maintenance services are performed by full and part-time employees.

We have established an infrastructure that includes 4 regional vice presidents of operations who oversee the overall performance and finances of each region, 16 regional operations managers who oversee the day-to-day operations of up to 10 to 12 residences, and team leaders who provide peer support for up to three to four residences. Residence personnel also are supported by corporate staff based at our headquarters. We also have regional property managers who oversee the maintenance of the residences and several regional marketing coordinators who assist with marketing the residence. Corporate and regional personnel work with the program directors to establish residence goals and strategies, quality assurance oversight, development of Company policies and procedures, government relations, marketing and sales, community relations, development and implementation of new programs, cash management, legal support, treasury functions, and human resource management.

### COMPETITION

The long-term care industry generally is highly competitive. We expect that the assisted living business, in particular, will become even more competitive in the future given the relatively low barriers to entry and continuing health care cost containment pressures.

We compete with numerous other companies providing similar long-term care alternatives. We operate in 16 states and each community in which we operate provides a unique market. Overall, most of our markets include an assisted living competitor offering assisted living facilities that are similar in size, price and range of service. Our competitors include other companies that provide adult day care in the home, higher priced assisted living centers (typically larger facilities with more amenities), congregate care facilities where tenants elect the services to be provided, and continuing care retirement centers on campus like settings.

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We expect to face increased competition from new market entrants as assisted living receives increased attention and the number of states which include assisted living in their Medicaid programs increases. Competition will also grow from new market entrants, including publicly and privately held companies focusing primarily on assisted living. Nursing facilities that provide long-term care services are also a potential source of competition for us. Providers of assisted living residences compete for residents primarily on the basis of quality of care, price, reputation, physical appearance of the facilities, services offered, family preferences, physician referrals and location. Some of our competitors operate on a not-for-profit basis or as charitable organizations. Some of our competitors are significantly larger than us and have, or may obtain, greater resources than ours. While we generally believe that there is moderate competition for less expensive segments of the private market and for Medicaid residents in small communities, we have seen an increase in competition in certain of our markets.

We believe that many assisted living markets have become overbuilt. Regulation and other barriers to entry into the assisted living industry are not substantial. In addition, because the segment of the population that can afford to pay our daily resident fee is finite, the number of new assisted living facilities may outpace demand in some markets. The effects of such overbuilding include (a) significantly longer fill-up periods, (b) pressure to lower or refrain from increasing rates, (c) competition for workers in already tight labor

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markets and (d) lower margins until excess units are absorbed. We have experienced slower fill-up than expected of new residences in some markets as well as declining occupancy in our stabilized residences due to the increase in options available to potential new residents when units are vacated. We believe that each local market is different, and we are and will continue to react in a variety of ways, including selective price discounting, to the specific competitive environment that exists in each market. There can be no assurance that we will be able to compete effectively in those markets where overbuilding exists, or that future overbuilding in other markets where we operate our residences will not adversely affect our operations.

### FUNDING

Assisted living residents or their families generally pay the cost of care from their own financial resources. Depending on the nature of an individual's health insurance program or long-term care insurance policy, the individual may receive reimbursement for costs of care under an "assisted living," "custodial" or "alternative care benefit." Government payments for assisted living have been limited. Some state and local governments offer subsidies for rent or services for low-income elders. Others may provide subsidies in the form of additional payments for those who receive Supplemental Security Income (SSI). Medicaid provides coverage for certain financially or medically needy persons, regardless of age, and is funded jointly by federal, state and local governments. Medicaid contracts for assisted living vary from state to state.

In 1981, the federal government approved a Medicaid waiver program called Home and Community Based Care which was designed to permit states to develop programs specific to the healthcare and housing needs of the low-income elderly eligible for nursing home placement (a "Medicaid Waiver Program"). In 1986, Oregon became the first state to use federal funding for licensed assisted living services through a Medicaid Waiver Program authorized by the Health Care Financing Administration ("HCFA"). Under a Medicaid Waiver Program, states apply to HCFA for a waiver to use Medicaid funds to support community-based options for the low-income elderly who need long-term care. These waivers permit states to reallocate a portion of Medicaid funding for nursing facility care to other



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forms of care such as assisted living. In 1994, the federal government implemented new regulations which empowered states to further expand their Medicaid Waiver Programs and eliminated restrictions on the amount of Medicaid funding states could allocate to community-based care, such as assisted living. A limited number of states including Oregon, New Jersey, Texas, Arizona, Nebraska, Florida, Idaho and Washington currently have operating Medicaid Waiver Programs that allow them to pay for assisted living care. We participate in Medicaid programs in all of these states except Florida. Without a Medicaid Waiver Program, states can only use federal Medicaid funds for long-term care in nursing facilities.

During the years ended December 31, 1998, 1999 and 2000, direct payments received from state Medicaid agencies accounted for approximately 10.7%, 10.4% and 11.1%, respectively, of our revenue while the tenant-paid portion received from Medicaid residents accounted for approximately 5.8%, 5.9% and 6.2%, respectively, of our revenue during these periods. We expect in the future that state Medicaid reimbursement programs will continue to constitute a significant source of our revenue.

### GOVERNMENT REGULATION

Our assisted living residences are subject to certain state statutes, rules and regulations, including those which provide for licensing requirements. In order to qualify as a state licensed facility, our residences must comply with regulations which address, among other things, staffing, physical design, required services and resident characteristics. As of December 31, 2000, we had obtained licenses in Oregon, Washington, Idaho, Nebraska, Texas, Arizona, Iowa, Louisiana, Ohio, New Jersey, Pennsylvania, Florida, Michigan, Georgia and South Carolina. We are not currently subject to state licensure requirements in Indiana. Our residences are also subject to various local building codes and other ordinances, including fire safety codes. These requirements vary from state to state and are monitored to varying degrees by state agencies.

As a provider of services under the Medicaid program in the United States, we are subject to Medicaid fraud and abuse laws, which prohibit any bribe, kickback, rebate or remuneration of any kind in return for the referral of Medicaid patients, or to induce the purchasing, leasing, ordering or arranging of any goods or

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services to be paid for by Medicaid. Violations of these laws may result in civil and criminal penalties and exclusions from participation in the Medicaid program. The Inspector General of the Department of Health and Human Services issued "safe harbor" regulations specifying certain business practices, which are exempt from sanctions under the fraud and abuse law. Several states in which we operate have laws that prohibit certain direct or indirect payments or fee-splitting arrangements between health care providers if such arrangements are designed to induce or encourage the referral of patients to a particular provider. We at all times attempt to comply with all applicable fraud and abuse laws. There can be no assurance that administrative or judicial interpretation of existing laws or regulations or enactments of new laws or regulations will not have a material adverse effect on our results of operations or financial condition.

Currently, the federal government does not regulate assisted living residences as such. State standards required of assisted living providers are less in comparison with those required of other licensed health care operators. Current Medicaid regulations provide for comparatively flexible state control over the licensure and regulation of assisted living residences. There can be no assurance that federal regulations governing the operation of assisted living

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residences will not be implemented in the future or that existing state regulations will not be expanded.

Under the Americans with Disabilities Act of 1990, all places of public accommodation are required to meet certain federal requirements related to access and use by disabled persons. Although we believe that our facilities are substantially in compliance with, or are exempt from, present requirements, we will incur additional costs if required changes involve a greater expenditure than anticipated or must be made on a more accelerated basis than anticipated. Further legislation may impose additional burdens or restrictions with respect to access by disabled persons, the costs of compliance with which could be substantial.

See Risk Factors, "We are subject to significant government regulation."

### LIABILITY AND INSURANCE

Providing services in the senior living industry involves an inherent risk of liability. Participants in the senior living and long-term care industry are subject to lawsuits alleging negligence or related legal theories, many of which may involve large claims and result in the incurrence of significant legal defense costs. We currently maintain insurance policies to cover such risks in amounts which we believe are in keeping with industry practice. There can be no assurance that a claim in excess of our insurance will not be asserted. A claim against us not covered by, or in excess of, our insurance, could have a material adverse affect on us.

Based on poor loss experience, insurers for the long term care industry have become increasingly wary of liability exposures. A number of insurance carriers have stopped writing coverage to this market, and those remaining have increased premiums and deductibles substantially. While nursing homes have been the primary targets of these insurers, assisted living companies, including us, have experienced premium and deductible increases. During the claim year ended December 31, 2000, our professional liability insurance coverage included deductible levels of \$100,000 per incident; for the claim year ending December 31, 2001 this deductible level has been replaced with a retention level of \$250,000 for all states except Florida and Texas in which our retention level is \$500,000. In certain states, particularly Florida and Texas, many long-term care providers are facing very difficult renewals. There can be no assurance that we will be able to obtain liability insurance in the future or that, if such insurance is available, it will be available on terms acceptable to us.

### EMPLOYEES

As of December 31, 2000 we had 3,613 employees, of whom 1,628 were full-time employees and 1,985 were part-time employees. None of our employees are represented by any labor union. We believe that our labor relations are generally good.

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### ITEM 2. PROPERTIES

The following chart sets forth, as of December 31, 2000 the location, number of units, date of licensure, and ownership status of our residences. In addition, the chart sets forth occupancy rates as of December 31, 2000.

RESIDENCE	UNITS	OPENING DATE (1)	OWNERSHIP (2)	OCCUPANCY (%) AT 12/31/00 (3)
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WEST REGION

Idaho				
Burley.....	35	08/97	Leased	100.0
Caldwell.....	35	08/97	Leased	100.0
Garden City.....	48	04/97	Owned	91.7
Hayden.....	39	11/96	Leased	94.9
Idaho Falls.....	39	01/97	Owned	43.6
Moscow.....	35	04/97	Owned	40.0
Nampa.....	39	02/97	Leased	94.9
Rexburg.....	35	08/97	Owned	77.1
Twin Falls.....	39	09/97	Owned	64.1
Sub Total.....	344			78.8
Oregon				
Astoria.....	28	08/96	Owned	92.9
Bend.....	46	11/95	Owned	100.0
Brookings.....	36	07/96	Owned	97.2
Canby.....	25	12/90	Leased	96.0
Estacada.....	30	01/97	Owned	76.7
Eugene.....	47	08/97	Leased	93.6
Hood River.....	30	10/95	Owned	100.0
Klamath Falls.....	36	10/96	Leased	100.0
Lincoln City.....	33	10/94	Owned	78.8
Madras.....	27	03/91	Owned	96.3
Myrtle Creek.....	34	03/96	Leased	79.4
Newberg.....	26	10/92	Leased	100.0
Newport.....	36	06/96	Leased	91.7
Pendleton.....	39	04/91	Leased	87.2
Prineville.....	30	10/95	Owned	90.0
Redmond.....	37	03/95	Leased	94.6
Silverton.....	30	07/95	Owned	83.3
Sutherlin.....	30	01/97	Leased	96.7
Talent.....	36	10/97	Owned	91.7
Sub Total.....	636			92.0
Washington				
Battleground.....	40	11/96	Leased	97.5
Bremerton (4).....	39	05/97	Owned	97.4
Camas.....	36	03/96	Leased	94.4
Enumclaw.....	40	04/97	Owned	95.0
Ferndale.....	39	10/98	Owned	92.3
Grandview.....	36	02/96	Leased	91.7
Hoquiam.....	40	07/97	Leased	82.5
Kelso.....	40	08/96	Leased	90.0

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RESIDENCE	UNITS	OPENING DATE (1)	OWNERSHIP (2)	OCCUPANCY (%) AT 12/31/00 (3)
Kennewick.....	36	12/95	Leased	86.1
Port Orchard.....	39	06/97	Owned	89.7
Port Townsend.....	39	01/98	Owned	100.0
Spokane.....	39	09/97	Owned	92.3
Sumner (4).....	48	03/98	Owned	83.3

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Vancouver.....	44	06/96	Leased	86.4
Walla Walla.....	36	02/96	Leased	100.0
Yakima.....	48	07/98	Owned	97.9
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Sub Total.....	639			92.2
Arizona				
Apache Junction.....	48	03/98	Owned	64.6
Bullhead City.....	40	08/97	Leased	70.0
Lake Havasu.....	36	04/97	Leased	100.0
Mesa.....	50	01/98	Owned	68.0
Payson.....	39	10/98	Owned	82.1
Peoria.....	50	07/99	Owned	42.0
Prescott Valley.....	39	10/98	Owned	87.2
Surprise.....	50	10/98	Owned	32.0
Yuma.....	48	03/98	Owned	93.8
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Sub Total.....	400			69.3
CENTRAL REGION				
Texas				
Abilene.....	38	10/96	Leased	86.8
Amarillo.....	50	03/96	Leased	96.0
Athens.....	38	11/95	Leased	94.7
Beaumont.....	50	04/96	Leased	78.0
Big Springs.....	38	05/96	Leased	89.5
Bryan.....	30	06/96	Leased	100.0
Canyon.....	30	06/96	Leased	96.7
Carthage.....	30	10/95	Leased	96.7
Cleburne.....	45	01/96	Owned	100.0
Conroe.....	38	07/96	Leased	97.4
College Station.....	39	10/96	Leased	76.9
Denison.....	30	01/96	Owned	100.0
Gainesville.....	40	01/96	Leased	100.0
Greenville.....	41	11/95	Leased	100.0
Gun Barrel City.....	40	10/95	Leased	90.0
Henderson.....	30	09/96	Leased	83.3
Jacksonville.....	39	12/95	Leased	97.4
Levelland.....	30	01/96	Leased	93.3
Longview.....	30	09/95	Leased	100.0
Lubbock.....	50	07/96	Leased	88.0
Lufkin.....	39	05/96	Leased	87.2
Marshall.....	40	07/95	Leased	80.0
McKinney.....	39	01/97	Owned	100.0
McKinney.....	50	05/98	Owned	84.0
Mesquite.....	50	07/96	Leased	98.0

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RESIDENCE	UNITS	OPENING DATE (1)	OWNERSHIP (2)	OCCUPANCY (%) AT 12/31/00 (3)
-----	-----	-----	-----	-----
Midland.....	50	12/96	Owned	84.0
Mineral Wells.....	30	07/96	Leased	100.0
Nacogdoches.....	30	06/96	Leased	100.0
Orange.....	36	03/96	Leased	88.9
Pampa.....	36	08/96	Leased	91.7
Paris Oaks.....	50	12/98	Owned	100.0
Plainview.....	36	07/96	Leased	88.9

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Plano.....	64	05/98	Owned	76.6
Port Arthur.....	50	05/96	Owned	96.0
Rowlett.....	36	10/96	Owned	97.2
Sherman.....	39	10/95	Leased	102.6
Sulphur Springs.....	30	01/96	Owned	93.3
Sweetwater.....	30	03/96	Leased	100.0
Temple.....	40	01/97	Leased	80.0
Wichita Falls.....	50	10/96	Leased	100.0
	-----			
Sub Total.....	1,581			92.2
Nebraska				
Beatrice.....	39	07/97	Leased	97.4
Blair.....	30	07/98	Owned	70.0
Columbus.....	39	06/98	Owned	97.4
Fremont.....	39	05/98	Owned	100.0
Nebraska City.....	30	06/98	Owned	90.0
Norfolk.....	39	04/97	Leased	84.6
Seward.....	30	10/98	Owned	70.0
Wahoo.....	39	06/97	Leased	79.5
York.....	39	05/97	Leased	92.3
	-----			
Sub Total.....	324			87.7
Iowa				
Atlantic.....	30	09/98	Owned	86.7
Carroll.....	35	01/99	Owned	100.0
Clarinda.....	35	09/98	Owned	100.0
Council Bluffs.....	50	03/99	Owned	68.0
Denison.....	35	05/98	Leased	88.6
Sergeant Bluff.....	39	11/99	Owned	28.2
	-----			
Sub Total.....	224			76.8
SOUTHEAST REGION				
Georgia				
Rome.....	39	08/99	Owned	51.3
Florida				
Defuniak Springs.....	39	07/99	Owned	53.9
Milton.....	39	06/99	Owned	79.5
NW Pensacola.....	39	06/99	Owned	43.6
Quincy.....	39	04/99	Owned	48.7
	-----			
Sub Total.....	156			56.4

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RESIDENCE	UNITS	OPENING DATE (1)	OWNERSHIP (2)	OCCUPANCY (%) AT 12/31/00 (3)
-----	-----	-----	-----	-----
Louisiana				
Alexandria.....	48	07/98	Owned	45.8
Bunkie.....	39	01/99	Owned	59.0
Houma.....	48	08/98	Owned	89.6
Ruston.....	39	01/99	Owned	89.7
	-----			
Sub Total.....	174			70.7
South Carolina				
Aiken.....	39	02/98	Owned	97.4
Clinton.....	39	11/97	Leased	89.7

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Goose Creek.....	39	08/98	Owned	79.5
Greenwood.....	39	05/98	Leased	76.9
Greer.....	39	06/99	Owned	89.7
James Island.....	39	08/98	Owned	97.4
North Augusta.....	39	10/98	Owned	82.1
Port Royal.....	39	09/98	Owned	74.4
Summerville.....	39	02/98	Owned	87.2
	-----			
Sub Total.....	351			86.0
EAST REGION				
Indiana				
Bedford.....	39	03/98	Owned	97.4
Bloomington.....	39	01/98	Owned	41.0
Camby.....	39	12/98	Owned	87.2
Crawfordsville.....	39	06/99	Owned	100.0
Elkhart.....	39	09/97	Leased	76.9
Fort Wayne.....	39	06/98	Owned	53.9
Franklin.....	39	05/98	Owned	46.2
Huntington.....	39	02/98	Owned	87.2
Jeffersonville.....	39	03/99	Owned	12.8
Kendallville.....	39	05/98	Owned	48.7
Lafayette.....	39	11/99	Owned	82.1
LaPorte.....	39	10/98	Owned	53.9
Logansport.....	39	02/98	Owned	89.7
Madison.....	39	10/97	Leased	74.4
Marion.....	39	03/98	Owned	43.6
Muncie.....	39	02/98	Owned	89.7
New Albany.....	39	05/98	Owned	74.4
New Castle.....	39	02/98	Owned	97.4
Seymour.....	39	05/98	Owned	94.9
Shelbyville.....	39	05/98	Owned	51.3
Warsaw.....	39	10/97	Owned	51.3
	-----			
Sub Total.....	819			69.2
Michigan				
Coldwater.....	39	10/99	Owned	66.7
Kalamazoo.....	39	11/99	Owned	66.7
Three Rivers.....	39	04/99	Owned	56.4
	-----			
Sub Total.....	117			63.3

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RESIDENCE	UNITS	OPENING DATE (1)	OWNERSHIP (2)	OCCUPANCY (%) AT 12/31/00 (3)
-----	-----	-----	-----	-----
New Jersey				
Bridgeton.....	39	03/98	Owned	89.7
Burlington.....	39	11/97	Owned	94.9
Egg Harbor.....	39	04/99	Owned	97.4
Glassboro.....	39	03/97	Leased	97.4
Millville.....	39	05/97	Leased	92.3
Pennsville.....	39	11/97	Owned	94.9
Rio Grande.....	39	11/97	Owned	94.9
Vineland.....	39	01/97	Leased	82.1
	-----			
Sub Total.....	312			93.0

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Ohio				
Bellefontaine.....	35	03/97	Owned	48.6
Bucyrus.....	35	01/97	Owned	100.0
Cambridge.....	39	10/97	Owned	100.0
Celina.....	39	04/97	Owned	76.9
Defiance.....	35	02/96	Owned	94.3
Findlay.....	39	03/97	Owned	56.4
Fremont.....	39	07/97	Leased	92.3
Greenville.....	39	02/97	Owned	100.0
Hillsboro.....	39	03/98	Owned	53.9
Kenton.....	35	03/97	Owned	91.4
Lima.....	39	06/97	Owned	28.2
Marion.....	39	04/97	Owned	92.3
Newark.....	39	10/97	Leased	100.0
Sandusky.....	39	09/98	Owned	59.0
Tiffin.....	35	06/97	Leased	85.7
Troy.....	39	03/97	Leased	100.0
Wheelersburg.....	39	09/97	Leased	59.0
Zanesville.....	39	12/97	Owned	92.3
	-----			
Sub Total.....	682			79.3
Pennsylvania				
Butler.....	39	12/97	Owned	94.9
Hermitage.....	39	03/98	Owned	64.1
Indiana.....	39	03/98	Owned	71.8
Johnstown.....	39	06/98	Owned	56.4
Latrobe.....	39	12/97	Owned	92.3
Lower Burrell.....	39	01/97	Owned	102.6
New Castle.....	39	04/98	Owned	94.9
Penn Hills.....	39	05/98	Owned	79.5
Uniontown.....	39	06/98	Owned	92.3
	-----			
Sub Total.....	351			82.9
	-----			
Grand Total.....	7,149			83.0%
	=====			

- 
- (1) Reflects the date operations commenced, typically the licensure date for developed residences and the date of purchase for acquired residences.
  - (2) As of December 31, 2000, we owned 115 residences and we leased 70 residences pursuant to long-term operating leases. Of the 115 owned residences, 37 are subject to permanent mortgage financing, 3 are

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subject to short-term loans which we intend to replace with permanent HUD mortgage financing, 8 secure our litigation payable, 3 were added as additional security for one lender and 16 were used as collateral for a financing that occurred subsequent to December 31, 2000. See Notes 5, 8 and 19 to the consolidated financial statements included elsewhere herein.

- (3) Occupancy is calculated based upon occupied units at December 31, 2000.
- (4) As of December 31, 2000, Bremerton and Sumner had received notices of stop placement of admissions and Sumner had received a notice of license revocation from the State of Washington Department of Social and Health Services. These matters were still outstanding at the time of this filing.

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In 2000, we also leased office space for the corporate office in Portland, Oregon and the regional offices in Vancouver, WA; Dallas, Texas; Omaha, Nebraska; and Dublin, Ohio.

### ITEM 3. LEGAL PROCEEDINGS

#### Securityholder Litigation Settlement

In September 2000, we reached an agreement to settle the class action litigation relating to the restatement of our financial statements for the years ended December 31, 1996 and 1997 and the first three fiscal quarters of 1998. This agreement received final court approval on November 30, 2000 and we were subsequently dismissed from the litigation with prejudice.

The total cost of the settlement was approximately \$10,020,000 (less \$1.0 million of legal fees and expenses reimbursed by our corporate liability insurance carriers and other reimbursements of approximately \$193,000). We made two payments of \$2.3 million each on October 23, 2000 and January 23, 2001 towards the settlement. The remaining amount due will be paid in two payments of \$2.3 million each, due on April 23, 2001 and July 23, 2001, and a final payment of \$1.0 million due within 90 days following the July 23, 2001 payment.

The settlement had been pending the approval of our corporate liability insurance carriers who had raised certain coverage issues that resulted in the filing of litigation between us and the carriers. These carriers consented to the settlement, and we and the carriers agreed to dismiss the litigation regarding coverage issues and to resolve those issues through binding arbitration. The arbitration proceeding is pending. To the extent that the carriers are successful, we and the carriers agreed that the carriers' recovery is not to exceed \$4.0 million. The parties further agreed that payment of any such amount awarded will not be due in any event until 90 days after we have satisfied our obligations to the plaintiffs in the class action, with any such amount to be subordinated to new or refinancing of existing obligations. We believe that we have strong defenses regarding this dispute and consequently have not recorded a liability in relation to this matter.

As a result of the class action settlement, we recorded a charge of approximately \$10,020,000, which was partially offset by a reduction in general, and administrative expenses of approximately \$1,193,000 as a result of the reimbursement of legal fees and expenses incurred in connection with the litigation. The settlement resulted in an increase in net loss of \$8,827,000 (or approximately \$0.52 per basic and diluted share) for the year ended December 31, 2000.

#### Indiana Litigation Settlement

In a lawsuit filed in 2000, the Indiana State Department of Health ("ISDH") had alleged that we were operating our Logansport, Indiana facility known as McKinney House as a residential care facility without a license. We believe our services have been consistent with those of a "Housing with Services Establishment" (which is not required to be licensed) pursuant to Indiana Code Section 12-10-15-1.

To avoid the expense and uncertainty of protracted litigation and, also because we wished to assure the State that we operate in a manner that is consistent with Indiana law, we agreed to the following settlement on behalf of all facilities owned and operated by us in the State of Indiana. The State and ALC agreed upon a Program Description that clarifies the services that we can provide without requiring licensure as a residential care facility. This Program Description provides guidelines regarding the physical and medical condition of the



residents in our facilities and the services to be provided to them. We agreed that prior to March 20, 2001, we will provide in-service training regarding the Program Description throughout our Indiana facilities. Under the Program Description, we must discharge residents who require certain types or levels of care that we agreed not to provide in Indiana. We are currently implementing the Program Description and, while its full impact is not now known, we do not expect the impact to be material to our financial condition, results of operations, cash flow and liquidity. Without admitting liability, we paid a civil penalty of \$10,000. The State dismissed the lawsuit against us with prejudice.

Other Litigation

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

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITYHOLDERS

We held our Annual Meeting of Stockholders on January 16, 2001. The meeting involved the election of six directors. The directors who were nominated and elected to serve as directors until the 2002 Annual Meeting of Stockholders and, in each case, until their respective successors are duly elected and qualified were Wm. James Nicol, John M. Gibbons, Jill M. Krueger, Richard C. Ladd, Bruce E. Toll and Leonard Tannenbaum. Shares represented at the annual meeting were 15,669,644 of total outstanding shares of 17,120,745 to reach a quorum of 91.5%. The results of the election were at least 87.3% in favor of each of the above six directors.

PART II

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

Our Common Stock, par value \$0.01 (the "Common Stock"), is listed on the American Stock Exchange ("AMEX") under the symbol "ALF." The following table sets forth the high and low closing sales prices of the Common Stock, as reported by the AMEX, for the periods indicated.

	1998		1999(1)		2000	
	HIGH	LOW	HIGH	LOW	HIGH	LOW
Years ended December 31:						
1st Quarter.....	\$21.63	\$17.50	\$14.50	\$3.31	\$2.38	\$1.31
2nd Quarter.....	21.38	14.13	3.31	2.88	1.50	0.63
3rd Quarter.....	18.00	12.44	--	--	0.88	0.44
4th Quarter.....	14.50	9.88	2.25	.81	0.63	0.19

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(1) On April 15, 1999, the AMEX halted trading in the Common Stock. Trading was resumed on October 4, 1999 after our restatement related to the years ended December 31, 1996 and 1997 and the first three fiscal quarters of 1998 was completed.

As of December 31, 2000, we had approximately 99 holders of record of Common Stock. We are unable to estimate the number of additional shareholders whose shares are held for them in street name or nominee accounts.

Our current policy is to retain any earnings to finance the operations of our business. In addition, certain outstanding indebtedness and certain lease agreements restrict the payment of cash dividends. It is anticipated that the terms of future debt financing may do so as well. Therefore, the payment of any cash dividends on the Common Stock is unlikely in the foreseeable future.

Our common stock currently is listed on the AMEX under the symbol "ALF," our 5.625% Convertible Subordinated Debentures due 2003 (the "5.625% Debentures") currently are listed on AMEX under the symbol "ALS5E03" and our 6.0% Convertible Subordinated Debentures due 2002 (the "6.0% Debentures") currently are listed on AMEX under the symbol "ALS6K02." AMEX recently notified us that we had fallen below certain of AMEX's continued listing guidelines and that it was reviewing our listing eligibility. In particular, we have incurred losses from continued operations for each of its past six fiscal years ending December 31, 2000, and the price per share of our common stock as quoted on AMEX recently has been below the minimum bid price of \$1.00 per share. We may choose to effect a reverse stock split in the event that the price of our common stock does not otherwise meet the minimum bid requirement. However, we reported a net loss of \$1.51 per basic and diluted share for the year ended December 31, 2000, and may not report net income in the near future. We have provided AMEX with additional information and have been involved in ongoing discussions with AMEX in connection with its review of our listing eligibility. While AMEX has decided not to delist us at this time, they will continue to review our listing status on a quarterly basis.

If AMEX were to delist our securities, it is possible that the securities would continue to trade on the over-the-counter market. However, the extent of the public market for the securities and the availability of quotations would depend upon such factors as the aggregate market value of each class of the securities, the interest in maintaining a market in such securities on the part of securities firms and other factors. There can be no assurance that any public market for our securities will exist in the event that such securities are delisted.

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### ITEM 6. SELECTED FINANCIAL DATA

The following table presents selected historical consolidated financial data. The consolidated statement of operations data for the years ended December 31, 1998, 1999 and 2000, as well as the consolidated balance sheet data as of December 31, 1999 and 2000, are derived from our consolidated financial statements included elsewhere in this report which have been audited by KPMG LLP, independent auditors. You should read the selected financial data below in conjunction with our consolidated financial statements, including the related notes, and the information in Item 7, "Management's Discussion and Analysis of Financial Condition and Results of Operations."

YEARS ENDED DECEMBER

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	1996 -----	1997 -----	1998 -----
	(IN THOUSANDS, EXCEPT PER S		
CONSOLIDATED STATEMENTS OF OPERATIONS DATA:			
Revenue.....	\$21,022	\$49,605	\$ 89,384
Operating expenses:			
Residence operating expenses.....	14,055	31,591	57,443
Corporate general and administrative.....	1,864	4,050	11,099
Building rentals.....	3,949	7,969	12,764
Depreciation and amortization.....	1,094	3,683	6,339
Litigation settlement.....	--	--	--
Terminated merger expense.....	--	--	1,068
Site abandonment costs.....	--	--	2,377
Write-off of impaired assets and related expenses.....	--	--	8,521
	-----	-----	-----
Total operating expenses.....	20,962	47,293	99,611
	-----	-----	-----
Operating income (loss).....	60	2,312	(10,227)
	-----	-----	-----
Other income (expense):			
Interest expense.....	(1,146)	(4,946)	(11,039)
Interest income.....	455	1,526	3,869
Gain (loss) on sale of assets.....	(854)	(1,250)	(651)
Loss on sale of marketable securities.....	--	--	--
Debenture conversion costs.....	(426)	--	--
Other income (expense), net.....	(4)	(121)	(1,174)
	-----	-----	-----
Total other expense.....	(1,975)	(4,791)	(8,995)
	-----	-----	-----
Loss before cumulative effect of change in accounting principle.....	(1,915)	(2,479)	(19,222)
Cumulative effect of change in accounting principle.....	--	--	(1,523)
	-----	-----	-----
Net loss.....	\$ (1,915)	\$ (2,479)	\$ (20,745)
	=====	=====	=====
Basic and diluted net loss per common share:			
Loss before cumulative effect of change in accounting principle.....	\$ (0.23)	\$ (0.21)	\$ (1.18)
Cumulative effect of change in accounting principle.....	--	--	(0.09)
	-----	-----	-----
Basic and diluted net loss per common share.....	\$ (0.23)	\$ (0.21)	\$ (1.27)
	=====	=====	=====
Basic and diluted weighted average common shares outstanding.....	8,404	11,871	16,273
	=====	=====	=====

	AT DECEMBER 31,		
	1996 -----	1997 -----	1998 -----
	(IN THOUSANDS)		
CONSOLIDATED BALANCE SHEET DATA:			
Cash and cash equivalents.....	\$ 2,105	\$ 63,269	\$ 55,036
Working capital (deficit).....	(27,141)	40,062	43,856
Total assets.....	147,223	324,367	414,669
Long-term debt, excluding current portion.....	49,663	157,700	266,286
Shareholders' equity.....	56,995	132,244	119,197

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QUARTERLY FINANCIAL DATA  
(UNAUDITED)  
(IN THOUSANDS EXCEPT PER SHARE, OCCUPANCY AND AVERAGE RENTAL DATA)

RESULTS OF OPERATIONS	1999 QUARTERLY FINANCIAL DATA					2000 QUARTERLY FINANCIAL DATA	
	1ST QTR	2ND QTR	3RD QTR	4TH QTR	YEAR TO DATE	1ST QTR	2ND QTR
Revenue.....	\$26,583	\$28,479	\$30,398	\$32,029	\$117,489	\$33,132	\$34,146
Operating income (loss)....	(4,243)	(6,115)	(2,561)	(2,025)	(14,944)	28	434
Net loss.....	(7,660)	(9,006)	(6,256)	(6,011)	(28,933)	(3,791)	(3,821)
Basis and diluted net loss per common share(1).....	\$ (0.45)	\$ (0.53)	\$ (0.37)	\$ (0.35)	\$ (1.69)	\$ (.22)	\$ (.22)
Basic and diluted weighted average common shares outstanding.....	17,116	17,116	17,121	17,121	17,119	17,121	17,121
Average monthly rental rate per unit.....	\$ 1,871	\$ 1,881	\$ 1,903	\$ 1,926	\$ 1,898	\$ 1,947	\$ 1,974
Average occupancy rate(2).....	72.9%	74.3%	76.0%	77.5%	75.1%	78.4%	79.8%
End of period occupancy rate(2).....	73.2%	75.9%	76.5%	78.7%	78.7%	79.6%	81.6%

(1) Quarter net loss per share amounts may not add to the full year total due to rounding.

(2) Based upon available units.

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

OVERVIEW

We operate, own and lease free-standing assisted living residences. These residences are primarily located in small middle-market rural and suburban communities with a population typically ranging from 10,000 to 40,000. We provide personal care and support services, and make available routine nursing services (as permitted by applicable law) designed to meet the personal and health care needs of our residents. As of December 31, 2000, we had operations in 16 states.

We experienced significant and rapid growth between 1994 and 1998, primarily through the development of assisted living residences and, to a lesser extent, through the acquisition of assisted living residences. At the closing of our initial public offering in November 1994, we had an operating base of five leased residences (137 units) located in Oregon. We opened twenty residences (798 units) in 1999 and no residences in 2000. As of December 31, 2000, we operated 185 residences (7,149 units), of which we owned 115 residences (4,515

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units) and leased 70 residences (2,634 units).

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

- residence operating expenses, such as staff payroll, food, property taxes, utilities, insurance and other direct residence operating expenses;
- general and administrative expenses consisting of regional management and corporate support functions such as legal, accounting and other administrative expenses;
- building rentals; and
- depreciation and amortization.

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

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

We believe that our current cash on hand, cash available from operations and financing by Heller will be sufficient to meet our working capital needs through July 2002. However, we will have up to \$45.0 million in principal from the Heller financing maturing on August 31, 2002 (unless the five wholly owned subsidiaries, which are the borrowers, are able to and do extend the maturity dates for up to three six-month extensions), and have \$161.3 million (less any amounts repurchased with the Heller line of credit) in principal amount of convertible debentures maturing between November 2002 and May 2003. We also expect the cost to maintain our long-lived assets in their present condition to increase; however, we cannot yet estimate the financial impact since our experience is limited due to the newness of these assets.

We are currently exploring various alternatives to address our financing needs and the maturities of our long-term debt. The Heller and Red Mortgage financings have been sought to fund potential working capital needs, to fund the cost of our shareholders' litigation settlement, the repurchase of 16 of our leased properties and the repurchase of some of our convertible debentures in the open market. We expect to replace the Red Mortgage financing with long-term HUD mortgage loans and we also expect to replace a substantial portion of

the Heller financing with long-term HUD mortgage loans, to the extent the processing time and increasing limitations by HUD on submission of applications and amount financed permit. In addition, we are also considering issuing new

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securities with longer maturities to the holders of our convertible debentures in exchange for some or all of their debentures. We have 48 unencumbered residences available to use as collateral for these various alternatives, 47 of which are subject to negative covenants not to encumber them except under certain circumstances, including the use of the net proceeds of the financing which they secure for the reduction of our indebtedness to our convertible debenture holders. No commitments are currently in place and there can be no assurance that our efforts will be successful, in which event we will have to consider other alternatives, including reorganization under the bankruptcy laws or raising highly dilutive capital through the issuance of equity or equity-related securities.

### RESULTS OF OPERATIONS

The following table sets forth, for the periods presented, operating expenses as a percentage of revenue.

	YEARS ENDED DECEMBER 31,		
	1998	1999	2000
	-----	-----	-----
Revenue.....	100.0%	100.0%	100.0%
Operating expenses:			
Residence operating expenses.....	64.3%	69.6%	68.1%
Corporate general and administrative.....	12.4%	18.0%	13.2%
Building rentals.....	12.8%	12.0%	10.6%
Building rentals to related party.....	1.5%	1.1%	0.9%
Depreciation and amortization.....	7.1%	7.6%	7.1%
Litigation settlement.....	--	--	7.2%
Terminated merger expense.....	1.2%	0.2%	--
Site abandonment costs.....	2.7%	4.2%	--
Write-off of impaired assets and related expenses.....	9.5%	--	--
	-----	-----	-----
Total operating expenses.....	111.4%	112.7%	107.1%
	-----	-----	-----
Operating loss.....	(11.4)%	(12.7)%	(7.1)%
	-----	-----	-----
Other income (expense):			
Interest expense.....	(12.4)%	(12.9)%	(11.7)%
Interest income.....	4.3%	1.4%	0.6%
Gain (loss) on sale of assets.....	(0.7)%	(0.1)%	--
Loss on sale of marketable securities.....	--	--	(0.3)%
Other income (expense), net.....	(1.3)%	(0.2)%	--
	-----	-----	-----
Total other income (expense).....	(10.1)%	(11.9)%	(11.4)%
	-----	-----	-----
Loss before cumulative effect of change in accounting principle.....	(21.5)%	(24.6)%	(18.5)%
Cumulative effect of change in accounting principle.....	(1.7)%	--	--
	-----	-----	-----
Net loss.....	(23.2)%	(24.6)%	(18.5)%
	=====	=====	=====

The following table sets forth, for the periods presented, the number of total residences and units operated, average occupancy rates and the sources of

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our revenue. The portion of revenues received from state Medicaid agencies are labeled as "Medicaid state portion" while the portion of our revenues that a Medicaid-eligible resident must pay out of his or her own resources is labeled "Medicaid resident portion."

TOTAL RESIDENCES -----	YEARS ENDED DECEMBER 31,		
	1998	1999	2000
Residences operated (end of period).....	165	185	185
Units operated (end of period).....	6,329	7,148	7,149
Average occupancy rate (based on occupied units).....	72.3%	75.1%	80.7%
Sources of revenue:			
Medicaid state portion.....	10.7%	10.4%	11.1%
Medicaid resident portion.....	5.8%	5.9%	6.2%
Private.....	83.5%	83.7%	82.7%
	-----	-----	-----
Total.....	100.0%	100.0%	100.0%
	=====	=====	=====

The following table sets forth, for the periods presented, the total number of residences and units operated, average occupancy rates and the sources of our revenue for the 59 Same Store Residences included in operating results for all of fiscal years 1997 and 1998, and the 108 Same Store Residences included in operating results for all of fiscal years 1998 and 1999 and the 165 Same Store Residences included in operating results for all of fiscal years 1999 and 2000. Same Store Residences are defined as those residences, which were operating throughout comparable periods.

SAME STORE RESIDENCES -----	YEARS ENDED DECEMBER 31,		YEARS ENDED DECEMBER 31,		YEARS ENDED DECEMBER 31,	
	1997	1998	1998	1999	1999	2000
Residences operated (end of period).....	59	59	108	108	165	165
Units operated (end of period).....	2,104	2,157	4,035	4,048	6,350	6,351
Average occupancy rate (based on occupied units).....	86.9%	93.5%	80.5%	84.7%	77.8%	83.7%
Sources of revenue:						
Medicaid state portion.....	11.9%	15.1%	12.7%	13.4%	10.8%	12.1%
Medicaid resident portion.....	6.5%	8.7%	6.9%	7.7%	6.1%	6.7%
Private.....	81.6%	76.2%	80.4%	78.9%	83.1%	81.2%
	-----	-----	-----	-----	-----	-----
Total.....	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%
	=====	=====	=====	=====	=====	=====

The following table sets forth, for the periods presented, the results of operations for the 59 Same Store Residences included in operating results for all of fiscal years 1997 and 1998, and the 108 Same Store Residences included in operating results for all of fiscal years 1998 and 1999 and the 165 Same Store Residences included in operating results for all of fiscal years 1999 and 2000 (in thousands).

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SAME STORE RESIDENCES	YEARS ENDED DECEMBER 31,		YEARS ENDED DECEMBER 31,		YEARS ENDED DECEMBER 31,	
	1997	1998	1998	1999	1999	2000
Revenue.....	\$38,274	\$42,002	\$70,920	\$77,881	\$113,511	\$127,851
Residence operating expenses.....	22,908	24,801	43,659	52,154	77,396	85,711
Residence operating income.....	15,366	17,201	27,261	25,727	36,115	42,140
Building rentals.....	5,635	6,375	12,385	14,825	15,336	15,336
Depreciation and amortization.....	2,280	1,647	3,451	3,067	7,181	7,181
Total other operating expenses.....	7,915	8,022	15,836	17,892	22,517	23,517
Operating income.....	\$ 7,451	\$ 9,179	\$11,425	\$ 7,835	\$ 13,598	\$ 19,140

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Year ended December 31, 2000 compared to year ended December 31, 1999:

	CONSOLIDATED YEARS ENDED DECEMBER 31,			SAME STORE RESIDENCES YEARS ENDED DECEMBER 31,		
	1999	2000	INCREASE/ (DECREASE)	1999	2000	INCREASE/ (DECREASE)
	(IN MILLIONS)			(IN MILLIONS)		
Revenue.....	\$117.5	\$139.4	18.6%	\$113.5	\$127.9	12.7%
Operating expenses:						
Residence operating expenses.....	81.8	95.0	16.1%	77.4	85.7	10.7%
Corporate general and administrative.....	21.2	18.4	(13.2)%	--	--	--
Building rentals.....	15.4	16.0	3.9%	15.3	16.0	4.6%
Depreciation and amortization.....	9.0	9.9	10.0%	7.2	7.2	--
Litigation settlement.....	--	10.0	100.0%	--	--	--
Terminated merger expense.....	0.2	--	(100.0)%	--	--	--
Site abandonment costs.....	4.9	--	(100.0)%	--	--	--
Total operating expenses.....	132.5	149.3	12.7%	99.9	108.9	9.0%
Operating income (loss).....	\$ (15.0)	\$ (9.9)	34.0%	\$ 13.6	\$ 19.0	39.7%

We incurred a net loss of \$25.8 million, or \$1.51 per basic and diluted share, on revenue of \$139.4 million for the year ended December 31, 2000 (the "2000 Period") as compared to a net loss of \$28.9 million, or \$1.69 per basic and diluted share, on revenue of \$117.5 million for the year ended December 31, 1999 (the "1999 Period").



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We had certificates of occupancy for 185 residences, all of which were included in the operating results as of the end of both the 2000 Period and 1999 Period. Of the residences included in operating results as of the end of the 2000 Period and 1999 Period, we owned 115 residences and leased 70 residences (all of which were operating leases).

Revenue. Revenue was \$139.4 million for the 2000 Period as compared to \$117.5 million for the 1999 Period, an increase of \$21.9 million or 18.6%.

The increase includes:

- \$7.5 million related to the full year impact of the 20 residences (798 units) which opened during the 1999 Period;
- \$14.4 million was attributable to the 165 Same Store Residences (6,351 units).

Revenue from the Same Store Residences was \$127.9 million for the 2000 Period as compared to \$113.5 million for the 1999 Period, an increase of \$14.4 million or 12.7%. The increase in revenue from Same Store Residences was attributable to a combination of an increase in average occupancy to 83.7% and average monthly rental rate to \$1,985 for the 2000 Period as compared to average occupancy of 77.8% and average monthly rental rate of \$1,891 for these same stores in the 1999 Period.

Residence Operating Expenses. Residence operating expenses were \$95.0 million for the 2000 Period as compared to \$81.8 million for the 1999 Period, an increase of \$13.2 million or 16.2%.

The increase includes:

- \$4.9 million related to the full year impact of the 20 residences (798 units) which opened during the 1999 Period;
- \$8.3 million was attributable to the 165 Same Store Residences (6,351 units).

Residence operating expenses for the Same Store Residences were \$85.7 million for the 2000 period as compared to \$77.4 million for the 1999 Period, an increase of \$8.3 million or 10.7%.

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The principal elements of the increase in Same Store residence operating expenses are:

- \$4.2 million related to additional payroll expenses incurred in connection with the increase in occupancy at the Same Store Residences during the period;
- \$1.4 million related to increase in real estate taxes as a result of changes in assessments;
- \$1.3 million related to provision for uncollectible rent due to the completion of an assessment of our accounts receivable collections process begun during the three months ended December 31, 2000. As a result, we increased our provision for bad debts, primarily related to private pay accounts, and wrote off or reserved balances where the probability of collection was low;

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- \$378,000 related to increase in utility costs as a result of increase in rates and increase in usage as result of an increase in occupancy; and
- \$277,000 related to increase in maintenance expense associated with the upkeep of our buildings.

Corporate General and Administrative. Corporate general and administrative expenses as reported were \$18.4 million for the 2000 Period as compared to \$21.2 million for the 1999 Period. Our corporate general and administrative expenses before capitalized payroll costs were \$21.8 million for the 1999 Period compared to \$18.4 million for the 2000 Period, a decrease of \$3.4 million. The principal elements of the decrease include:

- \$2.8 million related to decreased professional fees primarily associated with legal, financial advisory and accounting costs due to regulatory issues, securityholder litigation and the restatement of our financial statements for the years ended December 31, 1996, 1997 and the first three fiscal quarters of 1998;
- \$1.2 million as a result of reimbursement of legal and professional fees from our insurance carrier as a result of the settlement of our litigation related to the restatement of the financial statements for the years ended December 31, 1996 and 1997 and the first three fiscal quarters of 1998. Of the \$1.2 million in reimbursements, we incurred approximately \$600,000 of these expenses during the 2000 Period and the remaining \$600,000 during the year ended December 31, 1999; and
- \$1.8 million in the 1999 Period related to the final operations of our home health business.

The decrease was offset by increases in corporate, general and administrative expense of:

- \$1.3 million related to increased network costs associated with the development of our communications infrastructure, including dial-up and intranet access for our remote locations;
- \$500,000 related to increased payroll costs, including severance costs of \$1.2 million relating to former officers; and
- \$700,000 related to increased premiums for our directors and officers and liability insurance policies.

We capitalized \$617,000 of payroll costs associated with the development of new residences during the 1999 Period. Since we discontinued our development activities during the 1999 Period, we did not capitalize any payroll costs in the 2000 Period.

Building Rentals. Building rentals were \$16.0 million for the 2000 Period as compared to \$15.4 million for the 1999 Period, an increase of \$600,000 or 3.9%. This increase was primarily attributable to the additional rental expense associated with the March 1999 amendment of 16 of our leases which were previously accounted for as financings. The amendment eliminated our continuing involvement in the residences in the form of a fair value purchase option. As a result of the amendment, the leases have been reclassified as operating leases for the last nine months of the 1999 Period and the full 2000 Period.

Depreciation and Amortization. Depreciation and amortization was \$9.9 million for the 2000 Period as compared to \$9.0 million for the 1999 Period, an increase of \$900,000 or 10.0%. Depreciation expense was \$9.6 million and amortization expense related to goodwill was \$292,000 for the 2000 Period as compared to \$8.7 million and \$294,000, respectively, for the 1999 Period. The

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increase in depreciation is the result of a full

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year of depreciation associated with the 20 owned residences that commenced operations during the 1999 Period.

**Litigation Settlement.** During the third quarter of the 2000 Period we settled the class action litigation against us related to the restatement of our financial statements for the years ended December 31, 1996 and 1997 and the first three fiscal quarters of 1998. The total cost of this settlement to us was \$10.0 million. Accordingly, we recognized a charge of \$10.0 million during the 2000 Period. We received reimbursements of approximately \$1.2 million from our corporate liability insurance carriers and other parties in relation to the settlement. The \$1.2 million of reimbursements has been recorded as a reduction of corporate, general and administrative expenses as discussed above.

**Site Abandonment Costs.** In 1999, the Company wrote-off \$4.9 million of capitalized cost relating to the abandonment of all remaining development sites, with the exception of 10 sites where the Company owns the land.

**Interest Expense.** Interest expense was \$16.4 million for the 2000 Period as compared to \$15.2 million for the 1999 Period. Interest expense before capitalization for the 2000 Period was \$16.4 million as compared to \$17.2 million for the 1999 Period, a net decrease of \$800,000.

Interest expense decreased by:

- \$840,000 due to the March 1999 amendment of 16 of our operating leases which were previously accounted for as financings. As a result, the leases were accounted for as operating leases, effective March 31, 1999. Accordingly, rent expense related to such leases after the date of the amendment, has been classified as building rentals, rather than interest expense;
- \$80,000 due to financing fees related to variable rate debt and letter of credit renewals; and
- \$95,000 due to interest expense associated with the repayment of joint venture advances in February 1999.

This decrease was offset by an increase in interest expense of \$215,000 as a result of increases in interest rates on variable rate debt.

We capitalized \$2.0 million of interest expense for the 1999 Period. There was no capitalized interest in the 2000 Period as a result of the discontinuation of our development activities.

**Interest Income.** Interest income was \$786,000 for the 2000 Period as compared to \$1.6 million for the 1999 Period, a decrease of \$814,000. The decrease is related to interest income earned on lower average cash balances during the 2000 Period.

**Loss on Sale of Marketable Securities.** Loss on sale of marketable securities was \$368,000 for the 2000 Period as a result of the sale of securities with a historical cost basis of \$2.0 million for proceeds of \$1.6 million.

**Gain (Loss) on Sale of Assets.** Gain on sale of assets was \$13,000 for the 2000 Period as compared to a loss of \$127,000 for the 1999 Period. The gain during the 2000 Period was related to the sale of miscellaneous equipment. The

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loss during the 1999 Period was related to the disposal of leasehold improvements associated with relocating our corporate offices in January 1999.

Other Income (Expense). Other income was \$67,000 for the 2000 Period as compared to other expense of \$260,000 for the 1999 Period. Other income during the 2000 Period was primarily related to a contract to provide development services to a third party. Other expenses during the 1999 Period included \$170,000 of administrative fees incurred in connection with our February 1999 repurchase of the remaining joint venture partner's interest in the operations of 17 residences.

Net Loss. As a result of the above, net loss was \$25.8 million or \$1.51 per basic and diluted share for the 2000 Period, compared to a net loss of \$28.9 million or \$1.69 loss per basic and diluted share for the 1999 Period.

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Year ended December 31, 1999 compared to year ended December 31, 1998:

	CONSOLIDATED YEARS ENDED DECEMBER 31,			SAME STORE RESIDENCES YEARS ENDED DECEMBER 31,		
	1998	1999	INCREASE/ (DECREASE)	1998	1999	INCREASE/ (DECREASE)
	(IN MILLIONS)			(IN MILLIONS)		
Revenue.....	\$ 89.4	\$117.5	31.4%	\$70.9	\$77.9	9.9%
Operating expenses:						
Residence operating expenses....	57.4	81.8	42.5%	43.7	52.2	19.5%
Corporate general and administrative.....	11.1	21.2	91.0%	--	--	--
Building rentals.....	12.8	15.4	20.3%	12.4	14.8	19.4%
Depreciation and amortization...	6.3	9.0	42.9%	3.5	3.1	(11.4)%
Terminated merger expense.....	1.1	0.2	(81.8)%	--	--	--
Site abandonment costs.....	2.4	4.9	104.2%	--	--	--
Write off of impaired assets and related expenses.....	8.5	--	(100.0)%	--	--	--
	-----	-----	-----	-----	-----	-----
Total operating expenses.....	99.6	132.5	33.0%	59.6	70.1	17.6%
	-----	-----	-----	-----	-----	-----
Operating income (loss).....	\$(10.2)	\$(15.0)	47.1%	\$11.3	\$ 7.8	(31.0)%
	=====	=====	=====	=====	=====	=====

We incurred a net loss of \$28.9 million, or \$1.69 per basic and diluted share, on revenue of \$117.5 million for the year ended December 31, 1999 (the "1999 Period") as compared to a net loss (after the cumulative effect of change in accounting principle and other charges as described below) of \$20.7 million, or \$1.27 per basic and diluted share, on revenue of \$89.4 million for the year ended December 31, 1998 (the "1998 Period").

We had certificates of occupancy for 185 residences, all of which were included in the operating results as of the end of the 1999 Period as compared to certificates of occupancy for 173 residences, 165 of which were included in the operating results as of the end of the 1998 Period. Of the residences included in operating results as of the end of the 1999 Period, we owned 115

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residences and leased 70 residences (all of which were operating leases) as compared to 95 owned residences and 70 leased residences (54 of which were operating leases and 16 of which were accounted for as financings) as of the end of the 1998 Period.

Revenue. Revenue was \$117.5 million for the 1999 Period as compared to \$89.4 million for the 1998 Period, an increase of \$28.1 million or 31.4%.

The increase includes:

- \$20.8 million related to the full year impact of the 57 residences (2,302 units) which opened during the 1998 Period;
- \$3.9 million related to the opening of an additional 20 residences (798 units) during the 1999 Period; and
- \$7.0 million was attributable to the 108 Same Store Residences (4,048 units).

These increases were offset by:

- a reduction in revenues from home health operations of \$3.1 million in the 1999 Period (the Company exited all home health operations in 1998 and did not earn any revenues for such services during the 1999 Period); and
- a reduction of \$558,000 in revenues for a residence the Company leased and operated for nine months of the 1998 Period. The lease was terminated September 30, 1998.

Revenue from the Same Store Residences was \$77.9 million for the 1999 Period as compared to \$70.9 million for the 1998 Period, an increase of \$7.0 million or 9.9%. The increase in revenue from Same Store Residences was attributable to a combination of an increase in average occupancy to 84.7% and average

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monthly rental rate to \$1,873 for the 1999 Period as compared to average occupancy of 80.5% and average monthly rental rate of \$1,823 for the 1998 Period.

Residence Operating Expenses. Residence operating expenses were \$81.8 million for the 1999 Period as compared to \$57.4 million for the 1998 Period, an increase of \$24.4 million or 42.5%.

The increase includes:

- \$13.9 million related to the full year impact of the 57 residences (2,302 units) which opened during the 1998 Period;
- \$4.3 million related to the opening of an additional 20 residences (798 units) during the 1999 Period; and
- \$8.5 million was attributable to the 108 Same Store Residences (4,048 units).

These increases were offset by a reduction in expenses associated with our home health operations of \$2.3 million. We exited our home health operations during the 1998 Period. Expenses incurred during the 1999 Period for home health operations were related to the closure of the home health operations and are

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included in Corporate, General and Administrative expenses.

Residence operating expenses for the Same Store Residences were \$52.2 million for the 1999 Period as compared to \$43.7 million for the 1998 Period, an increase of \$8.5 million or 19.4%. This increase results from the additional expenses incurred in connection with the increase in occupancy at the Same Store Residences during the period.

Corporate General and Administrative. Corporate general and administrative expenses as reported were \$21.2 million for the 1999 Period as compared to \$11.1 million for the 1998 Period. Our corporate general and administrative expenses before capitalized payroll costs were \$21.8 million for the 1999 Period as compared to \$12.9 million for the 1998 Period, an increase of \$8.9 million. Of the increase:

- \$1.7 million, or 19.1%, related to increased payroll costs, including severance costs of \$1.0 million for certain terminated corporate employees including costs associated with severance and consulting agreements between us and our former chief executive officer;
- \$4.3 million, or 48.3%, related to additional professional fees primarily associated with increased legal, financial advisory and accounting costs due to regulatory issues, securityholder litigation and the restatement of our financial statements for the years ended December 31, 1996, 1997 and the first three fiscal quarters of 1998;
- \$1.8 million, or 20.2%, related to the final operations of our home health business, including provision for bad debt of \$510,000;
- \$1.1, or 12.4% related to an increase in travel and other related expenses associated with the increase in number of regional offices from three to five.

We capitalized \$1.8 million and \$617,000 of payroll costs associated with the development of new residences for each of the 1998 Period and the 1999 Period.

Building Rentals. Building rentals were \$15.4 million for the 1999 Period as compared to \$12.8 million for the 1998 Period, an increase of \$2.6 million. This increase was primarily attributable to \$2.5 million of additional rental expense associated with the March amendment of 16 of our leases, as discussed above, which were previously accounted for as financings. As a result of the amendment, the leases have been reclassified as operating leases for the last nine months of the 1999 Period.

As of the end of the 1999 Period we had 70 operating leases as compared to 54 operating leases as of the end of the 1998 Period.

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Depreciation and Amortization. Depreciation and amortization was \$9.0 million for the 1999 Period as compared to \$6.3 million for the 1998 Period, an increase of \$2.7 million. Depreciation expense was \$8.7 million and amortization expense was \$294,000 for the 1999 Period as compared to \$5.9 million and \$398,000, respectively, for the 1998 Period. The increase in depreciation is the result of:

- the full year effect of depreciation on the 53 owned residences which commenced operations during the 1998 Period; and
- depreciation associated with the 20 owned residences that commenced

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operations during the 1999 Period.

The increase in depreciation was offset by the impact of the March amendment of 16 of our leases, as discussed above, which were previously accounted for as financings. As a result of this amendment, the 1999 Period reflects 3 months of depreciation expense associated with these facilities as compared to 12 months in the 1998 Period.

Terminated Merger Expense. During the fourth quarter of the 1998 Period, we recorded a \$1.1 million charge relating to our terminated merger with American Retirement Corporation ("ARC"). On February 1, 1999 we agreed with ARC to terminate our previously announced merger agreement, which had been entered into during November 1998. We incurred approximately \$228,000 of additional merger related expenses during the first quarter of 1999.

Site Abandonment Costs. As a result of our decision to reduce the number of new residence openings during the 1998 Period and beyond, we wrote-off \$2.4 million of capitalized costs during the 1998 Period relating to the abandonment of certain development sites. In 1999, the Company wrote-off \$4.9 million of capitalized cost relating to the abandonment of all remaining development sites, with the exception of 10 sites where the Company owns the land.

Write-Off of Impaired Assets and Related Expenses. In the 1998 Period, we recorded an \$8.5 million charge consisting of a \$7.5 million write-off of unamortized goodwill resulting from the exit from our home health operations and a \$1.0 million provision for exit costs associates with closing such home health care operations. We recorded no such charges for the 1999 Period.

Interest Expense. Interest expense was \$15.2 million for the 1999 Period as compared to \$11.0 million for the 1998 Period. Gross interest expense for the 1999 Period was \$17.2 million as compared to \$17.0 million for the 1998 Period, a net increase of \$200,000.

Interest expense increased by:

- \$1.4 million due to interest expense related to the April 1998 issuance of 5.625% Debentures; and
- \$2.3 million related to the new mortgage financing entered into during the 1998 Period.

This increase was offset by decreases in interest expense of:

- \$616,000 as a result of the redemption in August 1998 of the 7.0% Convertible Subordinated Debentures due 2005 (the "7.0% Debentures");
- \$2.5 million as a result of the amendment of the 16 leases resulting in a change from financing obligations to operating leases; and
- \$380,000 as a result of the termination of the joint venture agreements in February, 1999.

We capitalized \$6.0 million of interest expense for the 1998 Period compared to \$2.0 million for the 1999 Period.

Interest Income. Interest income was \$1.6 million for the 1999 Period as compared to \$3.9 million for the 1998 Period, a decrease of \$2.3 million. The decrease is related to interest income earned on lower average cash balances during the 1999 Period primarily resulting from the completion of construction on 20 residences which opened during 1999.

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**Loss on Sale of Assets.** Loss on sale of assets was \$127,000 for the 1999 Period as compared to \$651,000 for the 1998 Period. The loss during the 1999 Period was related to the disposal of leasehold improvements associated with relocating our corporate offices in January 1999. Of the loss on sale of assets recorded during the 1998 Period, \$547,000 resulted from losses pertaining primarily to additional capital costs incurred during the 1998 Period on sale and leaseback transactions completed in the 1997 Period and \$75,000 related to losses incurred in connection with terminating one operating lease during the 1998 Period. The remainder of the loss on sale of assets was attributable to losses incurred in connection with one sale and leaseback transaction completed during the 1998 Period.

**Other Income (Expense).** Other expense was \$260,000 for the 1999 Period as compared to \$1.2 million for the 1998 Period. Other expenses during the 1999 Period included \$170,000 of administrative fees incurred in connection with our February 1999 repurchase of the remaining joint venture partner's interest in the operations of 17 residences. Other expense during the 1998 Period included \$907,000 of financing costs which were expensed during the period. Of such amount, \$614,000 related to financing costs which had been previously capitalized in association with a financing commitment that was terminated during the fourth quarter 1998 and the remaining \$293,000 was associated with the termination of a swap agreement at the end of the third quarter of the 1998 Period. In addition, other expenses during the 1998 Period included \$210,000 of administrative fees incurred in connection with our repurchase of the joint venture partner's interest in the operations of 21 residences during the period.

**Cumulative Effect of Change in Accounting Principle.** We adopted AICPA Statement of Position 98-5, Reporting on the Costs of Start-up Activities ("SOP 98-5") effective January 1, 1998. Under SOP 98-5, start-up costs associated with the opening of new residences are expensed as incurred. We recognized a charge of \$1.5 million during the 1998 Period associated with adopting such provision. We had no changes in accounting principle during the 1999 Period.

**Net Loss.** As a result of the above, net loss (after the cumulative effect of change in accounting principle and other charges as described above) was \$28.9 million or \$1.69 per basic and diluted share for the 1999 Period, compared to a net loss of \$20.7 million or \$1.27 loss per basic and diluted share for the 1998 Period.

### LIQUIDITY AND CAPITAL RESOURCES

At December 31, 2000, we had a working capital deficit of \$17.0 million (including current portion of settlement payable of \$7.8 million) and unrestricted cash and cash equivalents of \$9.9 million.

Net cash provided by operating activities was \$700,000 during the year ended December 31, 2000.

Net cash used in investing activities totaled \$808,000 during the year ended December 31, 2000. The primary sources of cash were \$1.6 million related to the sale of marketable securities and a decrease of \$1.1 million of restricted cash due to the release of funds restricted per the terms of agreements with U.S. Bank. We used \$3.5 million of cash in investing activities related to capital expenditures.

Net cash provided by financing activities totaled \$2.4 million during the year ended December 31, 2000. Proceeds of \$4.0 were received on a short-term bridge loan secured by three previously encumbered assets. The use of cash in financing activities was due to principal payments on long term debt of \$1.6 million.



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On March 12, 2001, we amended certain loan documents with U.S. Bank. Pursuant to the amendment, we agreed to pay fees of \$34,700 in exchange for the following: the modification of certain financial covenants, and the waiver of U.S. Bank's right to declare an event of default for our failure to comply with certain financial covenants as of December 31, 2000 and for our anticipated failure to comply with certain financial covenants for the three months ending March 31, 2001. The amendment also provides the following: approval for us to repurchase for cash up to \$25.0 million in face value of our convertible debentures prior to maturity; a requirement that we deposit \$500,000 in cash collateral with U.S. Bank in the event certain regulatory actions are commenced with respect to the properties securing our obligations to U.S. Bank; and the requirement that U.S. Bank release such deposits to us upon satisfactory resolution of the regulatory action. Failure to comply with any covenant constitutes an event of default, which will allow U.S. Bank (at its discretion) to declare any amounts outstanding under the loan documents to be due and payable. In addition, certain of our leases and

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loan agreements contain covenants and cross-default provisions such that a default on one of those agreements could cause us to be in default on one or more other agreements.

In November 2000, we entered into a short-term bridge loan with Red Mortgage in the amount of \$4.0 million secured by three previously unencumbered properties. This loan matures on August 1, 2001, requires monthly interest-only payments and bears interest at the greater of 10% or LIBOR plus 3.5%. We intend to replace this loan with long-term HUD financing prior to its maturity.

On March 2, 2001, we entered into an agreement with Heller for a \$45.0 million line of credit, under which five wholly owned subsidiaries are the jointly and severally liable borrowers of any funds drawn. This line matures on August 31, 2002 and requires monthly interest-only payments until maturity. This line bears an interest rate of 3.85% over the three-month LIBOR rate floating monthly and will be secured by up to 32 properties owned by the borrowers and leased to another of our affiliates or us. We guaranteed the line. In addition to having paid a commitment fee of \$450,000, we are to pay funding fees of 0.5% of the principal amount funded at the time of funding and pay an exit fee of 1.0% of the principal being repaid. The borrowers may elect to exercise up to three six-month extensions of the maturity date, subject to the satisfaction of certain conditions. We intend to replace a substantial portion of this financing with long-term HUD financing to the extent the processing time and increasing limitations by HUD on submission of applications and amount financed permit. While the line remains outstanding, we have agreed that we will not sell or grant mortgages on our remaining unencumbered properties, except one, unless the net proceeds are used to repurchase our convertible debentures or otherwise reduce our indebtedness (if approved by Heller). Proceeds of the line may be used for the payment of our shareholders' litigation settlement, the repurchase of 16 of our leased properties and the repurchase of some of our convertible debentures. Our initial draw on this line was \$1.3 million on March 2, 2001.

Our ability to satisfy our obligations, including payments with respect to our outstanding indebtedness and lease obligations, will depend on future performance, which is subject to our ability to stabilize our operations, and to a certain extent, general economic, financial, competitive, legislative, regulatory and other factors that are beyond our control. We made two payments of approximately \$2.3 million each towards our litigation settlement on October 23, 2000 and January 23, 2001 and on November 1, 2000 we made our \$4.7 million semi-annual interest payment on our convertible subordinated debentures. We are obligated to pay the remaining \$5.6 million related to the litigation settlement in two installments of approximately \$2.3 million each, due on April 23, 2001

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and July 23, 2001, with final payment of \$1.0 million due within 90 days following the July 23, 2001 payment. Additionally, our next \$4.7 million semi-annual interest payment on our convertible subordinated debentures is due on May 1, 2001. We may also be required to reimburse our insurance carriers for up to \$4.0 million of costs incurred by the carriers in connection with the securityholder litigation, depending on the outcome of a pending dispute over coverage (see Part I, Item 3 of this report).

We believe that our current cash on hand, cash available from operations and financing by Heller will be sufficient to meet our working capital needs through July 2002. However, we will have up to \$45.0 million in principal from the Heller financing maturing on August 31, 2002 (unless the five wholly owned subsidiaries, which are the borrowers, are able to and do extend the maturity dates for up to three six-month extensions), and have \$161.3 million (less any amounts repurchased with the Heller line of credit) in principal amount of convertible debentures maturing between November 2002 and May 2003. We also expect the cost to maintain our long-lived assets in their present condition to increase; however, we cannot yet estimate the financial impact since our experience is limited due to the newness of these assets.

Approximately \$27.2 million of our indebtedness was secured by letters of credit as of December 31, 2000 which in some cases have termination dates prior to the maturity of the underlying debt. As such letters of credit expire, beginning in 2003, we will need to obtain replacement letters of credit, post cash collateral or refinance the underlying debt. There can be no assurance that we will be able to procure replacement letters of credit from the same or other lending institutions on terms that are acceptable to us. In the event that we are unable to obtain a replacement letter of credit or provide alternate collateral prior to the expiration of any of these letters of credit, we would be in default on the underlying debt.

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We are currently exploring various alternatives to address our financing needs and the maturities of our long-term debt. The Heller and Red Mortgage financings have been sought to fund potential working capital needs, to fund the cost of our shareholders' litigation settlement, the repurchase of 16 of our leased properties and the repurchase of some of our convertible debentures in the open market. We expect to replace the Red Mortgage financing with long-term HUD mortgage loans and we also expect to replace a substantial portion of the Heller financing with long-term HUD mortgage loans, to the extent the processing time and increasing limitations by HUD on submission of applications and amount financed permit. In addition, we are also considering issuing new securities with longer maturities to the holders of our convertible debentures in exchange for some or all of their convertible debentures. We have 48 unencumbered residences available to use as collateral for these various alternatives, 47 of which are subject to negative covenants not to encumber them except under certain circumstances, including the use of the net proceeds of the financing which they secure for the reduction of our indebtedness to our convertible debenture holders. No commitments are currently in place and there can be no assurance that our efforts will be successful, in which event we will have to consider other alternatives, including reorganization under the bankruptcy laws or raising highly dilutive capital through the issuance of equity or equity-related securities.

### INFLATION

We do not believe that inflation has materially adversely affected our operations. We expect, however, that salary and wage increases for our skilled staff will continue to be higher than average salary and wage increases, as is common in the health care industry. We expect that we will be able to offset the

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effects of inflation on salaries and other operating expenses by increases in rental and service rates, subject to applicable restrictions with respect to services that are provided to residents eligible for Medicaid reimbursement.

### RECENT ACCOUNTING PRONOUNCEMENTS

In June 1998, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 133, Accounting for Derivative Instrument and Hedging Activities, as amended, which establishes accounting and reporting standards for derivative instruments and hedging activities by requiring that all derivatives be recognized into the balance sheet and measured at fair value. The effective date for SFAS No. 133 for the Company is January 1, 2001. At the current time, we do not have any derivative financial instruments.

### RISK FACTORS

Set forth below are the risks that we believe are material. This report on Form 10-K, including the risks discussed below, contains forward-looking statements made pursuant to the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. These forward-looking statements may be affected by risks and uncertainties, including without limitation (i) our ability to control costs and improve operating margins, (ii) the degree to which our future operating results and financial condition will be affected by litigation described in this report, (iii) the possibility that we will experience slower fill-up of our newer residences and/or declining occupancy in our stabilized residences, either of which would adversely affect residence revenues and operating margins, (iv) our ability to operate our facilities in compliance with evolving regulatory requirements and (v) the possibility that we will not be able to obtain financing needed to fund our future operations and retire our 6.0% Debentures and our 5.625% Debentures due in 2002 and 2003, respectively. In light of such risks and uncertainties, our actual results could differ materially from such forward-looking statements. Except as may be required by law, we do not undertake any obligation to publicly release any revisions to any forward-looking statements contained herein to reflect events and circumstances occurring after the date hereof or to reflect the occurrence of unanticipated events.

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### WE ARE HIGHLY LEVERAGED; OUR LOAN AND LEASE AGREEMENTS CONTAIN FINANCIAL COVENANTS.

We are highly leveraged. We had total indebtedness, including short term portion, of \$237.3 million as of December 31, 2000. In addition, we had shareholders' equity of \$63.9 million as of December 31, 2000. The degree to which we are leveraged could have important consequences, including:

- making it more difficult to satisfy our debt or lease obligations;
- increasing our vulnerability to general adverse economic and industry conditions;
- limiting our ability to obtain additional financing;
- requiring dedication of a substantial portion of our cash flow from operations to the payment of principal and interest on our debt or leases, thereby reducing the availability of such cash flow to fund working capital, capital expenditures or other general corporate purposes;

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- limiting our flexibility in planning for, or reacting to, changes in our business or industry; and
- placing us at a competitive disadvantage to less leveraged competitors.

Several of our debt instruments and leases contain financial covenants, including debt to cash flow and net worth tests. On March 12, 2001, we amended certain loan documents with U.S. Bank. Pursuant to the amendment, we agreed to pay fees of \$34,700 in exchange for the following: the modification of certain financial covenants, and the waiver of U.S. Bank's right to declare an event of default for our failure to comply with certain financial covenants as of December 31, 2000 and for our anticipated failure to comply with certain financial covenants for the three months ending March 31, 2001. The amendment also provides for the following: approval for us to repurchase for cash up to \$25.0 million in face value of our convertible debentures prior to maturity; a requirement that we deposit \$500,000 in cash collateral with U.S. Bank in the event certain regulatory actions are commenced with respect to the properties securing our obligations to U.S. Bank; and the requirement that U.S. Bank release such deposits to us satisfactory resolution of the regulatory action. We cannot provide assurance that we will comply in the future with the modified financial covenants included in the agreement, or with the financial covenants set forth in our other debt agreements and leases. If we fail to comply with one or more of the U.S. Bank covenants or any other debt or lease covenants (after giving effect to any applicable cure period), the lender or lessor may declare us in default of the underlying obligation and exercise any available remedies, which may include:

- in the case of debt, declaring the entire amount of the debt immediately due and payable;
- foreclosing on any residences or other collateral securing the obligation; and
- in the case of a lease, terminating the lease and suing for damages.

In addition, many of our debt instruments and leases contain "cross-default" provisions pursuant to which a default under one obligation can cause a default under one or more other obligations. Accordingly, we could experience a material adverse effect on our financial condition if any lender or lessor notifies us that we are in any such cross-default under any debt instrument or lease.

### WE WILL REQUIRE ADDITIONAL FINANCING.

Our ability to satisfy our obligations, including payments with respect to our outstanding indebtedness and lease obligations, will depend on future performance, which is subject to our ability to stabilize our operations, and to a certain extent, general economic, financial, competitive, legislative, regulatory and other factors that are beyond our control. We made two payments of approximately \$2.3 million each towards our litigation settlement on October 23, 2000 and January 23, 2001 and on November 1, 2000 we made our \$4.7 million semi-annual interest payment on our convertible subordinated debentures. We are obligated to pay the remaining \$5.6 million related to the litigation settlement in two installments of approximately \$2.3 million each, due on April 23, 2001 and July 23, 2001, with final payment of \$1.0 million due within 90 days following the July 23, 2001 payment. Additionally, our next \$4.7 million semi-annual interest payment on our convertible subordinated debentures is due on May 1, 2001. We may also be required to reimburse our

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insurance carriers for up to \$4.0 million of costs incurred by the carriers in connection with the securityholder litigation, depending on the outcome of a pending dispute over coverage (see Part I, Item 3 of this report).

We believe that our current cash on hand, cash available from operations and financing by Heller will be sufficient to meet our working capital needs through July 2002. However, we will have up to \$45.0 million in principal from the Heller financing maturing on August 31, 2002 (unless the five wholly owned subsidiaries, which are the borrowers, are able to and do extend the maturity dates for up to three six-month extensions), and have \$161.3 million (less any amounts repurchased with the Heller line of credit) in principal amount of convertible debentures maturing between November 2002 and May 2003. We also expect the cost to maintain our long-lived assets in their present condition to increase; however, we cannot yet estimate the financial impact since our experience is limited due to the newness of these assets.

We are currently exploring various alternatives to address our financing needs and the maturities of our long-term debt. The Heller and Red Mortgage financings have been sought to fund potential working capital needs, to fund the cost of our shareholders' litigation settlement, the repurchase of 16 of our leased properties and the repurchase of some of our convertible debentures in the open market. We expect to replace the Red Mortgage financing with long-term HUD mortgage loans and we also expect to replace a substantial portion of the Heller financing with long-term HUD mortgage loans, to the extent the processing time and increasing limitations by HUD on submission of applications and amount financed permit. In addition, we are also considering issuing new securities with longer maturities to the holders of our convertible debentures in exchange for some or all of their debentures. We have 48 unencumbered residences available to use as collateral for these various alternatives, 47 of which are subject to negative covenants not to encumber them except under certain circumstances, including the use of the net proceeds of the financing which they secure for the reduction of our indebtedness to our convertible debenture holders. No commitments are currently in place and there can be no assurance that our efforts will be successful, in which event we will have to consider other alternatives, including reorganization under the bankruptcy laws or raising highly dilutive capital through the issuance of equity or equity-related securities.

Approximately \$27.2 million of our indebtedness was secured by letters of credit as of December 31, 2000 which in some cases have termination dates prior to the maturity of the underlying debt. As such letters of credit expire, beginning in 2003, we will need to obtain replacement letters of credit, post cash collateral or refinance the underlying debt. There can be no assurance that we will be able to procure replacement letters of credit from the same or other lending institutions on terms that are acceptable to us. In the event that we are unable to obtain a replacement letter of credit or provide alternate collateral prior to the expiration of any of these letters of credit, we would be in default on the underlying debt.

### POSSIBLE AMERICAN STOCK EXCHANGE DELISTING.

Our common stock currently is listed on the AMEX under the symbol "ALF," our 5.625% Debentures currently are listed on AMEX under the symbol "ALS5E03" and our 6.0% Debentures currently are listed on AMEX under the symbol "ALS6K02." AMEX recently notified us that we had fallen below certain of AMEX's continued listing guidelines and that it was reviewing our listing eligibility. In particular, we have incurred losses from continued operations for each of its past six fiscal years ending December 31, 2000, and the price per share of our common stock as quoted on AMEX recently has been below the minimum bid price of \$1.00 per share. We may choose to effect a reverse stock split in the event that the price of our common stock does not otherwise meet the minimum bid requirement. However, we reported a net loss of \$1.51 per basic and diluted

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share for the year ended December 31, 2000, and may not report net income in the near future. We have provided AMEX with additional information and have been involved in ongoing discussions with AMEX in connection with its review of our listing eligibility. While AMEX has decided not to delist us at this time, they will continue to review our listing status on a quarterly basis.

If AMEX were to delist our securities, it is possible that the securities would continue to trade on the over-the-counter market. However, the extent of the public market for the securities and the availability of quotations would depend upon such factors as the aggregate market value of each class of the securities, the interest in maintaining a market in such securities on the part of securities firms and other factors. There can

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be no assurance that any public market for our securities will exist in the event that such securities are delisted.

WE MAY INCUR SIGNIFICANT COSTS AND LIABILITY AS A RESULT OF LITIGATION.

### Securityholder Litigation Settlement

In September 2000, we reached an agreement to settle the class action litigation relating to the restatement of our financial statements for the years ended December 31, 1996 and 1997 and the first three fiscal quarters of 1998. This agreement received final court approval on November 30, 2000 and we were subsequently dismissed from the litigation with prejudice.

The total cost of the settlement was approximately \$10,020,000 (less \$1.0 million of legal fees and expenses reimbursed by our corporate liability insurance carriers and other reimbursements of approximately \$193,000). We made two payments of \$2.3 million each on October 23, 2000 and January 23, 2001 towards the settlement. The remaining amount due will be paid in two payments of \$2.3 million each, due on April 23, 2001 and July 23, 2001, and a final payment of \$1.0 million due within 90 days following the July 23, 2001 payment.

The settlement had been pending the approval of our corporate liability insurance carriers who had raised certain coverage issues that resulted in the filing of litigation between us and the carriers. These carriers consented to the settlement, and we and the carriers agreed to dismiss the litigation regarding coverage issues and to resolve those issues through binding arbitration. The arbitration proceeding is pending. To the extent that the carriers are successful, we and the carriers agreed that the carriers' recovery is not to exceed \$4.0 million. The parties further agreed that payment of any such amount awarded will not be due in any event until 90 days after we have satisfied our obligations to the plaintiffs in the class action, with any such amount to be subordinated to new or refinancing of existing obligations. We believe that we have strong defenses regarding this dispute and consequently have not recorded a liability in relation to this matter.

As a result of the class action settlement, we recorded a charge of approximately \$10,020,000, which was partially offset by a reduction in general, and administrative expenses of approximately \$1,193,000 as a result of the reimbursement of legal fees and expenses incurred in connection with the litigation. The settlement resulted in an increase in net loss of \$8,827,000 (or approximately \$0.52 per basic and diluted share) for the year ended December 31, 2000.

Although we believe we have strong defenses regarding our dispute with the insurance carriers, we cannot predict the outcome of this litigation and currently are unable to evaluate the likelihood of success or the range of

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possible loss. However, if such litigation was determined adversely to us, such a determination could have a material adverse effect on our financial condition, results of operations, cash flow and liquidity.

### Indiana Litigation Settlement

In a lawsuit filed in 2000, the Indiana State Department of Health ("ISDH") had alleged that we were operating our Logansport, Indiana facility known as McKinney House as a residential care facility without a license. We believe our services have been consistent with those of a "Housing with Services Establishment" (which is not required to be licensed) pursuant to Indiana Code Section 12-10-15-1.

To avoid the expense and uncertainty of protracted litigation and, also because we wished to assure the State that we operate in a manner that is consistent with Indiana law, we agreed to the following settlement on behalf of all facilities owned and operated by us in the State of Indiana. The State and ALC agreed upon a Program Description that clarifies the services that we can provide without requiring licensure as a residential care facility. This Program Description provides guidelines regarding the physical and medical condition of the residents in our facilities and the services to be provided to them. We agreed that prior to March 20, 2001, we will provide in-service training regarding the Program Description throughout our Indiana facilities. Under the Program Description, we must discharge residents who require certain types or levels of care that we agreed not to provide in Indiana. We are currently implementing the Program Description and, while its full impact is

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not now known, we do not expect the impact to be material to our financial condition, results of operations, cash flow and liquidity. Without admitting liability, we paid a civil penalty of \$10,000. The State dismissed the lawsuit against us with prejudice.

### Other Litigation

In addition to the matters referred to in the immediately preceding paragraphs, we are involved in various lawsuits and claims arising in the normal course of business. In the aggregate, such other suits and claims should not have a material adverse effect on our financial condition, results of operations, cash flow and liquidity. However, if these matters were determined adversely to us, such a determination could have a material adverse effect on our financial condition, results of operations, cash flow and liquidity.

### WE ARE SUBJECT TO SIGNIFICANT GOVERNMENT REGULATION.

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

- the number of licensed residences and units per residence;
- the provision of services;
- equipment;
- staffing, including professional licensing and criminal background checks;
- operating policies and procedures;

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- fire prevention measures;
- environmental matters;
- resident characteristics;
- physical design and compliance with building and safety codes;
- confidentiality of medical information;
- safe working conditions;
- family leave; and
- disposal of medical waste.

Our cost to comply with these regulations is significant. In addition, it could adversely affect our financial condition or results of operations if a court or regulatory tribunal were to determine that we had failed to comply with any of these laws or regulations. Because these laws and regulations are amended from time to time we cannot predict when and to what extent liability may arise. See "Confidentiality of Medical Information," "Restrictions imposed by laws benefiting disabled persons" and "Medical waste."

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

- the imposition of fines, of which we paid \$16,000 in the aggregate in 2000;
- temporary stop placement of admission of new residents, or imposition of other conditions to admission of new residents to the facility, which included 4 residences (2 in Washington and 2 in Idaho) in 2000, 2 of which are still in stop placement as of this date;
- termination of a facility's Medicaid contract;

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- conversion of license to provisional status; and
- suspension or revocation of a facility's license, which in 2000 included one residence in Washington against which the state has commenced license revocation procedures. This matter is still pending at the time of this filing.

To date, these adverse actions have resulted in minimal fines and temporary suspension of admissions at certain residences. Because regulations vary from one jurisdiction to another and because determinations regarding whether to make a license provisional, to suspend or revoke a license, or to impose a fine, are subject to administrative discretion, it is difficult for us to predict whether a particular remedy will be sought or obtained in any given case. These types of regulatory enforcement actions may adversely affect residence occupancy levels, revenues and costs of operation. We cannot guarantee that federal, state, or local governments will not impose additional restrictions on our activities that



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could materially adversely affect us.

The operation of our residences is subject to federal and state laws prohibiting fraud by health care providers, including criminal provisions, which prohibit filing false claims or making false statements to receive payment or certification under Medicaid, or failing to refund overpayments or improper payments. Violation of these provisions is a felony punishable by up to five years imprisonment and/or \$25,000 fines. Civil provisions prohibit the knowing filing of a false claim or the knowing use of false statements to obtain payment. The penalties for such a violation are fines of not less than \$5,000 or more than \$10,000, plus treble damages, for each claim filed.

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

### OVERBUILDING IN THE ASSISTED LIVING INDUSTRY.

We believe that many assisted living markets have become or are on the verge of becoming overbuilt. Regulation and other barriers to entry into the assisted living industry are not substantial. In addition, because the segment of the population that can afford to pay our daily resident fee is finite, the development of new assisted living facilities could outpace demand. The effects of such overbuilding include (a) significantly longer fill-up periods, (b) pressure to lower or refrain from increasing rates, (c) competition for workers in already tight labor markets and (d) lower margins until excess units are absorbed. We believe that each local market is different, and we are and will continue to react in a variety of ways to the specific competitive environment that exists in each market. There can be no assurance that we will be able to compete effectively in those markets where overbuilding exists, or that future overbuilding in other markets where we have opened residences will not adversely affect our operations.

### WE MAY NOT BE ABLE TO ATTRACT AND RETAIN QUALIFIED EMPLOYEES AND CONTROL LABOR COSTS.

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

### OUR PROPERTIES ARE GEOGRAPHICALLY CONCENTRATED AND WE DEPEND ON THE ECONOMIES OF THE SPECIFIC AREAS IN WHICH WE OPERATE OUR PROPERTIES.

We depend significantly on the economies of Texas, Indiana, Oregon, Ohio

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and Washington. As of December 31, 2000, 21.6% of our properties were in Texas, 11.4% in Indiana, 10.3% in Oregon, 9.7% in Ohio and 8.6% in Washington. Adverse changes in general economic factors affecting the respective health care industries or laws and regulatory environment in any of these states could have a material adverse effect on our financial condition and results of operations.

WE DEPEND ON REIMBURSEMENT BY THIRD-PARTY PAYORS.

Although revenue at a majority of our residences come primarily from private payors, a portion of our revenues depend upon reimbursements from third-party government payors, including state Medicaid waiver programs. For the years ended December 31, 1998, 1999 and 2000, direct payments received from Medicaid funded programs accounted for approximately 10.7%, 10.4% and 11.1% respectively, of our revenue. Also, our tenant-paid portion of Medicaid revenue accounted for approximately 5.8%, 5.9% and 6.2% respectively, of our revenue during the years ended December 31, 1998, 1999 and 2000. We expect that state Medicaid waiver programs will continue to constitute a significant source of our revenue in the future. Furthermore, we cannot guarantee that our proportionate percentage of revenue received from Medicaid waiver programs will not increase. There are continuing efforts by governmental and private third-party payors to contain or reduce the costs of health care by lowering reimbursement rates, increasing case management review of services and negotiating reduced contract pricing. Recent changes include the development and implementation of a prospective payment system ("PPS") for reimbursement of various healthcare services. While it is unclear what effects PPS will have on our reimbursement from state Medicaid waiver programs, it is possible that our revenues and profitability may be affected adversely. Also, there has been, and our management expects that there will continue to be, additional proposals attempting to reduce the federal and some state budget deficits by limiting Medicaid reimbursement in general. Adoption of any of these proposals at either the federal or the state level could have a material adverse effect on our business, financial condition, results of operations and prospects.

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

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

CONFIDENTIALITY OF MEDICAL INFORMATION.

In 1996, the HIPAA law created comprehensive new requirements regarding the confidentiality of medical information that is or has been electronically transmitted or maintained. Under the 1996 law, Congress required the Department of Health and Human Services to promulgate regulations. The requirements set forth in the regulations are extensive and may require to us to significantly change the way we maintain and transmit healthcare information for our residents.

Healthcare providers must take "reasonable steps" to ensure that the provider, as well as the provider's business partners, comply with the law's requirements. Therefore, we may be required to ensure that the other entities with which we do business are also in compliance with these laws. HIPAA also created certain consumer rights with which we may be required to comply,

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including a right of notice regarding our information practices, a right of access to inspect and copy such individual's protected medical information, and a right to receive an accounting of all disclosures made by us, with certain exceptions. It is anticipated that significant changes in the regulations will occur prior to finalization; however, we do not expect that the costs

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to comply with the final regulations will have an adverse effect on our financial position, results of operations or cash flows.

### RESTRICTIONS IMPOSED BY LAWS BENEFITING DISABLED PERSONS.

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

### MEDICAL WASTE.

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

### WE MAY BE LIABLE FOR LOSSES NOT COVERED BY OR IN EXCESS OF OUR INSURANCE.

Providing services in the senior living industry involves an inherent risk of liability. Participants in the senior living and long-term care industry are subject to lawsuits alleging negligence or related legal theories, many of which may involve large claims and result in the incurrence of significant legal defense costs. We currently maintain insurance policies to cover such risks in amounts which we believe are in keeping with industry practice. There can be no assurance that a claim in excess of our insurance will not be asserted. A claim against us not covered by, or in excess of, our insurance, could have a material adverse affect on us.

Based on poor loss experience, insurers for the long term care industry have become increasingly wary of liability exposures. A number of insurance carriers have stopped writing coverage to this market, and those remaining have increased premiums and deductibles substantially. While nursing homes have been the primary targets of these insurers, assisted living companies, including us, have experienced premium and deductible increases. During our claim year ended December 31, 2000, our professional liability insurance coverage included deductible levels of \$100,000 per incident; for the claim year ending December

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31, 2001 this deductible has been replaced with a retention level of \$250,000, except in Florida and Texas in which the retention level is \$500,000. In certain states, particularly Florida and Texas, many long-term care providers are facing very difficult renewals. There can be no assurance that we will be able to obtain liability insurance in the future or that, if such insurance is available, it will be available on terms acceptable to us.

WE COULD INCUR SIGNIFICANT COSTS RELATED TO ENVIRONMENTAL REMEDIATION OR COMPLIANCE.

We are subject to various federal, state and local environmental laws, ordinances and regulations. Some of these laws, ordinances and regulations hold a current or previous owner, lessee or operator of real property liable for the cost of removal or remediation of some hazardous or toxic substances that could be located on, in or under such property. These laws and regulations often impose liability whether or not we knew of, or were responsible for, the presence of the hazardous or toxic substances. The costs of any required remediation or

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removal of these substances could be substantial. Furthermore, there is no limit to our liability under such laws and regulations. As a result, our liability could exceed our property's value and aggregate assets. The presence of these substances or failure to remediate these substances properly may also adversely affect our ability to sell or lease the property, or to borrow using our property as collateral.

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

### ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURE REGARDING MARKET RISK AND RISK SENSITIVE INSTRUMENTS

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

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

For variable rate debt, changes in interest rates generally do not impact the fair market value of the debt instrument, but do affect our future earnings and cash flows. We had variable rate debt of \$27.2 million outstanding at December 31, 2000 with a weighted average interest rate of 4.2%. Assuming that our balance of variable rate debt remains constant at \$27.2 million, each one-percent increase in interest rates would result in an annual increase in interest expense, and a corresponding decrease in cash flows, of \$272,000.

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Conversely, each one-percent decrease in interest rates would result in an annual decrease in interest expense, and a corresponding increase in cash flows, of \$272,000.

The table below presents principal cash flows and related weighted average interest rates by expected maturity dates (in thousands).

	DECEMBER 31, EXPECTED MATURITY DATE						TOTAL
	2001	2002	2003	2004	2005	THEREAFTER	
Long-term debt:							
Fixed rate.....	\$1,085	\$ 1,119	\$ 1,105	\$1,140	\$1,210	\$39,218	\$ 44,87
Average interest rate.....	7.93%	7.93%	7.93%	7.93%	7.93%	7.93%	7.9
Variable rate.....	\$ 605	\$ 674	\$ 728	\$ 786	\$ 852	\$23,575	\$ 27,22
Average interest rate.....	4.15%	4.15%	4.15%	4.15%	4.15%	4.15%	4.1
-----							
Total long-term debt.....	\$1,690	\$ 1,793	\$ 1,833	\$1,926	\$2,062	\$62,793	\$ 72,09
Convertible debentures:							
6.0% debentures.....	\$ --	\$86,250	\$ --	\$ --	\$ --	\$ --	\$ 86,25
Average interest rate.....	6.0%	6.0%	6.0%	6.0%	6.0%	6.0%	6.
5.625% debentures.....	\$ --	\$ --	\$75,000	\$ --	\$ --	\$ --	\$ 75,00
Average interest rate.....	5.625%	5.625%	5.625%	5.625%	5.625%	5.625%	5.62
-----							
Total convertible debentures.....	\$ --	\$86,250	\$75,000	\$ --	\$ --	\$ --	\$161,25
-----							
Total long-term debt and convertible debentures.....	\$1,690	\$88,043	\$76,833	\$1,926	\$2,062	\$62,793	\$233,34
=====							

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

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in interest rates will ultimately affect the amount of interest income earned and cash flow from these investments.

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

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

### ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

Financial statements and supplementary data required by this Item 8 are set forth as indicated in Item 14.

### ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND

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FINANCIAL DISCLOSURE

Not Applicable.

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PART III

ITEM 10. DIRECTORS AND EXECUTIVE OFFICERS OF THE COMPANY

GENERAL

We have provided below certain information regarding our directors and executive officers:

NAME -----	AGE (1) -----	POSITION -----
Wm. James Nicol(4).....	57	President, Chief Executive Officer and Chairman of Board of Directors
John M. Gibbons(2)(3)(4).....	52	Director, Vice Chairman of the Board of Directors
Richard C. Ladd(2).....	62	Director
Jill M. Krueger(2)(3)(4).....	41	Director
Bruce E. Toll(2).....	57	Director
Leonard Tannenbaum(3).....	29	Director
Sandra Campbell.....	54	Senior Vice President, General Counsel and Secretary
Nancy Gorshe.....	50	Senior Vice President of Community Relations
Drew Q. Miller.....	48	Senior Vice President, Chief Financial Officer and Treasurer
M. Catherine Maloney.....	38	Vice President, Controller and Chief Accounting Officer

(1) As of December 31, 2000.

(2) Member of the Audit Committee.

(3) Member of the Compensation Committee.

(4) Member of the Special Committee for Securityholder Litigation.

Wm. James Nicol was appointed to the Board of Directors as Chairman of the Board on March 3, 2000. Mr. Nicol has over 20 years experience of senior executive management, including finance and corporate development in health care service organizations. Mr. Nicol has most recently served as the Chief Financial Officer of HemoTherapies, Inc., a San Diego based medical device start-up company. Prior to joining HemoTherapies, he served in various senior executive roles for numerous companies, including Chief Operating Officer of Laguna Medical Systems, President and Chief Executive Officer of Health Management, Inc. and Chief Financial Officer of Careline, Inc. and Quantum Health Resources, Inc. Mr. Nicol has served as a senior officer and/or member of the Board of Directors of six publicly-traded companies.

John M. Gibbons was appointed to the Board of Directors in March 2000. He brings over 17 years of public company senior management experience in finance and executive management positions. From July 2000 to the present, he has served as President and Vice chairman of TMC Communications, Inc., a telecommunications services provider. From February 1994 until February 2000, he was employed at

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The Sports Club Company, a developer and operator of luxury sports and fitness clubs, Mr. Gibbons held a number of positions, including Chief Financial Officer, Chief Operating Officer and most recently President and Chief Executive Officer. He was a director of The Sports Club from 1995 through February 2000. Prior to joining The Sports Club, Mr. Gibbons was employed by Com-Systems, a publicly-traded long-distance telecommunications company, where he served in multiple capacities, including as Senior Vice-President, General Manager and Chief Financial Officer. Since July 2000, he has served on the board of Deckers Outdoor Corporation (AMEX-DECK).

Richard C. Ladd served as Chairman of our Board of Directors from March 1999 to March 2000 and has been a director since September 1994. Since September 1994, Mr. Ladd has been the President of Ladd and Associates, a health and social services consulting firm. He is also co-director of the National Long-Term Care Balancing Project and was an adjunct assistant professor at the School of Internal Medicine, University of Texas Medical Branch at Galveston, Texas. From June 1992 to September 1994, Mr. Ladd served as the Texas Commissioner of Health and Human Services where he oversaw the development and implementation of a 22,000-bed Medicaid Waiver Program to be used for assisted living and other community-based service

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programs. From November 1981 to June 1992, Mr. Ladd served as Administrator of the Oregon Senior and Disabled Services Division. He is also a member of numerous professional and honorary organizations.

Jill M. Krueger was elected to the Board of Directors in April 1999, and presently serves as Chairman of our Audit Committee. Since 1996, Ms. Krueger has served as President and Chief Executive Officer of Health Resources Alliance, an organization which provides rehabilitative and fitness services, pharmacy services, an extensive outcome measurement system and innovative programming and consulting services designed to optimize the health and well being of the elderly population. From 1988 to 1996 Ms. Krueger was a partner at KPMG LLP where she served as its Partner in Charge of the firm's National Long Term Care and Retirement Housing Practice.

Bruce E. Toll was elected to the Board of Directors in January 2001. Mr. Toll serves on the Board of Directors of UbiquiTel, Inc., a publicly traded company which provides Sprint PCS digital communication services to mid-size markets in the western and mid-western United States. He is the owner of BET Investments, Inc., which owns, develops, and manages commercial and industrial properties in the Philadelphia area. He is also the owner and operator of an automobile agency, Robert Auto Mall in Downingtown, Pennsylvania and the Chairman of Puresyn Corp., a biotech company located in Malvern, Pennsylvania. In addition, he is the President of Toll Management Company, which owns and manages commercial and apartment properties on the Philadelphia area. Mr. Toll is Vice-Chairman, founder, and director of Toll Brothers, Inc., which today is the leading builder of luxury homes in the nation and recipient of a number of awards. He is the father-in-law of Leonard Tannenbaum.

Leonard Tannenbaum, CFA, was elected to the Board of Directors in January 2001. Mr. Tannenbaum is currently the Managing Partner at MYFM Capital LLC, an investment banking firm. Mr. Tannenbaum currently serves on the board of directors of the following public companies: Cortech, Inc.; New World Coffee-Manhattan Bagel, Inc.; and General Devices, Inc. He also currently serves on the board of Timesys, an embedded Linux company, and Transcentives.com, an internet holding company. He formerly served on the board of Westower Corporation. Previously, Mr. Tannenbaum was the president of the on-line auction company CollectingNation.com, a partner in a \$50 million hedge fund, an assistant portfolio manager at Pilgrim Baxter, and an Assistant Vice President

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in Merrill Lynch's small company group. Mr. Tannenbaum received both his M.B.A. and Bachelors of Science from the Wharton School at the University of Pennsylvania. He is the son-in-law of Bruce E. Toll.

Sandra Campbell joined us as Senior Vice President, General Counsel and Secretary in January of 1998. Ms. Campbell has almost 20 years of experience in practicing law in real property, secured transactions and general business law. Prior to joining us, she was a partner in the law firm of Bullivant Houser Bailey where she was employed from April 1995 to December 1998. From January 1992 to April 1995, Ms. Campbell served as Chief Legal Counsel for First Fidelity Thrift & Loan Association.

Nancy Gorshe joined us as Vice President of Community Relations in January of 1998 and has over twenty years of experience in the field of geriatric health, community and long-term care and housing. Prior to joining us, she was President of Franciscan ElderCare Corporation which is comprised of nursing homes, assisted living facilities, and subacute units in nursing homes and hospitals from 1993 to 1997. In addition, Ms. Gorshe has served as Executive Director of Providence Elderplace, a long-term care HMO.

Drew Q. Miller joined us in March, 2000 as Senior Vice President, Chief Financial Officer and Treasurer. Mr. Miller has over 16 years of senior finance and accounting experience in health care services. From 1996 to 2000, Mr. Miller served as Chief Executive Officer and President of Advantage Behavior Health, Inc., a southern California-based comprehensive behavioral management company. Prior to Advantage, he served as Chief Financial Officer of Comprehensive Care Corporation, a publicly traded company engaged in the development, delivery and management of behavioral services.

M. Catherine Maloney joined us as Controller in June 1998, and currently serves as Vice President, Controller, and Chief Accounting Officer. Prior to joining us, Ms. Maloney was an Audit Manager with KPMG LLP.

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### SECTION 16(a) BENEFICIAL OWNERSHIP REPORTING COMPLIANCE

Section 16(a) of the Exchange Act requires our officers, directors and greater than ten-percent stockholders to file with the Commission and the American Stock Exchange initial reports of ownership and reports of changes in ownership of our Common Stock and other equity securities. Such persons or entities are required by Commission regulations to furnish us with copies of all Section 16(a) forms they file.

To our knowledge, based solely on review of the copies of such reports furnished to us and written representations that no other reports were required, during the fiscal year ended December 31, 2000, each of our officers, directors and 10% stockholders complied with all Section 16(a) filing requirements applicable to them.

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### ITEM 11. EXECUTIVE COMPENSATION

We have set forth in the following table information concerning the compensation paid during the fiscal year ended December 31, 2000 to Mr. Nicol and Dr. Wilson, each of whom served as our Chief Executive Officer during a portion of 2000 and each of our four other most highly compensated executive officers (collectively, the "Named Executive Officers").



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## SUMMARY COMPENSATION TABLE

NAME AND PRINCIPAL POSITION	YEAR	ANNUAL COMPENSATION (1)			LONG-TERM
		SALARY	BONUS (2)	OTHER COMPENSATION	COMPENSATION AWARDS
					SECURITIES UNDERLYING OPTIONS
Wm. James Nicol (4).....	2000	\$ 46,000	--	--	50,000
President and Chief Executive Officer and Chairman					
Keren Brown Wilson (5).....	2000	\$200,000	--	\$800,000 (3)	100,000
Founder, Former President,	1999	200,000	\$(100,000)	\$187,500 (3)	7,500
Chief Executive Officer and	1998	203,000	100,000	--	--
Vice Chairman					
Leslie Mahon (4).....	2000	\$ 70,000	--	\$350,000	10,000
Senior Vice President and	1999	141,300	17,500	--	30,000
Chief Operating Officer					
Drew Q. Miller (4).....	2000	\$145,000	--	--	150,000
Senior Vice President, Chief Financial Officer and Treasurer					
Sandra Campbell.....	2000	\$195,000	--	--	50,000
Senior Vice President,	1999	150,000	51,250	--	--
General Counsel and	1998	141,600	25,000	--	15,000
Secretary					
Nancy Gorshe (6).....	2000	\$150,000	\$ 12,500	--	--
Senior Vice President	1999	125,000	15,000	--	--
of Community Relations	1998	101,300	--	--	55,000

(1) Excludes certain perquisites and other personal benefit amounts, such as car allowance, which, for any executive officer did not exceed, in the aggregate, the lesser of \$50,000 or 10% of the total annual salary and bonus for such executive.

(2) Dr. Wilson was paid a bonus of \$100,000 in 1998 related to the execution of the ARC merger agreement. Payments made to her subsequent to December 31, 1998 were reduced by \$100,000 to reflect repayment of this bonus payments. Severance payment was made to Mr. Mahon during 2000 for \$350,000 in accordance with his employment agreement in April, 2000 when Mr. Mahon's position was eliminated.

(3) During 1999 Dr. Wilson agreed to forfeit 50,000 shares of restricted stock held by her for \$187,500. During 2000, we restructured our relationship with Dr. Wilson and agreed to pay Dr. Wilson the amount of \$800,000 to which she may have been entitled under her employment agreement, of which approximately \$182,000 was paid in 2000 and the remainder to be paid through monthly salary through December 31, 2001, and quarterly installments through September 30, 2001.

(4) Mr. Nicol and Mr. Miller began their employment with us in November 2000 and March 2000, respectively. Mr. Nicol was appointed President and Chief Executive Officer in November 2000. Mr. Mahon began his employment with us in March 1999 and resigned as Chief Operating Officer in April 2000.

(5) Dr. Wilson served as President and Chief Executive Officer during 2000 until

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October 2000.

(6) Ms. Gorshe began her employment with us in February 1998.

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We have provided in the following table information on stock options granted during 2000 to the Named Executive Officers.

STOCK OPTION GRANTS IN LAST FISCAL YEAR

NAME	INDIVIDUAL GRANTS				EXPIRATION DATE	POTENTIAL REAL VALUE AT ANNUAL RATE OF PRICE APPRECIATION OPTION TERM
	NUMBER OF SECURITIES UNDERLYING OPTIONS GRANTED	% OF TOTAL OPTIONS GRANTED TO EMPLOYEES IN FISCAL YEAR	EXERCISE PRICE (\$/SH)			
Wm. James Nicol.....	50,000	4.8%	\$1.81		2/29/10	\$ 95,025
Keren Brown Wilson.....	100,000	9.6%	1.44		3/29/10	151,200
Leslie Mahon.....	10,000	1.0%	1.44		3/29/10	15,120
Drew Q. Miller.....	150,000	14.4%	1.44		3/29/10	226,800
Sandra Campbell.....	50,000	4.8%	1.44		3/29/10	75,600
Nancy Gorshe.....	40,000	3.9%	1.44		3/29/10	60,480

(1) In accordance with rules of the Securities and Exchange Commission (the "Commission"), shown are the gains or "option spreads" that would exist for the respective options granted. These gains are based on the assumed rates of annual compound stock price appreciation of 5% and 10% from the date the option was granted over the full option term. These assumed annual compound rates of stock price appreciation are mandated by the rules of the Commission and do not represent our estimate or projection of future Common Stock prices.

We have provided in the following table information with respect to the Named Executive Officers concerning unexercised stock options held as of December 31, 2000.

AGGREGATED OPTION EXERCISES IN LAST FISCAL YEAR AND FISCAL YEAR-END OPTION VALUES

NAME	SHARES ACQUIRED ON EXERCISE	VALUE REALIZED	NUMBER OF SECURITIES UNDERLYING UNEXERCISED OPTIONS AT FISCAL YEAR-END	VALUE OF UNEXERCISED OPTIONS AT FISCAL YEAR-END
			EXERCISABLE/ UNEXERCISABLE	EXERCISABLE/ UNEXERCISABLE
Wm. James Nicol.....	--	--	0/ 50,000	\$0/\$0
Keren Brown Wilson.....	--	--	122,500/105,000	\$0/\$0

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Leslie Mahon.....	--	--	0/ 0	\$0/\$0
Drew Q. Miller.....	--	--	33,334/116,666	\$0/\$0
Sandra Campbell.....	--	--	0/ 50,000	\$0/\$0
Nancy Gorshe.....	--	--	0/ 40,000	\$0/\$0

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 (1) The closing trading price on the American Stock Exchange for the Common Stock on December 31, 2000 was \$0.31.

COMPENSATION OF DIRECTORS

Non-employee directors are compensated for services as a director and are reimbursed for travel expenses incurred in connection with their duties as directors. Under the terms of the 1994 Stock Option Plan, each new non-employee director receives non-qualified options to purchase 20,000 shares of common stock at the time he or she joins the Board of Directors. Such director options vest with respect to one third of the amount of each grant on each of the first, second and third anniversaries of the grant date, and expire on the earlier of the seventh anniversary of the date of vesting or one year following the director's ceasing to be a director for any reason.

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During 2000, each non-employee director received a fee of \$12,000 per year for services as a director, plus \$1,000 for attendance in person, or \$500 for attendance by telephone, at each meeting of the Board of Directors or of any committee meeting held on a day on which the Board of Directors did not meet. During 2000, those outside directors serving on the Executive Committee earned \$5,000 per month for such services and on February 29, 2000, Mr. Nicol and Mr. Gibbons each received non-qualified options to purchase 30,000 shares of common stock at \$1.81 per share for acting in such capacity. In January, 2001 the Board of Directors disbanded the Executive Committee and Mr. Gibbons was appointed Vice Chairman of the Board of Directors. Mr. Gibbons will receive \$5,000 per month for such services.

Mr. Nicol and Mr. Gibbons each received new non-employee director options to purchase 20,000 shares of Common Stock under the 1994 Stock Option Plan at \$1.81 per share on February 29, 2000. In addition, on February 29, 2000, Ms. Krueger, Mr. Ladd and Ms. Cavanaugh received nonqualified options to purchase at \$1.81 per share, 30,000, 10,000 and 10,000 shares of Common Stock, respectively.

EMPLOYMENT AGREEMENTS

Employment Agreements with Current Officers

Set forth below are summaries of employment and consulting agreements with certain individuals who were Named Executive Officers during 2000.

Wm. James Nicol

Effective November 1, 2000, we entered into an employment agreement with Wm. James Nicol, providing for Mr. Nicol's services as President and Chief Executive Officer. The agreement provides for such employment on a month-to-month basis, at a salary of not less than \$30,000 per month. Mr. Nicol will also be eligible for bonus payments and incentive compensation awards based on certain performance targets to be agreed between us and Mr. Nicol. Under the agreement, in the event of a termination of employment by us for any reason other than "Cause" (as defined), Mr. Nicol will be entitled to four months of pay, as well as a pro-rated bonus payment. In connection with his employment agreement, we agreed to indemnify Mr. Nicol to the extent permitted under Nevada

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law against liability and expenses incurred by him in any proceeding in which he is involved due to his role as officer or director.

Sandra Campbell

On December 31, 1997, we entered into an employment agreement with Sandra Campbell providing for Ms. Campbell's services as Senior Vice President, General Counsel and Secretary. We and Ms. Campbell agreed to amend the employment agreement as of January 1, 2000. The amendment effectuated no changes in Ms. Campbell's total annual compensation from the Company; it merely recharacterized the amounts. The agreement, as amended, provides for an initial two and one-half-year term, which expired without having been terminated, consequently the agreement is automatically extended on a continuous basis. We may terminate the agreement by providing Ms. Campbell with two and one-half years' prior notice of our intention to terminate her employment, and Ms. Campbell may terminate the agreement by providing us with four months' prior notice of her intention to resign. In addition, we may terminate the agreement at any time for "Cause" and Ms. Campbell may terminate the agreement for "Good Reason" (each as defined), and the agreement automatically terminates upon Ms. Campbell's death or permanent disability. If we terminate Ms. Campbell's employment other than for Cause and without providing the notice referred to above, or if Ms. Campbell terminates the agreement for Good Reason, then we must make a lump-sum payment to Ms. Campbell equal to two times her then-annual salary plus \$10,000. In addition, if there is a Change in Control (as defined), regardless of whether she remains in our employ, Ms. Campbell is entitled to receive an additional amount equal to two times her then-annual salary plus \$10,000, and all options exercisable for common stock automatically vest and become exercisable. The agreement provides that Ms. Campbell's salary is \$195,000. In addition, Ms. Campbell received options to purchase 50,000 shares of Common Stock, to become exercisable in annual installments of 16,666 shares commencing December 31, 1998, at an exercise price of \$16.50, equal to the fair market value of the Common Stock on the date of grant. These options were

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cancelled in 2000. The agreement includes an agreement to indemnify Ms. Campbell to the extent permitted under Nevada law against liability and expenses incurred by her in any proceeding in which she is involved due to her role as an officer.

Nancy Gorshe

On February 3, 1998, we entered into an employment agreement with Nancy Gorshe providing for Ms. Gorshe's services as Vice President/Community Relations. The agreement provides for an initial two-year term, subject to automatic one year extensions unless we notify Ms. Gorshe during the 90-day period ending on February 3 of each year that we wish to terminate the agreement on February 3 of the following year. We may terminate the agreement at any time for "Cause" (as defined). If we terminate Ms. Gorshe's employment without Cause and without offering Ms. Gorshe comparable employment (employment with us or any affiliated company that is not materially different in level of responsibility, at the same or higher salary level, with same or similar title or rank and within a 20-mile radius of her immediately prior position with us) or if within one year following a Change of Control (as defined) we either terminate Ms. Gorshe without Cause or she voluntarily resigns (and we have not offered her comparable employment in either case), then we must make a lump-sum payment to Ms. Gorshe in an amount equal to twice her then annual salary. In addition, if we terminate Ms. Gorshe within one year following a Change in Control, all Common Stock options held by Ms. Gorshe will automatically become immediately exercisable. The agreement provides that our President or Chief Executive Officer will determine Ms. Gorshe's annual compensation subject to adjustment from time to time at the discretion of the Board of Directors. Ms. Gorshe's

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current salary is \$150,000. The agreement further provides that Ms. Gorshe is subject to confidential information, and non-competition provisions until one year after the termination of Ms. Gorshe's employment. In addition, Ms. Gorshe received options to purchase 20,000 shares of Common Stock, to become exercisable in annual installments of 6,667 shares commencing on July 27, 1999, at an exercise price of \$16.50, equal to the fair market value of the Common Stock on the date of grant. These options were cancelled in 2000.

Drew Q. Miller

On March 16, 2000, we entered into an employment agreement with Drew Q. Miller providing for Mr. Miller's services as Senior Vice President, Chief Financial Officer and Treasurer. The agreement provides that Mr. Miller's annual base salary shall equal \$190,000. The agreement provides for an initial two-year term. If the agreement has not been terminated prior to the expiration of the initial term, then the agreement is automatically extended on a continuous basis. We may terminate the agreement by providing Mr. Miller with one and one-half years' prior notice of our intention to terminate his employment, and Mr. Miller may terminate the agreement by providing us with 45-days' prior notice of his intention to resign. In addition, we may terminate the agreement at any time for "Cause" (as defined) or Mr. Miller's permanent disability, and Mr. Miller may terminate the agreement in the event there is a Change of Control (as defined) or a material reduction in the scope and/or authority of his duties. The agreement automatically terminates upon Mr. Miller's death. If we terminate Mr. Miller's employment other than in connection with Mr. Miller's death or disability or for Cause, or if Mr. Miller terminates the agreement as a result of a Change of Control or a material reduction in the scope and/or authority of his duties, we will continue to be obligated to pay Mr. Miller's base salary until March 16, 2002 and all of Mr. Miller's options exercisable for common stock shall automatically vest and become exercisable. Pursuant to the agreement, Mr. Miller received options to purchase 150,000 shares of Common Stock, to become exercisable in monthly installments of 4,167 shares commencing April 16, 2000, at an exercise price of \$1.44, equal to the fair market value of the Common Stock on the date of grant. The agreement includes an agreement to indemnify Mr. Miller to the extent permitted under Nevada law against liability and expenses incurred by him in any proceeding in which he is involved due to his role as an officer.

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### Agreements with Former Officers

Keren Brown Wilson

On October 19, 2000, as part of a restructuring of our relationship with Dr. Keren Brown Wilson, Dr. Wilson resigned from the Board of Directors and from her position as President and Chief Executive Officer. Effective on this date, Dr. Wilson and we agreed among other things to the following: (i) Dr. Wilson will be an at-will employee until December 31, 2001, and her base salary is to be \$16,666.67 per month, with a total of \$200,000 to be paid in any event; (ii) when Dr. Wilson's employment terminates, her stock options will vest, if not already vested, and she will have one year from that date to exercise the stock options; and, (iii) we will pay Dr. Wilson \$559,677.37, plus 10% interest per annum from October 19, 2000, until fully paid, to be paid in four (4) equal quarterly installments commencing December 31, 2000.

In addition, we and Dr. Wilson agreed to the termination of Dr. Wilson's employment agreement effective October 19, 2000. The employment agreement provided for Dr. Wilson's services as President and Chief Executive Officer. The employment agreement provided for an initial four-year term, subject to automatic extension absent notice of termination under the terms of the

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employment agreement.

Under the employment agreement, in the event of a termination of employment for any reason other than "Cause" (as defined), Dr. Wilson was entitled to the payment of an amount equal to four times her annual salary. In the event of a termination within one year of a Change in Control (as defined) for any reason other than the death or disability or a termination by us for Cause, Dr. Wilson would be entitled to a \$3.0 million termination payment. The employment agreement also contained "gross-up" provisions to compensate Dr. Wilson in the event that any payment under the employment agreement was subject to an excise tax imposed under Section 4999 of the Internal Revenue Code. The employment agreement provided that Dr. Wilson was entitled to compensation at an annual rate of \$200,000.

In connection with her employment agreement, we agreed to indemnify Dr. Wilson to the extent permitted under Nevada law against liability and expenses incurred by her in any proceeding in which she is involved due to her role as officer or director.

James Cruckshank

Effective as of March 3, 2000, we entered into a separation and consulting agreement with Mr. Cruckshank which provided, among other things, for the termination of Mr. Cruckshank's employment agreement, entered into on March 15, 1999.

Pursuant to the separation and consulting agreement, Mr. Cruckshank agreed to provide us consulting services through December 31, 2000, for which we paid him a bi-weekly amount equal to \$3,000.

Pursuant to Mr. Cruckshank's employment agreement, Mr. Cruckshank was granted options exercisable for 30,000 shares of Common Stock. In connection with the termination of employment, Mr. Cruckshank agreed to the termination, as of March 2, 2000, of his options to purchase 20,000 shares of Common Stock, which were to vest on March 15, 2001 and March 15, 2002. We also agreed with Mr. Cruckshank that his options to purchase 10,000 shares of Common Stock, which have an exercise price of \$3.813 per share, will expire March 31, 2001.

Leslie Mahon

On March 15, 1999, we entered into an employment agreement with Leslie Mahon providing for Mr. Mahon's services as Vice President and Chief Operating Officer. On April 21, 2000, the position of Vice President and Chief Operating Officer was eliminated and we paid Mr. Mahon a lump-sum payment of \$350,000 in accordance with his employment agreement. Except with respect to such payment and the termination of Mr. Mahon's employment, the provisions of Mr. Mahon's employment agreement remain in effect. The employment agreement provides that Mr. Mahon is subject to confidential information restrictions for as long as Mr. Mahon possesses any confidential information, and non-competition provisions until one year after the termination of Mr. Mahon's employment. In addition, Mr. Mahon received options to purchase

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30,000 shares of Common Stock, exercisable in annual installments of 10,000 shares commencing March 15, 2000, at an exercise price of \$5.00, equal to the fair market value of the Common Stock on the date of the grant. Mr. Mahon agreed to the cancellation of these options.

COMPENSATION COMMITTEE INTERLOCKS AND INSIDER PARTICIPATION

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At December 31, 2000, the Compensation Committee was comprised of John Gibbons, Bradley Razook, and Gloria Cavanaugh. From January 1, 2000 to March 28, 2000, the Compensation Committee was comprised of Mr. Razook, Ms. Cavanaugh, and Ms. Krueger. On March 28, 2000, Mr. Nicol replaced Ms. Krueger on the Compensation Committee. In November 2000, Mr. Gibbons replaced Mr. Nicol on the Compensation Committee following Mr. Nicol's October 19, 2000 appointment as President and Chief Executive Officer. Mr. Razook served as Chair of the Compensation Committee throughout 2000. From January 17, 2001 to the present, the Compensation Committee was comprised of John Gibbons (Chairman), Jill Krueger and Leonard Tannenbaum.

Mr. Razook, is President and Managing Director at Cohen & Steers Capital Advisors LLC ("C&S Advisors"). On January 24, 2000, we entered into an agreement with C&S Advisors pursuant to which we paid C&S Advisors \$471,000 through December 31, 2000 for financial advisory services. This agreement terminated on December 31, 2000, except that we are required to pay C&S Advisors fees under this agreement if we complete certain financing and merger transactions on or prior to December 31, 2001. We are currently exploring various financing alternatives and the closing of any such financing could result in the payment of fees to C&S Advisors. On March 2, 2001, we closed the Heller financing and paid C&S Advisors \$457,000 in relation to this transaction.

In December 2000, we entered into an agreement with MYFM Capital LLC under which we could establish a line of credit with BET Associates LP ("BET") as lender, providing for loans of up to \$10.0 million. Subsequent to December 31, 2000, we terminated the agreement and paid MYFM \$50,000 in connection with such termination. Bruce E. Toll, our largest shareholder, and a current member of our Board of Directors, is the sole member of BRU Holdings Company, Inc. LLC, which is the sole general partner of BET. Leonard Tannenbaum is the Managing Partner of MYFM Capital, LLC, the son-in-law of Mr. Toll, a 10% limited partner of BET and a current member of our Board of Directors.

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### ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT

We have set forth in the following table information as of February 16, 2001 with respect to the beneficial ownership of our Common Stock (based upon information provided by such persons) by:

- (1) each of our directors;
- (2) each person who is known by us to own beneficially more than 5% of our common stock;
- (3) each of the Named Executive Officers for the fiscal year ended December 31, 2000; and
- (4) our directors and executive officers as a group.

NAME AND ADDRESS OF BENEFICIAL OWNER(1)	SHARES BENEFICIALLY OWNED (2)	PERCENT OF CLASS
Wm. James Nicol.....	17,501	--
Richard C. Ladd.....	21,111	*
John M. Gibbons.....	17,501	*
Jill Krueger.....	26,668	*

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Bruce E. Toll(3)..... 3103 Philmont Avenue Huntington Valley, Pennsylvania 19006	3,105,698.65	17.5%
Leonard Tannenbaum..... 16 School St., 2nd Floor Rye, NY 10580-2952	469,603	2.7%
Les Mahon.....	11	*
Sandra Campbell.....	24,476	*
Nancy Gorshe.....	18,945	*
Drew Q. Miller.....	54,166	*
Keren Brown Wilson(4).....	882,912	5.2%
John W. Adams(5)..... 885 Third Avenue, 34th Floor New York, New York 10022	1,635,600	9.6%
Greenlight Capital, L.L.C.(6)..... 420 Lexington Avenue, Suite 875 New York, New York 10170	1,566,012	8.8%
Capital Group International, Inc. and Capital Guardian Trust(7)..... 11800 Santa Monica Blvd. Los Angeles, CA 90025	1,645,000	9.6%
All directors and executive officers as a group (15 persons).....	243,352	1.4%

-----  
\* Less than 1%.

- (1) Except as otherwise noted above, the address of the directors and officers is c/o Assisted Living Concepts, Inc., 11835 NE Glenn Widing Drive, Building E, Portland, Oregon, 97220-9057.
- (2) Includes options to purchase 17,501 shares held by Mr. Nicol, 21,111 shares held by Mr. Ladd, 17,501 shares held by Mr. Gibbons, 26,668 shares held by Ms. Krueger, 24,476 shares held by Ms. Campbell, 54,166 shares held by Mr. Miller, 18,945 shares held by Ms. Gorshe, and 62,984 shares held collectively by the executive officers not named above, which are exercisable within 60 days of February 16, 2001. Beneficial ownership is determined in accordance with the rules and regulations of the Securities and Exchange Commission. Shares of Common Stock subject to currently exercisable options, or options that will become exercisable within 60 days of February 16, 2001, and shares issuable on conversion of debentures are deemed to be outstanding for purposes of computing the percentage of the person holding the options or debentures, but are not outstanding for purposes of computing the percentage of any other person or entity.

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- (3) Based on the Form 13D/A as filed on November 22, 2000. 575,098.65 of such shares are issuable upon the conversion of \$12.1 million of our 6.0% Debentures and \$1.0 million of our 5.625% Debentures to BET Associates, L.P., a partnership controlled by Mr. Toll, and 2,530,600 of such shares are held by BRU Holding Company Inc., LLC, a limited liability company controlled by Mr. Toll.
- (4) Based on the Form 13G as filed on April 12, 2000.
- (5) Based on the Form 13G/A as filed on February 16, 2001. These shares are held by JWA Investment Corp. and Tempe Wicke investments L.P., which in turn are controlled by Mr. Adams.



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(6) Based on the Form 13D as filed on December 30, 1999. 667,412 of such shares are issuable upon the conversion of the Company's 6.0% Debentures.

(7) Based on the Form 13G/A as filed on February 12, 2001.

### ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS

During 1999, Supportive Housing Services, Inc. ("SHS") provided services to us for market feasibility analysis, site pre-acquisition services, field construction supervision, construction management oversight and building setup in conjunction with our development activities. We terminated the agreement for these services effective January 2000. At that time SHS was owned 75% by Dr. Wilson's spouse. In fiscal 2000, we paid SHS approximately \$69,000 for services performed in 1999.

In June 1999 we entered into a agreement with Concepts in Community Living, Inc. ("CCL"), a company owned by Dr. Wilson's spouse, pursuant to which CCL provided market research, demographic review and competitor analysis in many of our current markets. This agreement was terminated on December 12, 1999. In fiscal 2000, we paid CCL \$69,000 for services performed in 1999.

We lease six residences from Assisted Living Facilities, Inc. of which Dr. Wilson's spouse owns a 25% interest. During 2000, we paid Assisted Living Facilities, Inc. approximately \$1.3 million for building rent and escrow reserves.

For information regarding certain other relationships and related transactions, see Item 11 "Compensation Committee Interlocks and Insider Participation."

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### PART IV

### ITEM 14. EXHIBITS, FINANCIAL STATEMENT SCHEDULES, AND REPORTS ON FORM 8-K

#### (a) 1 and 2. Consolidated Financial Statements and Financial Statement Schedules

The financial statements and financial statement schedules listed in the accompanying index to financial statements and financial statement schedules are filed as part of this Annual Report.

#### 3. Exhibits

Those Exhibits required to be filed by Item 601 of Regulation S-K are listed on the accompanying index immediately following the signature page and are filed as part of this Report.

#### (b) Reports on Form 8-K

On October 19, 2000, we filed a report on Form 8-K announcing that we had restructured our relationship with Keren Brown Wilson, our former President, Chief Executive Officer and Vice Chairman of the Board.

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ASSISTED LIVING CONCEPTS, INC. AND SUBSIDIARIES

INDEX TO CONSOLIDATED FINANCIAL STATEMENTS

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AND FINANCIAL STATEMENT SCHEDULE  
(ITEM 14(a))

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INDEPENDENT AUDITORS' REPORT

To the Board of Directors and Shareholders  
of Assisted Living Concepts, Inc. and Subsidiaries

We have audited the accompanying consolidated balance sheets of Assisted Living Concepts, Inc. and subsidiaries as of December 31, 1999 and 2000, and the related consolidated statements of operations, comprehensive loss, shareholders' equity, and cash flows for each of the years in the three-year period ended December 31, 2000. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

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

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Assisted Living Concepts Inc. and subsidiaries as of December 31, 1999 and 2000, and the results of their operations and their cash flows for each of the years in the three-year period ended December 31, 2000, in conformity with accounting principles generally accepted in the United States of America.

/s/ KPMG LLP

Portland, Oregon  
March 12, 2001

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ASSISTED LIVING CONCEPTS, INC.

CONSOLIDATED BALANCE SHEETS  
(IN THOUSANDS, EXCEPT SHARE AMOUNTS)

ASSETS

	DECEMBER 31,	
	1999	2000
	-----	-----
Current assets:		
Cash and cash equivalents.....	\$ 7,606	\$ 9,889
Marketable securities, available for sale.....	1,680	--
Accounts receivable, net of allowance for doubtful accounts of \$1,062 at 1999 and \$1,399 at 2000.....	4,069	2,448
Prepaid insurance.....	282	1,765
Prepaid expenses.....	666	1,042
Other current assets.....	3,419	2,729
	-----	-----
Total current assets.....	17,722	17,873
	-----	-----
Restricted cash.....	7,555	6,466
Property and equipment, net.....	305,648	298,744
Goodwill, net.....	5,077	4,785
Other assets, net.....	10,186	8,590
	-----	-----
Total assets.....	\$346,188	\$336,458
	=====	=====

LIABILITIES AND SHAREHOLDERS' EQUITY

Current liabilities:		
Accounts payable.....	\$ 1,318	\$ 2,708
Construction payable.....	1,078	--
Accrued real estate taxes.....	4,466	4,835
Accrued interest expense.....	1,940	1,937
Accrued payroll expense.....	2,773	4,017
Other accrued expenses.....	2,030	4,229
Bridge loan payable.....	--	4,000
Litigation settlement payable.....	--	7,765
Tenant security deposits.....	2,245	2,484
Related party payable.....	--	626
Other current liabilities.....	341	565
Current portion of long-term debt and capital lease obligation.....	1,494	1,690
	-----	-----
Total current liabilities.....	17,685	34,856
	-----	-----
Other liabilities.....	5,960	6,059
Long-term debt and capital lease obligation, net of current portion.....	71,949	70,407
Convertible subordinated debentures.....	161,250	161,250
	-----	-----
Total liabilities.....	256,844	272,572
	-----	-----

Commitments and contingencies  
Shareholders' equity:

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Preferred Stock, \$.01 par value; 1,000,000 shares authorized; None issued or outstanding.....	--	--
Common Stock, \$.01 par value; 80,000,000 shares authorized; issued and outstanding 17,120,745 shares at December 31, 1999 and 2000.....	171	171
Additional paid-in capital.....	144,443	144,451
Fair market value in excess of historical cost of acquired net assets attributable to related party transactions.....	(239)	(239)
Accumulated other comprehensive loss.....	(320)	--
Accumulated deficit.....	(54,711)	(80,497)
	-----	-----
Total shareholders' equity.....	89,344	63,886
	-----	-----
Total liabilities and shareholders' equity.....	\$346,188	\$336,458
	=====	=====

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

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### ASSISTED LIVING CONCEPTS, INC.

#### CONSOLIDATED STATEMENTS OF OPERATIONS (IN THOUSANDS, EXCEPT PER SHARE AMOUNTS)

	YEARS ENDED DECEMBER 31,		
	1998	1999	2000
	-----	-----	-----
Revenue.....	\$ 89,384	\$117,489	\$139,423
Operating expenses:			
Residence operating expenses.....	57,443	81,767	95,032
Corporate general and administrative.....	11,099	21,178	18,365
Building rentals.....	11,400	14,103	14,734
Building rentals to related party.....	1,364	1,264	1,270
Depreciation and amortization.....	6,339	8,981	9,923
Litigation settlement.....	--	--	10,020
Terminated merger expense.....	1,068	228	--
Site abandonment costs.....	2,377	4,912	--
Write-off of impaired assets and related expenses.....	8,521	--	--
	-----	-----	-----
Total operating expenses.....	99,611	132,433	149,344
	-----	-----	-----
Operating loss.....	(10,227)	(14,944)	(9,921)
	-----	-----	-----
Other income (expense):			
Interest expense.....	(11,039)	(15,200)	(16,363)
Interest income.....	3,869	1,598	786
Gain (loss) on sale of assets.....	(651)	(127)	13
Loss on sale of marketable securities.....	--	--	(368)
Other income (expense), net.....	(1,174)	(260)	67
	-----	-----	-----
Total other expense.....	(8,995)	(13,989)	(15,865)
	-----	-----	-----
Loss before cumulative effect of change in accounting principle.....	(19,222)	(28,933)	(25,786)

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Cumulative effect of change in accounting principle.....	(1,523)	--	--
	-----	-----	-----
Net loss.....	\$ (20,745)	\$ (28,933)	\$ (25,786)
	=====	=====	=====
Basic and diluted net loss per common share:			
Loss before cumulative effect of change in accounting principle.....	\$ (1.18)	\$ (1.69)	\$ (1.51)
Cumulative effect of change in accounting principle.....	(0.09)	--	--
	-----	-----	-----
Basic and diluted net loss per common share.....	\$ (1.27)	\$ (1.69)	\$ (1.51)
	=====	=====	=====
Basic and diluted weighted average common shares outstanding.....			
	16,273	17,119	17,121
	=====	=====	=====

CONSOLIDATED STATEMENTS OF COMPREHENSIVE LOSS  
(IN THOUSANDS)

	YEARS ENDED DECEMBER 31,		
	1998	1999	2000
	-----	-----	-----
Net loss.....	\$ (20,745)	\$ (28,933)	\$ (25,786)
Other comprehensive loss:			
Unrealized loss on investments.....	--	(320)	--
Reclassification adjustment for loss included in net loss.....	--	--	320
	-----	-----	-----
Comprehensive loss.....	\$ (20,745)	\$ (29,253)	\$ (25,466)
	=====	=====	=====

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

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ASSISTED LIVING CONCEPTS, INC.

CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY  
(IN THOUSANDS)

	COMMON STOCK		ADDITIONAL	UNEARNED	FAIR MARKET	ACCUMU
	SHARES	AMOUNT	PAID-IN	COMPENSATION	VALUE IN	OTH
	-----	-----	CAPITAL	EXPENSE	EXCESS OF	COMPRESH
	-----	-----	-----	-----	HISTORICAL	LOS
	-----	-----	-----	-----	COST	-----
Balance at December 31, 1997.....	15,646	\$156	\$141,460	\$ (4,100)	\$ (239)	
Common stock repurchased....	(529)	(5)	(7,057)	--	--	
Conversion of subordinated debentures.....	1,855	19	13,387	--	--	
Exercise of employee stock options.....	122	1	745	--	--	
Issuance of restricted						

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stock.....	250	2	(2)	--	--	
Compensation expense earned on restricted stock.....	--	--	--	608	--	
Net loss.....	--	--	--	--	--	
	-----	-----	-----	-----	-----	-----
Balance at December 31, 1998.....	17,344	173	148,533	(3,492)	(239)	
Exercise of employee stock options.....	27	--	158	--	--	
Compensation expense earned on restricted stock.....	--	--	--	180	--	
Retirement of restricted stock.....	(250)	(2)	(4,248)	3,312	--	
Unrealized loss on marketable securities.....	--	--	--	--	--	(3)
Net loss.....	--	--	--	--	--	
	-----	-----	-----	-----	-----	-----
Balance at December 31, 1999.....	17,121	171	144,443	--	(239)	(3)
Compensation expense on issuance of consultant options.....	--	--	8	--	--	
Reclassification adjustment for loss included in net loss.....	--	--	--	--	--	3
Net loss.....	--	--	--	--	--	
	-----	-----	-----	-----	-----	-----
Balance at December 31, 2000.....	17,121	\$171	\$144,451	\$ --	\$ (239)	\$
	=====	=====	=====	=====	=====	=====

TOTAL  
SHAREHOLDERS'  
EQUITY  
-----

Balance at December 31, 1997.....	\$132,244
Common stock repurchased....	(7,062)
Conversion of subordinated debentures.....	13,406
Exercise of employee stock options.....	746
Issuance of restricted stock.....	--
Compensation expense earned on restricted stock.....	608
Net loss.....	(20,745)
	-----
Balance at December 31, 1998.....	119,197
Exercise of employee stock options.....	158
Compensation expense earned on restricted stock.....	180
Retirement of restricted stock.....	(938)
Unrealized loss on marketable securities.....	(320)
Net loss.....	(28,933)

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Balance at December 31, 1999.....	89,344
Compensation expense on issuance of consultant options.....	8
Reclassification adjustment for loss included in net loss.....	320
Net loss.....	(25,786)
-----	
Balance at December 31, 2000.....	\$ 63,886
=====	

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

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ASSISTED LIVING CONCEPTS, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS  
(IN THOUSANDS)

	YEARS ENDED DECEMBER 31,		
	1998	1999	2000
	-----	-----	-----
OPERATING ACTIVITIES:			
Net loss.....	\$ (20,745)	\$ (28,933)	\$ (25,786)
Adjustment to reconcile net loss to net cash provided by (used in) operating activities:			
Depreciation and amortization.....	6,339	8,981	9,923
Provision for doubtful accounts.....	359	883	1,932
Site abandonment costs.....	2,377	4,912	--
Write-off of impaired assets and related expenses.....	8,521	--	--
Loss on the sale of marketable securities.....	--	--	368
Loss (gain) on sale of assets.....	651	127	(13)
Cumulative effect of change in accounting principle.....	1,523	--	--
Compensation expense earned on restricted stock.....	608	180	--
Compensation expense on issuance of consultant options....	--	--	8
Changes in assets and liabilities, excluding effects of acquisitions:			
Accounts receivable.....	(3,302)	175	(311)
Prepaid expenses.....	(88)	44	(1,859)
Other current assets.....	(909)	953	690
Other assets.....	1,314	564	1,596
Accounts payable.....	(237)	(304)	1,390
Accrued expenses.....	2,840	245	3,809
Other current liabilities.....	2,922	(2,271)	8,854
Other liabilities.....	823	2,545	_99
	-----	-----	-----
Net cash provided by (used in) operating activities.....	2,996	(11,899)	700
	-----	-----	-----
INVESTING ACTIVITIES:			
Sale of marketable securities, available for sale.....	--	2,000	1,632

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Purchase of marketable securities, available for sale.....	(4,000)	--	--
Restricted cash.....	--	(7,555)	1,089
Funds held in trust.....	1,956	--	--
Proceeds from sale and leaseback transactions.....	8,113	--	--
Proceeds from sale of property and equipment.....	--	19	14
Purchases of property and equipment.....	(117,972)	(27,824)	(3,543)
Acquisitions, net of cash, debt acquired and issuance of common stock.....	(11,366)	--	--
	-----	-----	-----
Net cash used in investing activities.....	(123,269)	(33,360)	(808)
	-----	-----	-----
<b>FINANCING ACTIVITIES:</b>			
Proceeds from bridge loan.....	--	--	4,000
Proceeds from long-term debt.....	49,004	--	--
Payments on long-term debt and capital lease obligation....	(289)	(1,491)	(1,609)
Proceeds from issuance of common stock, net.....	746	158	--
Repurchase of common stock.....	(7,062)	--	--
Debt issuance costs of offerings and long-term debt.....	(5,359)	--	--
Proceeds from issuance of convertible subordinated debentures.....	75,000	--	--
Retirement of restricted stock.....	--	(838)	--
	-----	-----	-----
Net cash provided by (used in) financing activities.....	112,040	(2,171)	2,391
	-----	-----	-----
Net (decrease) increase in cash and cash equivalents.....	(8,233)	(47,430)	2,283
Cash and cash equivalents, beginning of year.....	63,269	55,036	7,606
	-----	-----	-----
Cash and cash equivalents, end of year.....	\$ 55,036	\$ 7,606	\$ 9,889
	=====	=====	=====
<b>Supplemental disclosure of cash flow information:</b>			
Cash payments for interest.....	\$ 16,480	\$ 15,528	\$ 14,945
Cash payments for income taxes.....	\$ --	\$ --	\$ --
<b>Non-cash transactions:</b>			
Decrease in construction payable and property and equipment.....	\$ (11,941)	\$ (5,864)	\$ (1,078)
Conversion of subordinated debentures (net of \$509 of unamortized financing costs in 1998).....	13,406	--	--
Purchase of equipment with capital lease obligation.....	--	--	263
Conversion of construction financing to sale leaseback....	2,150	--	--
Unrealized loss on investment.....	--	(320)	--
Amendment of leases and removal of related assets.....	--	29,492	--
Retirement of restricted stock.....	--	3,412	--
Amendment of leases and removal of related debt.....	--	31,488	--

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

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ASSISTED LIVING CONCEPTS, INC.

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

#### 1. NATURE OF BUSINESS AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

##### THE COMPANY

Assisted Living Concepts, Inc. ("the Company") owns, leases and operates assisted living residences which provide housing to older persons who need help with the activities of daily living such as bathing and dressing. The Company



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provides personal care and support services and makes available routine health care services, as permitted by applicable law, designed to meet the needs of its residents. The accompanying financial statements reflect the operating results of 165, 185 and 185 residences for the years ended December 31, 1998, 1999 and 2000, respectively. Residences are included in operating results as of the first day of the month following licensure.

On November 22, 1994, the Company sold 4,000,000 shares of common stock at \$4.625 per share in an initial public offering realizing net proceeds of approximately \$16.4 million after underwriter discounts, commissions and other expenses.

In August 1995, the Company completed the offering of \$20.0 million 7% Convertible Subordinated Debentures ("7% Debentures") due August, 2005 realizing net proceeds of approximately \$19.2 million after discounts, commissions and other expenses. In September 1996, \$6.1 million of the 7% Debentures were converted into 811,333 shares of the Company's common stock which resulted in \$13.9 million of 7% Debentures outstanding. In August 1998, the Company called for redemption all of the remaining \$13.9 million of the 7% Debentures. All of the 7% Debentures were converted into shares of the Company's common stock, resulting in the issuance of 1,855,334 additional shares of common stock.

In July 1996, the Company sold 4,192,500 shares of common stock at \$9.50 per share in a public offering realizing net proceeds of \$37.3 million, after underwriter discounts, commissions and other expenses.

In June 1997 the Company's Board of Directors declared a dividend distribution of one preferred share purchase right ("Preferred Share Purchase Right") on each outstanding share of the Company's common stock. In the event that a person or group of persons acquires or announces a tender offer to acquire 15% or more of the common stock (the "Acquiring Person"), the Preferred Stock Purchase Rights, subject to certain limited exceptions, will entitle each shareholder (other than the Acquiring Person) to buy one one-hundredth of a share of newly created Series A Junior Participating Preferred Stock of the Company at an exercise price of \$54. The Company may redeem the rights at one cent per right at any time before a person or group has acquired 15% or more of the outstanding common stock. The record date for Preferred Share Purchase Right distribution was June 30, 1997.

In October 1997 the Company sold 4,140,000 shares of common stock at \$18.50 per share in a public offering realizing net proceeds of \$72.1 million, after underwriter discounts, commissions and other expenses.

In October 1997, the Company completed the public offering of \$86.3 million of 6% Convertible Subordinated Debentures ("6% Debentures") due November 2002 realizing net proceeds of \$82.9 million after underwriter discounts, commissions and other expenses. The 6% Debentures are convertible at any time at or prior to maturity, unless previously redeemed, at a conversion price of \$22.57 per common share, which equates to an aggregate of 3,821,444 shares of the Company's common stock.

In April 1998, the Company completed the offering of \$75.0 million of 5.625% Convertible Subordinated Debentures ("5.625% Debentures") due May 2003 realizing net proceeds of \$72.2 million after discounts, commissions and other expenses. The 5.625% Debentures are convertible at any time at or prior to maturity, unless previously redeemed, at a conversion price of \$26.184 per common share, which equates to an aggregate of 2,864,345 shares of the Company's common stock.

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### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

During the year ended December 31, 1998, the Company purchased approximately 529,000 shares of its common stock for a total purchase price of approximately \$7.1 million in accordance with a stock repurchase plan initiated in May 1998. The Board of Directors terminated the stock repurchase plan in November, 1998.

On November 8, 2000, the Company modified and amended its Rights Agreement to provide that the acquisition of up to \$15.0 million in face value of the Company's convertible debentures is not to be considered "beneficially owned," as defined under the Rights Agreement, for purposes of calculating whether a beneficial owner owns 15% or more of the Company's common shares then outstanding, in which event certain rights as described in the Rights Agreement would arise.

### PRINCIPLES OF CONSOLIDATION

The consolidated financial statements include the accounts of Assisted Living Concepts Inc. and its wholly owned subsidiaries (the "Company"). All significant intercompany balances and transactions have been eliminated in consolidation.

### CASH EQUIVALENTS AND MARKETABLE SECURITIES

Cash equivalents of \$6.0 million and \$4.6 million at December 31, 1999 and 2000, respectively, consist of highly liquid investments with maturities of three months or less at the date of purchase. The Company's investments in marketable securities are classified as available for sale. These investments are stated at fair value with any unrealized gains or losses included as accumulated other comprehensive loss in shareholders' equity. Interest income is recognized when earned.

### LEASES

The Company determines the classification of its leases as either operating or capital at their inception. The Company reevaluates such classification whenever circumstances or events occur that require the reevaluation of the leases.

The Company accounts for arrangements entered into under sale and leaseback agreements pursuant to Statement of Financial Accounting Standards (SFAS) No. 98, "Accounting for Leases." For transactions that qualify as sales and operating leases, a sale is recognized and the asset is removed from the books. For transactions that qualify as sales and capital leases, the sale is recognized, but the asset remains on the books and a capital lease obligation is recorded. Transactions that do not qualify for sales treatment are treated as financing transactions. In the case of financing transactions, the asset remains on the books and a finance obligation is recorded as part of long-term debt. Losses on sale and leaseback agreements are recognized at the time of the transaction absent indication that the sales price is not representative of fair value. Gains are deferred and recognized on a straight-line basis over the initial term of the lease.

All of the Company's leases contain various provisions for annual increases in rent, or rent escalators. Certain of these leases contain rent escalators with future minimum annual rent increases that are not considered contingent rents. The total amount of the rent payments under such leases with non-contingent rent escalators is being charged to expense on the straight-line method over the term of the leases. The Company records a deferred credit, included in other liabilities, to reflect the excess of rent expense over cash

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payments. This deferred credit is reduced in the later years of the lease term as the cash payments exceed the rent expense (See Note 5). Other liabilities included \$1.9 million of such amount at December 31, 1999 and 2000.

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### ASSISTED LIVING CONCEPTS, INC.

#### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

##### PROPERTY AND EQUIPMENT

Property and equipment are recorded at cost and depreciation is computed over the assets' estimated useful lives on the straight-line basis as follows:

Buildings and building improvements.....	40 years
Furniture and equipment.....	3 to 7 years

Equipment under capital lease is recorded at the net present value of the future minimum lease payments at the inception of the lease. Amortization of equipment under capital lease is provided using the straight-line method over the estimated useful life of 5 years.

Asset impairment is analyzed on assets to be held and used by the rental demand by market to determine if future cash flows (undiscounted and without interest charges) are less than the carrying amount of the asset. If an impairment is determined to have occurred, an impairment loss is recognized to the extent the assets carrying amount exceeds its fair value. Assets the Company intends to dispose of are reported at the lower of (i) fair carrying amount or (ii) fair value less the cost to sell. The Company has not recognized any impairment losses on property through the year ended December 31, 2000.

Interest and certain payroll costs incurred during construction periods are capitalized as part of the building costs. Maintenance and repairs are charged to expense as incurred, and significant betterments and improvements are capitalized. Construction in process includes pre-acquisition costs and other direct costs related to acquisition, development and construction of residences. If a project is abandoned, any costs previously capitalized are expensed.

##### GOODWILL

Costs in excess of the fair value of the net assets acquired in purchase transactions as of the date of acquisition have been recorded as goodwill and are being amortized over periods ranging between 15 and 20 years on a straight-line basis. Amortization of goodwill was \$398,000, \$294,000, and \$292,000 respectively, for the years ended December 31, 1998, 1999 and 2000. Accumulated amortization of goodwill at December 31, 1999 and 2000 was \$629,000 and \$922,000, respectively. The Company assesses the recoverability of its goodwill by determining whether the amortization of the goodwill balance over its remaining life can be recovered through the undiscounted future operating cash flows of the acquired operations. The amount of goodwill impairment, if any, is measured based on projected discounted future operating cash flows using a discount rate reflecting the Company's average cost of funds. The assessment of the recoverability of goodwill will be impacted if estimated future operating cash flows are not achieved.

During the year ended December 31, 1998, the Company wrote-off all the unamortized goodwill (approximately \$7.5 million) associated with Pacesetter Home Health Care, Inc. ("Pacesetter"), a wholly owned subsidiary of Home and

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Community Care, Inc. The shut-down of Pacesetter operations was a result of a change in the regulatory reimbursement environment during the quarter ended June 30, 1998 (See Note 10).

### PRE-OPENING COSTS

Prior to the adoption of American Institute of Certified Public Accountants ("AICPA") Statement of Position 98-5, Reporting on the Costs of Start-up Activities ("SOP 98-5"), pre-opening costs associated with newly developed residences were capitalized and amortized over 12 months. As a result of the Company's adoption of SOP 98-5 (effective as of January 1, 1998), pre-opening costs are expensed as incurred.

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ASSISTED LIVING CONCEPTS, INC.

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

#### ADVERTISING COSTS

Advertising costs are expensed as incurred and were \$368,000, \$853,000 and \$612,000 for the years ended December 31, 1998, 1999 and 2000, respectively.

#### CUMULATIVE EFFECT OF CHANGE IN ACCOUNTING PRINCIPLE

Effective January 1, 1998, the Company adopted SOP 98-5, which requires that pre-opening costs be expensed as incurred. In connection with such adoption, \$1.5 million of previously capitalized, unamortized pre-opening costs were written off as of January 1, 1998 and presented in the accompanying statement of operations for fiscal year 1998 as the cumulative effect of a change in accounting principle.

#### DEFERRED FINANCING COSTS

Financing costs related to the issuance of debt are capitalized as other assets and amortized to interest expense over the term of the related debt using the straight-line method, which approximates the effective interest method. Amortization of deferred financing costs were \$978,000, \$1.6 million, and \$1.6 million, respectively, for the years ended December 31, 1998, 1999 and 2000. Accumulated amortization of deferred financing costs at December 31, 1999 and 2000 were \$3.1 million and \$4.7 million, respectively.

#### INCOME TAXES

The Company uses the asset and liability method of accounting for income taxes under which deferred tax assets and liabilities are recognized for the estimated future tax consequences attributable to the differences between the financial statement carrying amounts of the existing assets and liabilities and their respective tax bases (temporary differences). Deferred tax assets are reduced by a valuation allowance when, in the opinion of management, it is more likely than not that some portion or all of the deferred tax assets will not be realized.

#### REVENUE RECOGNITION

Revenue is recognized when services are rendered and consists of residents' fees for basic housing and support services and fees associated with additional services such as routine health care and personalized assistance on a fee for service basis. The collectibility of the accounts receivable is assessed periodically and a provision for doubtful accounts is recorded as considered necessary.

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### CLASSIFICATION OF EXPENSES

Residence operating expenses exclude all expenses associated with corporate or support functions which have been classified as corporate general and administrative expense.

### COMPREHENSIVE LOSS

On January 1, 1998, the Company adopted SFAS No. 130, "Reporting Comprehensive Income." SFAS No. 130 establishes standards for reporting and presentation of comprehensive income and its components in a full set of financial statements. Comprehensive loss consists of net loss and several other items that current accounting standards require to be recognized outside of net loss and is presented in the consolidated statements of shareholders' equity and comprehensive loss. The Statement requires only additional disclosures in the consolidated financial statements; it does not affect the Company's financial position or net loss.

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ASSISTED LIVING CONCEPTS, INC.

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

#### NET LOSS PER COMMON SHARE

Basic earnings per share (EPS) is calculated using net loss attributable to common shares divided by the weighted average number of common shares outstanding for the period. Diluted EPS is calculated in periods with net income using income attributable to common shares considering the effects of dilutive potential common shares divided by the weighted average number of common shares and dilutive potential common shares outstanding for the period.

Vested options to purchase 833,000, 983,000 and 477,000 shares of common stock were outstanding during the years ended December 31, 1998, 1999 and 2000, respectively. These options were excluded from the respective computations of diluted loss per share, as their inclusion would be antidilutive.

Also excluded from the computations of diluted loss per share, for the years ended December 31, 1998, 1999 and 2000 were, 6,685,789 shares of common stock issuable upon conversion of the Company's convertible subordinated debentures (see Note 9) and 250,000 shares of restricted stock for the year ended December 31, 1998 (see Note 14) as their inclusion would be antidilutive.

#### SEGMENT REPORTING

Financial Accounting Standards Board SFAS No. 131, Disclosure about Segments of an Enterprise and Related Information requires public enterprises to report certain information about their operating segments in a complete set of financial statements to shareholders. It also requires reporting of certain enterprise-wide information about the Company's products and services, its activities in different geographic areas, and its reliance on major customers. The basis for determining the Company's operating segments is the manner in which management operates the business. The Company has no foreign operations and no customers which provide over 10 percent of gross revenue. The Company reviews operating results at the residence level; it also meets the aggregation criteria in order to report the results as one business segment.

#### USE OF ESTIMATES

The Company has made certain estimates and assumptions relating to the

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reporting of assets and liabilities, and the disclosure of contingent assets and liabilities, and the reported amounts of revenue and expenses during the reporting period to prepare these financial statements in conformity with accounting principles generally accepted in the United States of America. Actual results could differ from those estimates.

### WORKER'S COMPENSATION

The Company utilizes third-party insurance for losses and liabilities associated with worker's compensation claims subject to deductible levels of \$250,000 per occurrence. Losses up to this deductible level are accrued based upon the Company's estimates of the aggregate liability for claims incurred based on Company experience.

### RECLASSIFICATIONS

Certain reclassifications have been made in the prior years' financial statements to conform to the current year's presentation. Such reclassifications had no effect on previously reported net loss or shareholders' equity.

### FAIR VALUE OF FINANCIAL INSTRUMENTS

The carrying amount of cash and cash equivalents, accounts receivable, accounts payable, construction payable and accrued liabilities approximates fair value because of the short-term nature of the accounts and/or because they are invested in accounts earning market rates of interest. The carrying amount of the

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ASSISTED LIVING CONCEPTS, INC.

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

Company's long-term debt approximates fair value as the interest rates approximate the current rates available to the Company. The following table sets forth the carrying amount and approximate fair value (based on quoted market values) of the Company's subordinated debentures as of December 31, 1999 and 2000 (in thousands):

	1999		2000	
	CARRYING AMOUNT	FAIR VALUE	CARRYING AMOUNT	FAIR VALUE
6% Debentures.....	\$86,250	\$50,888	\$86,250	\$36,225
5.625% Debentures.....	75,000	43,500	75,000	29,250

### STOCK-BASED COMPENSATION

The Company applies the intrinsic value-based method of accounting prescribed by Accounting Principles Board ("APB") Opinion No. 25, Accounting for Stock Issued to Employees, and related interpretations including FASB Interpretation No. 44, Accounting for Certain Transactions Involving Stock Compensation an interpretation of APB Opinion No. 25 issued in March 2000, to account for its fixed plan stock options. Under this method, compensation expense is recorded on the date of grant only if the current market price of the underlying stock exceeded the exercise price. SFAS No. 123, Accounting for

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Stock-Based Compensation, established accounting and disclosure requirements using a fair value-based method of accounting for stock-based employees compensation plans. As allowed by SFAS No. 123, the Company has elected to continue to apply the intrinsic value-based method of accounting described above, and has adopted the disclosure requirements of SFAS No. 123.

The Amended and Restated 1994 Employee Stock Option Plan (the "1994 Plan") combines an incentive and nonqualified stock option plan, a stock appreciation rights ("SAR") plan and a stock award plan (including restricted stock). The 1994 Plan is a long-term incentive compensation plan and is designed to provide a competitive and balanced incentive and reward program for participants.

The Company's Non-Executive Employee Equity Participation Plan (the "Non-Officer Plan") is a non-qualified stock option plan intended as a long-term incentive compensation plan designed to provide a competitive and balanced incentive and reward programs for participants.

The Company accounts for stock and stock options issued to non-employees in accordance with the provisions of SFAS No. 123 and Emerging Issues Task Force (EITF) consensus on Issue No. 96-18, Accounting for Equity Instruments that are Issued to Other than Employees for Acquiring, or in Conjunction with Selling, Goods or Services.

### CONCENTRATION OF CREDIT RISK

The Company depends on the economies of Texas, Indiana, Oregon, Ohio and Washington and to some extent, on the continued funding of State Medicaid waiver programs in some of those states. As of December 31, 2000, 21.6% of the Company's properties were in Texas, 11.4% in Indiana, 10.3% in Oregon, 9.7% in Ohio and 8.6% in Washington. Adverse changes in general economic factors affecting the respective health care industries or laws and regulator environment in each of these states, including Medicaid reimbursement rates, could have a material adverse effect on the Company's financial condition and results of operations.

State Medicaid reimbursement programs constitute a significant source of revenue for the Company. During the years ended December 31, 1998, 1999 and 2000, direct payments received from state Medicaid agencies accounted for approximately 10.7%, 10.4%, and 11.1% respectively, of the Company's revenue while the tenant paid portion received from Medicaid residents accounted for approximately 5.8%, 5.9% and 6.2%,

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ASSISTED LIVING CONCEPTS, INC.

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

respectively, of the Company's revenue during these periods. The Company expects in the future that State Medicaid reimbursement programs will constitute a significant source of revenue for the Company.

## 2. ACQUISITIONS AND JOINT VENTURE

### Acquisitions

Effective October 23, 1997, the Company acquired 98.8% of the outstanding capital stock of Home and Community Care, Inc. ("HCI") that it did not already own. The Company had acquired an initial 1.2% interest in HCI as a result of HCI's acquisition of Pacesetter, a home health care agency in which the Company had made an investment in November 1996. Several employees of the Company, including members of the Board of Directors, owned collectively approximately

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40.0% of the outstanding common stock in HCI (See Note 13). The HCI purchase was completed at a purchase price of approximately \$4.0 million in cash (which reflects approximately \$5.3 million of cash paid net of (i) approximately \$250,000 in cash acquired, (ii) approximately \$850,000 in fees from HCI for services rendered during 1997, and (iii) \$150,000 in dividends received from HCI during 1997), and the assumption of approximately \$6.6 million in liabilities. HCI stockholders were entitled to receive certain "earnout" payments over a two-year period based on the number of HCI's assisted living residence sites, which the Company elected to complete. At the time of the acquisition, HCI had 20 sites under development. For each completed residence, HCI stockholders received an additional \$7,500 per unit (approximately \$300,000 per residence) in cash. During the years ended December 31, 1998 and 1999, the Company paid earnout payments of \$1.7 million and \$1.5 million, respectively, and capitalized such payments in property and equipment.

The acquisition was accounted for as a purchase, and the operating results of HCI have been included in the Company's consolidated financial statements since the date of acquisition. The cost of the acquisition was allocated based on the estimated fair value of the net assets acquired of approximately \$3.4 million. The excess of the aggregate purchase price over the fair market value of net assets acquired of approximately \$7.5 million was recorded as goodwill.

During the second quarter of 1998 the Company announced a plan to exit all home health business operations being conducted by Pacesetter. During the year ended December 31, 1998, the Company incurred a \$8.5 million charge to earnings associated with exiting the Pacesetter operations. Such charge consisted of (i) a \$7.5 million write-off of all unamortized goodwill associated with Pacesetter and (ii) a \$1.0 million provision for exit costs expected to be incurred during the phase out of the Pacesetter business. During the fourth quarter 1998, the \$1.4 million provision for exit costs was reduced by \$400,000 to \$1.0 million as a result of a change in the estimate for such exit costs. In addition, the Company incurred a \$1.0 million charge recorded as site abandonment expense during second quarter 1998 for previously capitalized development costs relating to 11 sites acquired in the HCI acquisition that it had determined not to develop (See Notes 6 and 10).

Effective October 23, 1997, the Company acquired the 90.1% of the outstanding capital stock of Carriage House Assisted Living Inc. ("Carriage House") it did not already own. Several employees of the Company, including members of the Board of Directors, owned collectively approximately 23.0% of the outstanding common stock of Carriage House (See Note 13). The Company had acquired its initial 9.9% ownership in Carriage House's outstanding capital stock during 1996. The acquisition was completed at a purchase price of \$5.2 million with the exchange of 337,460 shares of Common Stock (based on a stock price of \$15.41 per share) for all of the outstanding common stock of Carriage House and the assumption of approximately \$3.2 million in liabilities.

The acquisition was accounted for as a purchase and the operating results of Carriage House have been included in the Company's consolidated financial statements since the acquisition date. The cost of the acquisition has been allocated based on the estimated fair value of the net assets acquired of approximately

\$3.4 million. The excess of the aggregate purchase price over the fair market value of net assets acquired of approximately \$4.7 million has been recorded as goodwill and is being amortized on a straight-line basis over 20 years.



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On April 30, 1998, the Company completed the acquisitions of two assisted living residences in Plano and McKinney, Texas, having units of 64 and 50, respectively. The residences were acquired for a total purchase price of approximately \$5.2 million. The acquisitions were accounted for as purchases and the operating results of the facilities have been included in the Company's consolidated financial statements since the acquisition date. The cost of the acquisitions has been allocated based on the estimated fair value of the net assets acquired of approximately \$5.2 million. No goodwill was recorded.

On July 1, 1998, the Company completed the acquisition of an assisted living residence in Alexandria, Louisiana having 48 units. The residence was acquired for a purchase price of approximately \$2.8 million. The acquisition was accounted for as a purchase and the operating results of the facility have been included in the Company's consolidated financial statements since the acquisition date. The cost of the acquisition has been allocated based on the estimated fair value of the net assets acquired of approximately \$2.8 million. No goodwill was recorded.

On December 1, 1998, the Company completed the acquisition of an assisted living residence in Paris, Texas, having 50 units. The residence was acquired for a purchase price of approximately \$3.4 million. The acquisition was accounted for as a purchase and the operating results of the facility have been included in the Company's consolidated financial statements since the acquisition date. The cost of the acquisition has been allocated based on the estimated fair value of the net assets acquired of approximately \$3.0 million. The excess of the aggregate purchase price over the fair market value of net assets acquired is approximately \$432,000 and has been recorded as goodwill and is being amortized on a straight-line basis over 20 years.

### Joint Venture

During 1997, the Company entered into joint venture agreements with a joint venture partner to operate certain new assisted living residences which commenced operations during the second, third and fourth quarters of 1997. Of the \$2.3 million of total capital raised by the joint venture partner to invest in such arrangements, the Company contributed \$300,000 and recorded such investment in other non-current assets. In addition, certain members of management held interests in the joint venture partner. Pursuant to the joint venture agreements, the Company entered into irrevocable management agreements under which the Company managed the residences operated by the joint venture for an amount equal to the greater of 8% of gross revenues or \$2,000 per month per residence. Because the Company retained direct control of the residences operated by the joint venture, the Company consolidated the operations of the residences subject to the joint venture agreements in its consolidated financial statements. The joint venture partner reimbursed the Company for 90.0% of the start-up losses of the joint venture, and the Company recognized such reimbursements as loans included in other liabilities. The Company also reflected amounts paid to repurchase the joint venture partner's interest in excess of reimbursed losses as interest and other expense. Interest was calculated based on the average loan balance using an imputed 20.0% interest rate and other expense was calculated based on a \$10,000 administrative fee per residence. The Company received loss reimbursements of \$4.7 million for the year ended December 31, 1998. The Company repaid \$4.0 million of these loans in 1998, and incurred interest and other expense of \$687,000 in connection with these loans, for the year ended December 31, 1998. As of December 31, 1998, 17 residences owned or leased by the Company were being operated by the joint venture. During the first quarter of 1999 the Company announced that it had negotiated with the joint venture partner to purchase, for approximately \$3.8 million, all of the joint venture partner's interest in the remaining 17 residences subject to the joint venture agreements (See Note 13).

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ASSISTED LIVING CONCEPTS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

3. RESTRICTED CASH

Restricted cash consists of \$4.4 million related to loan agreements (see Note 8) with U.S. Bank National Association ("U.S. Bank"), \$1.0 million related to certain lease agreements (See Note 5), and \$1.1 related to required workers compensation insurance deposits.

4. MARKETABLE SECURITIES

Marketable securities consist of U.S. Treasury securities and other highly liquid marketable debt securities. The aggregate market value of securities held at December 31, 1999 was \$1.7 million. The investments held at December 31, 1999 had a historical cost of \$2.0 million and were classified as available for sale in accordance with Statement of Financial Accounting Standards No. 115, Accounting for Certain Investment in Debt and Equity Securities. As a result, unrealized investment losses of \$320,000 are included as a component of comprehensive loss and shareholders' equity at December 31, 1999. These investments were sold during the year ended December 31, 2000 for \$1.6 million, resulting in realized losses of \$368,000.

5. LEASES

A summary of leases that the Company has entered into is as follows:

	NUMBER OF LEASED RESIDENCES ("OREGON LEASES")	NUMBER OF SALE AND LEASEBACK RESIDENCES ACCOUNTED FOR AS OPERATING LEASES	TOTAL NUMBER OF OPERATING LEASES	NUMBER OF SALE AND LEASEBACK RESIDENCES ACCOUNTED FOR AS FINANCINGS	UNITS UN OPERATI LEASES
	-----	-----	-----	-----	-----
Leases at December 31, 1997...	7	44	51	16	1,906
Leases entered into during 1998.....	--	4	4	--	139
Lease expansions during 1998.....	--	--	--	--	47
Leases terminated during 1998.....	(1)	--	(1)	--	(45)
	--	--	--	---	-----
Leases at December 31, 1998...	6	48	54	16	2,047
Lease expansions during 1999.....	--	--	--	--	13
Leases modified and reclassified during 1999....	--	16	16	(16)	573
	--	--	--	---	-----
Leases at December 31, 1999...	6	64	70	--	2,633
Lease expansions during 2000.....	--	--	--	--	1
	--	--	--	---	-----
Leases at December 31, 2000...	6	64	70	--	2,634
	==	==	==	===	=====

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The Company has entered into agreements to lease six assisted living residences in Oregon from Assisted Living Facilities, Inc., a related party (the "Oregon Leases"). During 1998 the Company terminated a lease with Oregon Heights Partners ("OHP"). The lessor in each case obtained funding through the sale of bonds issued by the state of Oregon, Housing and Community Services Department ("OHCS"). In connection with the Oregon Leases, the Company entered into "Lease Approval Agreements" with OHCS and Assisted Living Facilities, Inc., pursuant to which the Company is obligated to comply with the terms and conditions of certain regulatory agreements to which the lessor is a party (See Note 8). The leases, which have fixed terms of 10 years, have been accounted for as operating leases. Aggregate deposits on these residences as of December 31, 1999 and 2000 were \$126,000 which are reflected in other assets.

During 1998 the Company completed the sale of 4 residences under sale and leaseback arrangements. The Company sold the residences for approximately \$10.3 million and leased them back over initial terms ranging from 12 to 15 years. The Company did not enter into any sale and leaseback agreements in 1999 or 2000.

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ASSISTED LIVING CONCEPTS, INC.

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

The Company recognized losses of \$651,000 on the above sale and leaseback transactions for the year ended December 31, 1998. The losses are presented in the Consolidated Statements of Operations as net loss on sale of assets. Gains on sale and leaseback transactions of \$508,000 for the year ended December 31, 1998, have been recorded as deferred income included in other liabilities and are being amortized over the initial terms of the corresponding leases.

In March 1999, the Company amended 16 leases, resulting in the reclassification of such leases from financings to operating leases (see Note 6).

In June 1999, the Company amended all of its 37 leases with LTC. These amendments included provisions to restructure future minimum annual rent increases, or "rent escalators," that were not deemed to be contingent rents. Because of the rent escalators, prior to the amendments, the Company accounted for rent expense related to such leases on a straight-line basis. From the date of the amendment forward, the Company has accounted for the amended leases on a contractual cash payment basis and amortizes the deferred rent balance, at the date of the amendment, over the remaining initial term of the lease. Those amendments also redefined the lease renewal option with respect to certain leases and provided the lessor with the option to declare an event of default in the event of a change of control under certain circumstances. In addition, the amendments also provide the Company with the ability, subject to certain conditions, to sublease or assign its leases with respect to two Washington residences.

Certain of the Company's leases and loan agreements contain covenants and cross-default provisions such that a default on one of those instruments could cause the Company to be in default on one or more other instruments. Pursuant to certain lease agreements, the Company restricted \$1.0 million of cash balances as additional collateral (see Note 3). The Company did not meet certain financial covenants at December 31, 2000 but has subsequently received a waiver of the right to declare an event of default (See Note 8).

As of December 31, 2000, future minimum annual lease payments under operating leases are as follows (in thousands):

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2001.....	\$ 16,805
2002.....	16,805
2003.....	16,805
2004.....	16,805
2005.....	16,805
Thereafter.....	96,888
	-----
	\$180,913
	=====

6. PROPERTY AND EQUIPMENT

As of December 31, 1999 and 2000, property and equipment, stated at cost, consist of the following (in thousands):

	1999	2000
	-----	-----
Land.....	\$ 21,329	\$ 21,378
Buildings and building improvements.....	286,347	287,178
Equipment.....	5,344	7,149
Furniture.....	8,602	8,638
	-----	-----
Total property and equipment.....	321,622	324,343
Less accumulated depreciation and amortization.....	15,974	25,599
	-----	-----
Property and equipment -- net.....	\$305,648	\$298,744
	=====	=====

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ASSISTED LIVING CONCEPTS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

Land, buildings and certain furniture and equipment relating to 51 residences serve as collateral for the litigation payable (See Note 16), bridge loan payable (See Note 7) and for long-term debt (See Note 8). The Company also encumbered the land, buildings and certain furniture and equipment relating to 16 additional properties in March, 2001 in relation to the Heller Healthcare Finance, Inc., ("Heller") financing (See Note 19).

Depreciation and amortization expense was \$5.9 million, \$8.7 million and \$9.6 million, for the years ended December 31, 1998, 1999 and 2000, respectively.

In 2000, the Company entered into a capital lease agreement to finance information technology equipment. The lease expires on March 30, 2003. The gross amount of equipment and related accumulated amortization recorded under this capital lease was \$263,000 and \$18,000, respectively at December 31, 2000.

During the years ended December 31, 1998 and 1999 the Company capitalized interest costs of \$6.0 million and \$2.0 million, respectively, relating to financing of construction in process. In addition, the Company capitalized payroll costs that were directly related to the construction and development of the residences of \$1.8 million and \$617,000 for the years ended December 31,

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1998 and 1999, respectively. No interest or payroll costs were capitalized in 2000.

As a result of the Company's decision to reduce the number of new residence openings during the year ended December 31, 1998 and beyond, the Company wrote-off \$2.4 million of capitalized costs during 1998 relating to the abandonment of 36 development sites. In 1999, the Company wrote-off \$4.9 million of capitalized costs relating to the abandonment of all remaining development sites, with the exception of 10 sites where the Company owns the land. Of these 10 sites, 7 are being held for future development (\$1.0 million) and are included in land, and 3 sites (\$452,000) are listed for sale and included in other current assets.

The Company had certificates of occupancy for 185 residences, all of which were included in the operating results as of December 31, 2000. Of the residences with certificates of occupancy, the Company owned 115 residences and leased 70 residences (all of which are operating leases).

During 1996 and 1997 the Company entered into 16 sale and leaseback transactions which contained purchase options entitling the Company to purchase the properties at fair market value at the end of initial lease terms ranging from 14 to 15 years. As a result of the purchase options the Company accounted for these sale and leaseback transactions using the financing method in SFAS No. 98, Accounting for Leases. In March 1999, the Company amended these leases. The amendments eliminated the Company's purchase option; therefore, the leases were reclassified as operating leases at that date. As a result of the amendments, the Company recorded (i) the disposal of net property and equipment in the amount of \$29.5 million, (ii) the extinguishment of long-term debt in the amount of \$31.5 million and (iii) a deferred gain of \$2.0 million. The deferred gain is included in other non-current liabilities and is being amortized over the remaining initial lease term as an offset to rent expense.

7. BRIDGE LOAN PAYABLE

In November 2000, the Company entered into a short-term bridge loan with Red Mortgage ("Red Mortgage") in the amount of \$4.0 million secured by three previously unencumbered properties. This loan matures on August 1, 2001, requires monthly interest-only payments and bears annual interest at the greater of 10% or LIBOR plus 3.5% (10.3% at December 31, 2000).

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ASSISTED LIVING CONCEPTS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

8. LONG-TERM DEBT

As of December 31, 1999 and 2000, long-term debt consists of the following (in thousands):

	1999	2000
	-----	-----
Trust Deed Notes, payable to the State of Oregon Housing and Community Services Department (OHCS) through 2028.....	\$10,025	\$ 9,890
Variable Rate Multifamily Revenue Bonds, payable to the Washington State Housing Finance Commission Department through 2028.....	8,235	7,900
Variable Rate Demand Revenue Bonds, Series 1997 payable to		

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the Idaho Housing and Finance Association through 2017....	7,120	6,875
Variable Rate Demand Revenue Bonds, Series A-1 and A-2 payable to the State of Ohio Housing Finance Agency through 2018.....	12,845	12,445
Capital lease obligation.....	--	212
Mortgages payable.....	35,218	34,775
	-----	-----
Total long-term debt.....	\$73,443	\$72,097
Less current portion.....	1,494	1,690
	-----	-----
Long-term debt.....	\$71,949	\$70,407
	=====	=====

The Trust Deed Notes payable to OHCS are secured by buildings, land, furniture and fixtures of six Oregon residences. The notes are payable in monthly installments including interest at effective rates ranging from 7.375% to 9.0%.

The Variable Rate Multifamily Revenue Bonds are payable to the Washington State Housing Finance Commission Department and at December 31, 2000 were secured by an \$8.7 million letter of credit and by buildings, land, furniture and fixtures of the five Washington residences. The letter of credit expires in 2003. The bonds had a weighted average interest rate of 4.24% during 2000.

The Variable Rate Demand Housing Revenue Bonds, Series 1997 are payable to the State of Idaho Housing and Finance Association and at December 31, 2000 were secured by a \$7.5 million letter of credit and by buildings, land, furniture and fixtures of four Idaho residences. The letter of credit expires in 2004. The bonds had a weighted average interest rate of 4.27% during 2000.

In July 1998, the Company obtained \$12.7 million in Variable Rate Demand Housing Revenue Bonds with the State of Ohio Housing Finance Agency ("OHFA") and \$530,000 in Taxable Variable Rate Demand Housing Revenue Bonds with OHFA. The bonds are due July 2018 and are secured by a \$13.5 million letter of credit and by buildings, land, furniture and fixtures of seven Ohio residences. The letter of credit expires in 2005. The bonds had a weighted average interest rate of 4.20% during 2000.

In April 1998, the Company obtained \$14.6 million in mortgage financing at a fixed interest rate of 7.73% and secured by a mortgage encumbering each of seven Texas residences. The mortgage terms include monthly payments of \$110,000 over 25 years with a balloon payment of \$11.8 million due at maturity in May 2008.

In July 1998, the Company obtained \$6.6 million in mortgage financing at a fixed interest rate of 7.58% and secured by a mortgage encumbering each of three Oregon residences. The mortgage terms include monthly payments of \$49,000 over 25 years with a balloon payment of \$5.3 million due at maturity in August 2008.

In September 1998, the Company obtained \$5.9 million in mortgage financing at a fixed interest rate of 8.79% and secured by one Pennsylvania residence and one South Carolina residence. The mortgage terms include monthly payments of \$43,000 over 25 years with a balloon payment of \$5.9 million due at maturity in September 2008.

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In November 1998, the Company obtained \$8.7 million in mortgage financing at a fixed interest rate of 8.65% and secured by a mortgage encumbering each of three New Jersey residences. The mortgage terms include monthly payments of \$71,000 over 25 years with a balloon payment of \$7.2 million due at maturity in December 2008.

As of December 31, 2000, the following annual principal payments are required (in thousands):

2001.....	\$ 1,690
2002.....	1,793
2003.....	1,833
2004.....	1,926
2005.....	2,062
Thereafter.....	62,793
	-----
Total.....	\$72,097
	=====

The Company's credit agreements with U.S. Bank contain restrictive covenants which include compliance with certain financial ratios. During the third quarter of 1999, the Company amended certain loan agreements with U.S. Bank. Pursuant to the amendment, the Company agreed to provide \$8.3 million of additional cash collateral in exchange for the waiver of certain possible defaults related to the delivery of financial statements and compliance with financial covenants, including an amendment to certain financial covenants. The amendment also provides for the release of the additional collateral upon the achievement of specified performance targets, provided that the Company is in compliance with the other terms of the loan agreements. The Company achieved certain of these specified targets during the fourth quarter of fiscal 1999 and the first quarter of fiscal 2000 resulting in the release of \$1.2 million and \$1.1 million of the restricted cash, respectively.

On July 21, 2000, the Company finalized an agreement with U.S. Bank whereby U.S. Bank agreed to modify and waive certain financial covenants with which the Company would have otherwise failed to comply as of June 30, 2000. In exchange for the modification and waiver of financial covenants through the quarters ended June 30, 2000 and September 30, 2000, the Company provided three previously unencumbered Washington state properties as additional collateral. The agreement also provided for the release of \$1.8 million of cash collateral currently held by U.S. bank upon the satisfaction of certain conditions, which were satisfied in August 2000.

The Company determined that it would not meet the U.S. Bank covenants at December 31, 2000. On March 12, 2001, the Company amended certain loan documents with U.S. Bank. Pursuant to the amendment, the Company agreed to pay fees of \$34,700 in exchange for the following: the modification of certain financial covenants, and the waiver of U.S. Bank's right to declare an event of default for the Company's failure to comply with certain financial covenants as of December 31, 2000 and for its anticipated failure to comply with certain financial covenants for the three months ending March 31, 2001. The amendment also provides the following: approval for the Company to repurchase for cash up to \$25.0 million in face value of its convertible debentures prior to maturity; a requirement that the Company deposit \$500,000 in cash collateral with U.S. Bank in the event certain regulatory actions are commenced with respect to the properties securing its obligations to U.S. Bank; and the requirement that U.S. Bank release such deposits to the Company upon satisfactory resolution of the regulatory action. Failure to comply with any covenant constitutes an event of default, which will allow U.S. Bank (at its discretion) to declare any amounts

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outstanding under the loan documents to be due and payable. In addition, certain of the Company's leases and loan agreements contain

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### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

covenants and cross-default provisions such that a default on one of those instruments could cause the Company to be in default on one or more other agreements.

In addition to the debt agreements with OHCS related to the six owned residences in Oregon, the Company has entered into Lease Approval Agreements with OHCS and the lessor of the Oregon Leases, which obligates the Company to comply with the terms and conditions of the underlying trust deed relating to the leased buildings. Under the terms of the OHCS debt agreements, the Company is required to maintain a capital replacement escrow account to cover expected capital expenditure requirements for the Oregon Leases and the six OHCS loans, which as of December 31, 1999 and 2000 was \$378,000 and \$422,000, respectively, and is reflected in other assets in the accompanying financial statements. In addition, for the six OHCS loans in the Company's name, a contingency escrow account is required. This account had a balance of \$172,000 as of December 31, 1999 and 2000, and is reflected in other current assets. Distribution of any assets or income of any kind by the Company is limited to once per year after all reserve and loan payments have been made, and only after receipt of written authorization from OHCS.

As of December 31, 1999 and 2000, the Company was restricted from distributing \$233,000 and \$278,000 respectively, of income, in accordance with the terms of the loan agreements and Lease Approval Agreements with OHCS.

As a further condition of the debt agreements, the Company is required to comply with the terms of certain regulatory agreements which provide, among other things, that in order to preserve the federal income tax exempt status of the bonds, the Company is required to lease at least 20% of the units of the projects to low or moderate income persons as defined in Section 142(d) of the Internal Revenue Code. There are additional requirements as to the age and physical condition of the residents with which the Company must also comply. Non-compliance with these restrictions may result in an event of default and cause acceleration of the scheduled repayment.

#### 9. CONVERTIBLE SUBORDINATED DEBENTURES

In August 1995, the Company completed the offering of \$20.0 million of 7% Debentures due August 2005 realizing net proceeds of approximately \$19.2 million. The 7% Debentures were convertible at any time at or prior to maturity, unless previously redeemed, at a conversion price of \$7.50 per common share.

In September 1996, \$6.1 million of the 7% Debentures were converted into 811,333 shares of the Company's common stock which resulted in \$13.9 million of 7% Debentures remaining outstanding. In August 1998, the Company called for redemption of all of the remaining \$13.9 million of the 7% Debentures. All of the 7% Debentures were converted into shares of the Company's Common Stock, resulting in the issuance of 1,855,334 additional shares of common stock.

In October 1997, the Company completed the offering of \$86.3 million of 6% Debentures due November 2002, realizing net proceeds of approximately \$82.9 million. The 6% Debentures are convertible at any time at or prior to maturity, unless previously redeemed, at a conversion price of \$22.57 per common share, which equates to an aggregate of 3,821,444 shares of the Company's common stock



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and bear interest payable semi-annually on May 1 and November 1 of each year, commencing May 1, 1998. The 6% Debentures are unsecured and subordinated to all senior indebtedness of the Company. The 6% Debentures are subject to redemption, as a whole or in part, at any time from time to time commencing on or after November 15, 2000 at the Company's option at a redemption price equal to 100% of the principal amount thereof, plus accrued and unpaid interest to the redemption date.

In April 1998, the Company completed the private placement of \$75.0 million of 5.625% Debentures due May 2003, realizing net proceeds of approximately \$72.2 million. The 5.625% Debentures are convertible at any time at or prior to maturity, unless previously redeemed, at a conversion price of \$26.184 per common share, which equates to an aggregate of approximately 2,864,345 shares of the Company's common stock and

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ASSISTED LIVING CONCEPTS, INC.

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

bear interest payable semiannually on May 1 and November 1 of each year, commencing November 1, 1998. The 5.625% Debentures are unsecured and subordinated to all senior indebtedness of the Company. The 5.625% Debentures are subject to redemption, as a whole or in part, at any time from time to time on or after May 15, 2001 at the Company's option at a redemption price equal to 100% of the principal amount thereof, plus accrued and unpaid interest to the redemption date.

#### 10. WRITE-OFF OF IMPAIRED ASSETS AND RELATED EXPENSES

In June 1998, the Company announced a plan to exit all home health business operations being conducted by Pacesetter. The decision to exit Pacesetter's operations was a result of certain laws becoming effective that adversely affected the prospective payment system for home health care services. Based on this decision, the Company recorded a \$8.9 million charge to earnings during the second quarter 1998. Such charge consisted of (i) a \$7.5 million write-off of all unamortized goodwill associated with Pacesetter and (ii) a \$1.4 million provision for estimated exit costs expected to be incurred during the phase out period. Of this \$1.4 million provision, \$560,000 related to severance, salaries and benefits incremental to the shut down effort; \$720,000 related to leases, equipment and related costs of closing offices; and \$150,000 related to travel and moving costs. During the fourth quarter 1998, the \$1.4 million provision for exit costs was reduced by \$400,000 to \$1.0 million as a result of a change in the estimate for such exit costs. During the years ended December 31, 1998 and 1999, approximately \$760,000 and \$154,000, respectively of this reserve was utilized. The remaining reserve of approximately \$86,000 and \$54,000 at December 31, 1999 and 2000, respectively, consists primarily of lease termination costs. Expenses related to Pacesetter's final operations of \$430,000 and \$1.8 million for the six month period of June 1998 through December 1998 and for the year ended December 31, 1999 have been expensed as incurred. The phase out period concluded during 1999. The \$1.8 million in 1999 includes bad debt expense of \$510,000, recorded in the fourth quarter, and is included in corporate, general and administrative expense.

#### 11. TERMINATION OF MERGER AGREEMENT

On February 1, 1999, the Company agreed with American Retirement Corporation ("ARC") to terminate its previously announced merger agreement, which had been entered into during November 1998. The Company recorded charges of approximately \$1.1 million and \$228,000 in 1998 and 1999, respectively, for costs relating to the terminated merger agreement.

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### 12. INCOME TAXES

The Company incurred a loss for both financial reporting and tax return purposes for the years ended December 31, 1998, 1999, and 2000 and, as such, there was no current or deferred tax provision.

The provision for income taxes differs from the amount of loss determined by applying the applicable U.S. statutory federal rate to pretax loss as a result of the following items at December 31:

	1998	1999	2000
	-----	-----	-----
Statutory federal tax rate.....	(34.0)%	(34.0)%	(34.0)%
Non deductible goodwill.....	12.4%	0.3%	0.3%
Losses for which no benefit is provided.....	21.5%	33.6%	26.9%
Litigation settlement.....	--%	--%	6.6%
Other.....	0.1%	0.1%	0.2%
	-----	-----	-----
Effective tax rate.....	--%	--%	--%
	=====	=====	=====

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### ASSISTED LIVING CONCEPTS, INC.

#### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

An analysis of the significant components of deferred tax assets and liabilities, consists of the following as of December 31 (in thousands):

	1999	2000
	-----	-----
Deferred tax assets:		
Net operating loss carryforward.....	\$ 19,876	\$ 27,846
Investment in joint venture operations.....	2,815	1,741
Deferred gain on sale and leaseback transactions.....	1,555	1,480
Other.....	3,836	3,470
	-----	-----
Total deferred tax assets.....	28,082	34,537
Valuation allowance.....	(19,422)	(25,530)
Deferred tax liabilities:		
Property and equipment, primarily due to depreciation.....	(8,316)	(8,210)
Other.....	(344)	(797)
	-----	-----
Total deferred tax liabilities.....	(8,660)	(9,007)
	-----	-----
Net deferred tax asset (liability).....	\$ --	\$ --
	=====	=====

The valuation allowance for deferred tax assets as of December 31, 1999 and 2000 was \$19.4 million and \$25.5 million, respectively. The increase in the total valuation allowance for the years ended December 31, 1998, 1999 and 2000 was \$6.1 million, \$10.5 million, and \$6.1 million, respectively.

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As a result of acquisitions, the Company acquired net operating loss carryforwards for federal and state tax purposes approximating \$311,000 which are available to offset future taxable income, if any, through 2011. The future use of these net operating loss carryforwards is subject to certain limitations under the Internal Revenue Code and therefore, the Company has established a valuation allowance of \$117,500 to offset the deferred tax asset related to the loss carryforwards. Additionally, any tax benefit realized from the use of approximately \$100,000 of the acquired operating loss carryforwards will be applied to reduce goodwill.

At December 31, 2000, the Company had net operating loss carryforwards of approximately \$73.7 million and \$59.0 million available to reduce future federal and state taxable income, respectively. The carryforwards expire at various dates beginning in the year 2009 through the year 2021.

The portion of the valuation allowance for deferred tax assets for which subsequently recognized tax benefits will be applied directly to contributed capital is \$1.4 million as of December 31, 2000. This amount is attributable to differences between financial and tax reporting of employee stock option transactions.

### 13. RELATED PARTY TRANSACTIONS

The Company leases six residences from Assisted Living Facilities, Inc. The spouse of the Company's former president and chief executive officer owns a 25% interest in Assisted Living Facilities, Inc. For the years ended December 31, 1998, 1999 and 2000, the Company incurred lease rental expense of \$1.2 million, \$1.3 million, and \$1.3 million, respectively. In addition, in 1997 the Company leased one residence from Oregon Heights Partnership ("OHP") in which the former president and chief executive officer's spouse owns an interest. The Company paid OHP \$195,000 in rent payments in 1998. The lease with OHP was terminated in September 1998, effective October 1, 1998.

In 1997, the Company contracted with Supportive Housing Services, Inc. ("SHS") to provide services to the Company for market feasibility analysis, site pre-acquisition services, field construction supervision and construction management oversight in conjunction with the Company's development activities. SHS was owned 75% by the former president and chief executive officer's spouse. The Company paid \$3.8 million, \$1.6 million, and \$69,000 during the years ended December 31, 1998, 1999, and 2000, respectively, (including

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ASSISTED LIVING CONCEPTS, INC.

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

the amounts paid to CCL (as defined below)) for such development services. The Company capitalized such payments as construction in process. In July 1999 the Company delivered 180 days' written notice terminating their agreement with SHS for such consulting services.

Commencing in 1995, the Company contracted with Concepts in Community Living, Inc. ("CCL"), directly and through its developers, to perform feasibility studies and pre-development consulting services for the developers on the Company's behalf. CCL is owned 100% by the former president and chief executive officer's spouse. For the years ended December 31, 1998, 1999 and 2000, the Company paid CCL indirectly through SHS for these services fees of \$566,000, \$255,000, and \$0, respectively, which were capitalized in construction in process on the consolidated balance sheets. In June 1999 the Company entered into a new agreement with CCL pursuant to which CCL provided market research,

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demographic review and competitor analysis in many of our current markets. The agreement provided that Company pay CCL a retainer of \$10,000 per month, plus fees in excess of the retainer, if any, in connection with specific projects that the Company authorizes under the agreement. The Company paid CCL \$157,000 and \$17,000 for such services in 1999 and 2000, respectively. The Company terminated the June 1999 agreement by notice dated December 12, 1999.

The Company acquired HCI and Carriage House in October of 1997 (See Note 2). Several employees of the Company, including members of the Board of Directors, owned collectively 40.0% of the outstanding common stock in HCI and approximately 23.0% of the outstanding common stock of Carriage House. Pursuant to the HCI acquisition agreement, during 1998 and 1999 related parties (current or former officers, directors, or employees) received "earnout" payments from the Company of \$428,000 and \$416,000, respectively, related to HCI sites the Company elected to develop. There were no such payments in 2000.

During 1997, the Company entered into joint venture agreements with a joint venture partner to operate certain new assisted living residences which commenced operations during the second, third and fourth quarters of 1997 (See Note 2). The Company, Mr. McBride, the Company's former Chairman and Chief Executive Officer, Dr. Wilson, the Company's former President and Chief Executive Officer, and Dr. Wilson's spouse each acquired interests in the joint venture partner. During 1998, Mr. McBride owned a \$400,000 or 16.6% interest, and Dr. Wilson's spouse owned a \$200,000 or 8.3% interest, in the joint venture. On February 10, 1999, the Company announced with respect to these joint venture agreements that it had negotiated with the joint venture partner to purchase, for approximately \$3.8 million, all of the joint venture partner's interests in the operation of the remaining 17 residences subject to the joint venture agreements. As a result of such purchases, Mr. McBride and Dr. Wilson's spouse received distributions of approximately \$537,000 and \$269,000, respectively in 1999. The Company has no current intention of entering into similar arrangements in the future.

During 1998 Mr. Razook, one of the Company's former directors, was Managing Director and Head of the Health Care Industry Group of Schroder & Co. Inc. ("Schroders"), an investment banking firm. During 1998 Schroders served as the initial purchaser of our \$75.0 million offering of 5.625% Debentures for which Schroders received a customary commission. Also during 1998, Schroders provided financial advisory services and delivered a fairness opinion in connection with a proposed merger for which the Company paid Schroders a fee of \$200,000. In March 1999, Mr. Razook became President and Managing Director at Cohen & Steers Capital Advisors LLC ("C&S Advisors"). Pursuant to an agreement with Cohen & Steers Capital Management, Inc., an affiliate of C&S Advisors ("CSCM"), the Company paid CSCM and C&S Advisors \$1.3 million in 1999 for financial advisory services. On January 24, 2000, the Company's agreement with CSCM was terminated by mutual consent, and a new agreement with C&S Advisors was entered into. Pursuant to the new agreement, the Company paid C&S Advisors approximately \$471,000 for financial advisory services in connection with certain financing and merger and acquisition transactions. The new agreement terminated on December 31, 2000, except that even after the expiration or termination of the new agreement the Company is required to pay C&S Advisors fees under the new agreement if the Company

completes certain financing, including the Heller financing discussed in Note 18, and merger and acquisition transactions on or prior to December 31, 2001. On March 2, 2001, the Company closed the Heller financing and paid C&S Advisors

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\$457,000 in relation to this transaction (See Note 20).

In December 2000, the Company entered into an agreement with MYFM Capital, LLC ("MYFM") under which the Company could establish a line of credit with BET Associates LP ("BET") as lender, providing for loans of up to \$10.0 million. Subsequent to December 31, 2000, the Company terminated the agreement and paid MYFM \$50,000 in connection with such termination. Bruce E. Toll, who is the beneficial owner of 3.1 million of our common shares, and a current member of the Company's Board of Directors, is the sole member of BRU Holdings Company, Inc., LLC, which is the sole general partner of BET. Leonard Tannenbaum is the Managing Partner of MYFM Capital, LLC, the son-in-law of Mr. Toll, a 10% limited partner of BET, and is also a current member of the Company's Board of Directors.

### 14. STOCK OPTION PLANS AND RESTRICTED STOCK

The Company has two Stock Option Plans (the "Plans") which provide for the issuance of incentive and non-qualified stock options and restricted stock. Except for the Board of Directors administering the options of the non-employee Directors, the Plans are administered by the Compensation Committee of the Board of Directors which establish the terms and provisions of options granted under the Plans, not otherwise provided under the Plans. Incentive options may be granted only to officers or other full-time employees of the Company, while non-qualified options may be granted to directors, officers or other employees of the Company, or consultants who provide services to the Company.

The Amended and Restated 1994 Stock Option Plan combines an incentive and nonqualified stock option plan, a stock appreciation rights ("SAR") plan and a stock award plan (including restricted stock). The 1994 Plan is a long-term incentive compensation plan and is designed to provide a competitive and balanced incentive and reward program for participants.

Under the Amended and Restated 1994 Stock Option Plan (the "1994 Plan"), the Company may grant options or award restricted stock to its employees, consultants and other key persons for up to 2,208,000 shares of common stock. The exercise price of each option equals the market price of the Company's stock on the date of grant. Each option shall expire on the date specified in the option agreement, but not later than the tenth anniversary of the date on which the option was granted. Options typically vest three years from the date of issuance and typically are exercisable within seven years from the date of vesting. Each option is exercisable in equal installments as designated by the Compensation Committee or the Board at the option price designated by the Compensation Committee or the Board, as applicable; however, incentive options cannot be less than the fair market value of the common stock on the date of grant. All options are nontransferable and subject to adjustment upon changes in the Company's capitalization. The Board of Directors, at its option, may discontinue or amend the 1994 Plan at any time, provided that certain conditions are satisfied.

Under the Non-Executive Employee Equity Participation Plan of Assisted Living Concepts, Inc. (the "Non-Officer Plan") the Company may grant consultants and non-executives up to 1,000,000 shares of Common Stock pursuant to non-qualified options granted under the Non-Officer Plan. Officers, directors and significant employees of the Company are not eligible to participate in the Non-Officer Plan.

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The per share weighted-average fair value of each option grant is estimated on the date of grant using the Black-Scholes option-pricing model with the following weighted-average assumptions used for grants as of December 31:

	1998	1999	2000
	-----	-----	-----
Expected dividend yield.....	--	--	--
Expected volatility.....	45.12%	73.70%	98.57%
Risk-free interest rate.....	5.56%	6.14%	5.26%
Expected life (in years).....	10	3	3

The Company applies APB Opinion No. 25 in accounting for its Plans, and accordingly, no compensation cost has been recognized for its stock options issued to employees in the financial statements as all options were issued at fair value on the date of the grant. Had the Company determined compensation cost based on the fair value at the grant date for its stock options under SFAS No. 123, the Company's net loss would have been reduced to the pro forma amounts indicated below: (in thousands except per share data)

	1998	1999	2000
	-----	-----	-----
Net loss as reported.....	\$ (20,745)	\$ (28,933)	\$ (25,786)
Net loss pro forma.....	(23,990)	\$ (31,772)	\$ (27,586)
Basic and diluted net loss per common share as reported.....	\$ (1.27)	\$ (1.69)	\$ (1.51)
Basic and diluted net loss per common share pro forma.....	\$ (1.47)	\$ (1.86)	\$ (1.61)

Pro forma net loss reflects only options granted after 1995. Therefore, the full impact of calculating compensation costs for stock options under SFAS No. 123 is not reflected in the pro forma net loss amounts presented above because compensation cost is reflected over the option's vesting period of three years and compensation cost for options granted prior to January 1, 1996 is not considered. The resulting pro forma compensation costs may not be representative of that expected in the future years.

A summary of the status of the Company's stock options as of December 31, 1998, 1999 and 2000 and changes during the years ended on those dates is presented below:

	1998		1999		2000
	-----	-----	-----	-----	-----
	1998	WEIGHTED- AVERAGE	1999	WEIGHTED- AVERAGE	2000
	NUMBER OF	EXERCISE	NUMBER OF	EXERCISE	NUMBER OF
	SHARES	PRICE	SHARES	PRICE	SHARES
	-----	-----	-----	-----	-----
Options at beginning of the year.....	1,629,967	\$10.82	1,867,169	\$12.07	1,744,420
Granted.....	674,132	15.76	460,250	3.71	1,038,850
Exercised.....	(121,606)	6.00	(26,934)	5.83	--

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Canceled.....	(315,324)	15.82	(556,065)	12.65	(1,309,372)
	-----		-----		-----
Options at end of the year.....	1,867,169	\$12.07	1,744,420	\$ 9.78	1,473,898
	=====		=====		=====
Options exercisable at end of year.....	833,465		982,973		476,686
Weighted-average fair value of options granted during the year.....	\$10.22		\$2.52		\$1.32

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

The following table summarized information about stock options outstanding at December 31, 2000.

RANGE OF EXERCISE PRICES	OPTIONS OUTSTANDING			OPTIONS EXERCISABLE	
	NUMBER OUTSTANDING	WEIGHTED- AVERAGE REMAINING CONTRACTUAL LIFE	WEIGHTED- AVERAGE EXERCISE PRICE	NUMBER EXERCISABLE	WEIG AVE EXERCI
0.00\$to 0.38.....	51,000	9.85	\$ 0.38	--	\$
1.00\$to 1.13.....	346,148	9.33	1.12	9,666	
1.31\$to 1.44.....	383,500	9.00	1.44	44,503	
1.50\$to 1.69.....	44,834	8.87	1.67	15,171	
1.75\$to 1.81.....	156,500	9.15	1.81	32,727	
2.19\$to 2.88.....	131,837	8.44	2.86	45,196	
3.19\$to 4.63.....	154,668	3.05	4.56	151,339	
4.88\$to 16.50.....	166,826	6.53	11.38	146,577	1
16.7\$5 to 20.75.....	38,085	7.18	17.55	31,173	1
21.2\$5 .....	500	7.25	21.25	334	2
	-----			-----	
	1,473,898		\$ 3.38	476,686	\$
	=====			=====	

In October 1997, the Company awarded 250,000 shares of non-voting restricted stock to two key executive officers. At the time of the grant the Company's common stock had a fair market value of \$17.00 per share. No cash consideration was paid for such shares by the recipients. Such shares vested in three equal annual installments, commencing on the fourth anniversary of grant. The Company recorded unearned compensation expense of \$4.3 million in connection with the issuance of the restricted stock as of the date of the grant. This unearned compensation expense was reflected as a separate component of shareholders' equity to be amortized as compensation expense over the seven year vesting period. The Company recorded \$608,000 and \$180,000 of compensation expense with respect to such award for the years ended December 31, 1998 and 1999, respectively. The Company recorded the issuance of the restricted stock in 1998 upon issuance. During the first quarter of 1999, the Company retired the 250,000 shares of restricted stock upon payment to the two key executives of \$750,000 and \$187,500 (the latter of which was reduced to \$87,500 to reflect repayment of a \$100,000 bonus paid in 1998 to one of the key executives) in consideration for the forfeiture of their interest in the 250,000 shares of

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restricted stock.

In November 2000, the Board of Directors, at the recommendation of the Compensation Committee, approved an offer (the "Offer") to holders of options under both the 1994 Stock Option Plan and the Non-Officer Plan. The Company agreed to make lump sum payments of \$250 to each option holder that agreed to the cancellation of all of his options having an exercise price of \$5.00 or greater ("Eligible Options"), except that certain executive officers, directors, and consultants were asked to agree to the cancellation of their Eligible Options without any payment. The Company completed the Offer in December 2000, paying approximately \$17,000 for the cancellation of options covering the issuance of 596,103 shares of common stock.

### 15. WORKER'S COMPENSATION

The Company utilizes third-party insurance for losses and liabilities associated with worker's compensation claims subject to deductible levels of \$250,000 per occurrence for all claims incurred beginning January 1, 2000. Claims incurred prior to January 1, 2000 were fully insured. Losses up to this deductible level are accrued based upon the Company's estimates of the aggregate liability for claims incurred based on Company experience. At December 31, 2000, other current liabilities includes worker's compensation claims payable of approximately \$1.0 million relating to outstanding 2000 claims.

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ASSISTED LIVING CONCEPTS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

### 16. LEGAL PROCEEDINGS

#### Securityholder Litigation Settlement

In September, 2000, the Company reached an agreement to settle the class action litigation relating to the restatement of its financial statements for the years ended December 31, 1996 and 1997 and the first three fiscal quarters of 1998. This agreement received final court approval on November 30, 2000 and the Company was subsequently dismissed from the litigation with prejudice.

The total cost of the settlement was approximately \$10,020,000 (less \$1.0 million of legal fees and expenses reimbursed by the Company's corporate liability insurance carriers and other reimbursements of approximately \$193,000). The Company made two payments of \$2.3 million each on October 23, 2000 and January 23, 2001 towards the settlement. The remaining amount due will be paid in two payments of \$2.3 million each, due on April 23, 2001 and July 23, 2001, and a final payment of \$1.0 million due within 90 days following the July 23, 2001 payment.

The settlement had been pending the approval of the Company's corporate liability insurance carriers who had raised certain coverage issues that resulting the filing of litigation between the Company and the carriers. These carriers consented to the settlement, and the Company and the carriers agreed to dismiss the litigation regarding coverage issues and to resolve those issues through binding arbitration. The arbitration proceeding is pending. To the extent that the carriers are successful, the Company and the carriers have agreed that the carriers' recovery is not to exceed \$4.0 million. The parties further agreed that payment of any such amount awarded or agreed to will not be due in any event until 90 days after the Company has satisfied its obligations to the plaintiffs in the class action, with any such amount to be subordinated to new or refinancing of existing obligations. The Company believes it has strong defenses regarding this dispute and consequently has not recorded a



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liability in relation to this matter.

As a result of the class action settlement, the Company recorded a charge of approximately \$10,020,000, which was partially offset by a reduction in general, and administrative expenses of approximately \$1,193,000 as a result of the reimbursement of legal fees and expenses incurred in connection with the litigation. The settlement resulted in an increase in net loss of \$8,827,000 (or approximately \$0.52 per basic and diluted share) for the year ended December 31, 2000.

Although the Company believes it has strong defenses regarding its dispute with the insurance carriers, the Company cannot predict the outcome of this litigation and currently is unable to evaluate the likelihood of success or the range of possible loss. However, if such litigation was determined adversely to the Company, such a determination could have a material adverse effect on its financial condition, results of operations, cash flow and liquidity.

### Indiana Litigation Settlement

The Company was served with a complaint, filed May 30, 2000 in the Marion (Indiana) Superior Court on behalf of the Commissioner of the Indiana State Department of Health ("ISDH"). ISDH had alleged that the Company was operating its Logansport, Indiana facility known as McKinney House as a residential care facility without a license. The Company believes that its services were consistent with those of a "Housing with Services Establishment" (which is not required to be licensed) pursuant to Indiana Code Section 12-10-15-1.

To avoid the expense and uncertainty of protracted litigation and, also because the Company wished to assure the State that it operates in a manner that is consistent with Indiana law, the Company agreed to the following settlement on behalf of all facilities owned and operated by the Company in the State of Indiana. The Company and the State agreed upon a Program Description that clarifies the services that the Company can provide without requiring licensure as a residential care facility. This Program Description provides

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ASSISTED LIVING CONCEPTS, INC.

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

guidelines regarding the physical and medical condition of the residents in the Company's facilities and the services to be provided to them. The Company agreed that prior to March 20, 2001, it would provide in-service training regarding the Program Description throughout its Indiana facilities. Under the Program Description, the Company must discharge residents who require certain types or levels of care that the Company agreed not to provide in Indiana. The Company is currently implementing the Program Description and, while its full impact is not now known, the Company does not expect the impact to be material to its financial condition, results of operations, cash flow and liquidity. Without admitting liability, the Company paid a civil penalty of \$10,000. The State dismissed the lawsuit against the Company with prejudice.

### Other Litigation

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

### 17. EMPLOYEE BENEFIT PLANS

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Effective January 1, 1998, the Company implemented a 401(k) Savings Plan ("the Plan"). The Plan is a defined contribution plan covering employees of Assisted Living Concepts, Inc. who have one year of service and are age 21 or older. Each year participants may contribute up to 15% of pre-tax annual compensation and 100% of any Employer paid cash bonus (not to exceed \$10,000), as defined in the Plan. ALC may provide matching contributions as determined annually by ALC's Board of Directors. Contributions are subject to certain limitations. The Company has not made any contributions to this plan.

Effective November 5, 1998, the Company implemented a Severance Pay Plan for Program Directors, Associate Program Directors, and Corporate and Regional Office Operations Employees ("the Severance Plan"). The Severance Plan was amended, effective January 1, 2001. This Severance Plan covers certain eligible employees and provides that under specific conditions employees may receive up to 6 months annual base salary as severance pay, depending upon their length of service with the Company and other factors that are defined in the Severance Plan. During the year ended December 31, 1999, the Company paid out benefits of \$19,000 under this plan. No such benefits were paid during the years ended December 31, 1998 and 2000.

### 18. LIQUIDITY

The Company's ability to satisfy its obligations, including payments with respect to its outstanding indebtedness and lease obligations, will depend on future performance, which is subject to its ability to stabilize its operations, and to a certain extent, general economic, financial, competitive, legislative, regulatory and other factors that are beyond its control. The Company made two payments of approximately \$2.3 million each towards its litigation settlement on October 23, 2000 and January 23, 2001 and on November 1, 2000 made its \$4.7 million semi-annual interest payment on its convertible subordinated debentures. The Company is obligated to pay the remaining \$5.6 million related to the litigation settlement in two installments of approximately \$2.3 million each, due on April 23, 2001 and July 23, 2001, with final payment of \$1.0 million due within 90 days following the July 23, 2001 payment. Additionally, the Company's next \$4.7 million semi-annual interest payment on its convertible subordinated debentures is due on May 1, 2001. The Company may also be required to reimburse its insurance carriers for up to \$4.0 million of costs incurred by the carriers in connection with the securityholder litigation, depending on the outcome of a pending dispute over coverage (See Note 16).

The Company believes that its current cash on hand, cash available from operations and financing by Heller (obtained subsequent to year end) will be sufficient to meet its working capital needs through July 2002. However, the Company will have up to \$45.0 million in principal from the Heller financing maturing on

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ASSISTED LIVING CONCEPTS, INC.

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

August 31, 2002 (unless the five wholly owned subsidiaries, which are the borrowers, are able to and do extend the maturity dates for up to three six-month extensions), and have \$161.3 million (less any amounts repurchased with the Heller line of credit) in principal amount of convertible debentures maturing between November 2002 and May 2003. The Company also expects the cost to maintain its long-lived assets in their present condition to increase; however, the Company cannot yet estimate the financial impact since its experience is limited due to the newness of these assets (See Note 19).

The Company is currently exploring various alternatives to address its

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financing needs and the maturities of its long-term debt. The Heller and Red Mortgage financings have been sought to fund potential working capital needs, to fund the cost of the Company's shareholder litigation settlement, the repurchase of 16 of the Company's leased properties and the repurchase of some of its convertible debentures in the open market. The Company expects to replace the Red Mortgage financing with long-term HUD mortgage loans and also expects to replace a substantial portion of the Heller financing with long-term HUD mortgage loans, to the extent the processing time and increasing limitations by HUD on submission of applications and amount financed permit. In addition, the Company is also considering issuing new securities with longer maturities to the holders of its convertible debentures in exchange for some or all of their debentures. The Company has 48 unencumbered residences available to use as collateral for these various alternatives, 47 of which are subject to negative covenants not to encumber them except under certain circumstances, including the use of the net proceeds of the financing which they secure for the reduction of the Company's indebtedness to its convertible debenture holders. No commitments are currently in place and there can be no assurance that the Company's efforts will be successful, in which event the Company will have to consider other alternatives, including reorganization under the bankruptcy laws or raising highly dilutive capital through the issuance of equity or equity-related securities.

### 19. SUBSEQUENT EVENTS

#### Equipment Financing

Effective February 22, 2001, the Company entered into a loan agreement to finance technology equipment in the amount of \$550,000. The agreement required an initial payment of \$150,000 (which has been paid) and monthly payments of \$25,000 (principal and interest) until maturity on August 31, 2002. The loan bears an interest rate of 12.5% and is secured by the related technology equipment which had been purchased in 2000.

#### Heller Financing

On March 2, 2001, the Company entered into an agreement with Heller Healthcare Finance, Inc. for a \$45.0 million line of credit, under which five wholly owned subsidiaries are the jointly and severally liable borrowers of any funds drawn. This line matures on August 31, 2002, requires monthly interest-only payments until maturity. This line bears an interest rate of 3.85% over the three-month LIBOR rate floating monthly and will be secured by up to 32 properties owned by the borrowers and leased to the Company or another of its wholly owned subsidiaries. The Company guaranteed the line. In addition to having paid a commitment fee of \$450,000, the Company is to pay funding fees of 0.5% of the principal amount funded at the time of funding and pay an exit fee of 1.0% of the principal being repaid. The borrowers may elect to exercise up to three six-month extensions of the maturity date, subject to the satisfaction of certain conditions. The Company intends to replace a substantial portion of this financing with long-term HUD financing to the extent the processing time and increasing limitations by HUD on submission of applications and amount financed permit. While the line remains outstanding, the Company has agreed that it will not sell or grant mortgages on its remaining unencumbered properties, except one, unless the net proceeds are used to repurchase the Company's convertible debentures or otherwise reduce its indebtedness (if approved by Heller). Proceeds of the line may be used for the payment of the Company's shareholders' litigation settlement, the repurchase of 16 of its

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leased properties and the repurchase of some of its convertible debentures. The Company made an initial draw of \$1.3 million on this line on March 2, 2001.

20. LISTING STATUS WITH AMERICAN STOCK EXCHANGE (UNAUDITED)

The Company's common stock currently is listed on the American Stock Exchange ("AMEX") under the symbol "ALF," its 5.625% Convertible Subordinated Debentures currently are listed on AMEX under the symbol "ALS5E03" and its 6.0% Convertible Subordinated Debentures currently are listed on AMEX under the symbol "ALS6K02." AMEX recently notified the Company that the Company had fallen below certain of AMEX's continued listing guidelines and that it was reviewing the Company's listing eligibility. In particular, the Company has incurred losses from continued operations for each of its past six fiscal years ending December 31, 2000, and the price per share of the Company's common stock as quoted on AMEX recently has been below the minimum bid price of \$1.00 per share. The Company may choose to effect a reverse stock split in the event that the price of its common stock does not otherwise meet the minimum bid requirement. However, the Company reported a net loss of \$1.51 per basic and diluted share for the year ended December 31, 2000. The Company has provided AMEX with additional information and has been involved in ongoing discussions with AMEX in connection with its review of the Company's listing eligibility. While AMEX has decided not to delist the Company at this time, they will continue to review its listing status on a quarterly basis.

If AMEX were to delist the Company's securities, it is possible that the securities would continue to trade on the over-the-counter markets. However, the extent of the public market for the securities and the availability of quotations would depend upon such factors as the aggregate market value of each class of the securities, the interest in maintaining a market in such securities on the part of securities firms and other factors. There can be no assurance that any public market for the Company's securities will exist in the event that such securities are delisted.

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SIGNATURES

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

ASSISTED LIVING CONCEPTS INC.  
Registrant

March 13, 2000

By: /s/ DREW Q. MILLER

-----  
Name: Drew Q. Miller  
Title: Senior Vice President, Chief  
Financial  
Officer and Treasurer

March 13, 2000

By: /s/ M. CATHERINE MALONEY

-----  
Name: M. Catherine Maloney  
Title: Vice President, Controller  
and  
Chief Accounting Officer

POWER OF ATTORNEY

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KNOW ALL PERSONS BY THESE PRESENTS:

That the undersigned officers and directors of Assisted Living Concepts, Inc. do hereby constitute and appoint Wm. James Nicol or Drew Q. Miller, and each of them, the lawful attorney and agent or attorneys and agents with power and authority to do any and all acts and things and to execute any and all instruments which said attorneys and agents, or either of them, determine may be necessary or advisable or required to enable to comply with the Securities and Exchange Act of 1934, as amended, and any rules or regulations or requirements of the Securities and Exchange Commission in connection with this Annual Report on Form 10-K. Without limiting the generality of the foregoing power and authority, the powers granted include the power and authority to sign the names of the undersigned officers and directors in the capacities indicated below to this Annual Report on Form 10-K or amendment or supplements thereto, and each of the undersigned hereby ratifies and confirms all that said attorneys and agent, or either of them, shall do or cause to be done by virtue hereof. This Power of Attorney may be signed in several counterparts.

IN WITNESS WHEREOF, each of the undersigned has executed this Power of Attorney as of the dated indicated opposite his or her name.

PURSUANT TO THE REQUIREMENTS OF THE SECURITIES AND EXCHANGE ACT OF 1934, THE REPORT HAS BEEN SIGNED BELOW BY THE FOLLOWING PERSONS ON BEHALF OF THE REGISTRANT AND IN THE CAPACITIES AND ON THE DATES INDICATED.

SIGNATURE -----	TITLE -----	DATE -----
/s/ WM. JAMES NICOL ----- Wm. James Nicol	Chairman, President and Chief Executive Officer	March 13,
/s/ DREW Q. MILLER ----- Drew Q. Miller	Senior Vice President, Chief Financial Officer and Treasurer	March 13,
/s/ M. CATHERINE MALONEY ----- M. Catherine Maloney	Vice President, Controller and Chief Accounting Officer	March 13,

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SIGNATURE -----	TITLE -----	DATE -----
/s/ JOHN M. GIBBONS ----- John M. Gibbons	Director and Vice Chairman	March 13,
/s/ RICHARD C. LADD ----- Richard C. Ladd	Director	March 13,
/s/ JILL M. KRUEGER -----	Director	March 13,

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Jill M. Krueger

/s/ BRUCE E. TOLL

Director

March 13,

Bruce E. Toll

/s/ LEONARD TANNENBAUM

Director

March 13,

Leonard Tannenbaum

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SCHEDULE II

ASSISTED LIVING CONCEPTS, INC.

VALUATION AND QUALIFYING ACCOUNTS  
YEARS ENDED DECEMBER 31, 1998, 1999 AND 2000  
(IN THOUSANDS)

COLUMN A ----- DESCRIPTION -----	COLUMN B ----- BALANCE AT BEGINNING OF YEAR -----	COLUMN C ----- ADDITIONS -----	COLUMN D ----- DEDUCTIONS (1) -----	COLUMN E ----- BALANCE AT END OF YEAR -----
Year ended December 31, 1998:				
Valuation accounts deducted from assets:				
Allowance for doubtful receivables.....	\$ 79	\$ 359	\$ 259	
Year ended December 31, 1999:				
Valuation accounts deducted from assets:				
Allowance for doubtful receivables.....	\$ 179	\$1,071 (2)	\$ 188	
Year ended December 31, 2000:				
Valuation accounts deducted from assets:				
Allowance for doubtful receivables.....	\$1,062	\$1,932	\$1,595	

-----  
(1) Represents amounts written off.

(2) \$561,000 of additions were charged to operating expenses, \$510,000 of additions related to home health operations which were discontinued and are reported in general and administrative expenses in 1999.

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ASSISTED LIVING CONCEPTS, INC. AND SUBSIDIARIES

INDEX TO EXHIBITS

EXHIBIT

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NO. -----	DESCRIPTION -----
3.1	Articles of Incorporation of the Company (Incorporated by reference to the same titled exhibit to the Company's Registration Statement on Form S-1, File No. 33-83938).
3.2	By laws of the Company (Incorporated by reference to the same titled exhibit to the Company's Registration Statement on Form S-1, File No. 33-83938).
4.1	Indenture, dated as of October 2, 1997 by and between the Company and Harris Trust and Savings Bank, as Trustee providing for Issuance of Securities in Series. (Incorporated by reference to Exhibit 4.1 to the Company's Report on Form 8-K, dated October 20, 1997, File No. 1-13498).
4.2	Rights Agreement dated as of June 12, 1997, between Assisted Living Concepts, Inc. and American Stock Transfer & Trust Company, as Rights Agent, which includes the form of Certificate of Resolution Establishing Designations, Preferences and Rights of Series A Junior Participating Preferred Stock of Assisted Living Concepts Inc. as Exhibit A, the form of Right Certificate as Exhibit B and the Summary of Rights to Purchase Preferred Shares as Exhibit C (Incorporated by reference to the same titled exhibit to the Company's Report on Form 8-K, dated July 24, 1997, File No. 1-83938).
4.3	Amendment to Registration Rights Agreement, dated as of June 12, 1997, effective as of November 8, 2000.
4.4	Indenture, dated as of April 13, 1998, by and between the Company and Harris Trust and Savings Bank, as Trustee (Incorporated by reference to the same titled exhibit to the Company's Registration Statement on Form S-3, dated May 11, 1998, Registration No. 333-52297).
4.5	Form of Debenture (Incorporated by reference to the same titled exhibit to the Company's Registration Statement on Form S-3, dated May 11, 1998, Registration No. 333-52297).
10.1	Indemnification Agreement dated October 3, 1997 by and between the Company and Keren Brown Wilson. (Incorporated by reference to the same titled exhibit to the Company's Report on Form 8-K, dated October 20, 1997, File No. 1-13498).
10.2	Amended and Restated 1994 Stock Option Plan of the Company (Incorporated by reference to the same titled exhibit to the Company's Report on Form 8-K, dated October 20, 1997, File No. 1-13498).
10.3	Non-Executive Employee Equity Participation Plan of the Company (Incorporated by reference to the same titled exhibit to the Company's Registration Statement on Form S-8, dated July 13, 1998, Registration No. 333-58953).
10.4	Deferred Compensation Plan of the Company (Incorporated by reference to the same titled exhibit to the Company's Report on Form 10-K for the fiscal year ended December 31, 1998).
10.5	Amended and Restated Employment Agreement, dated October 1999, as amended as of March 15, 1999, by and between the Company and Keren Brown Wilson (Incorporated by reference to the same titled exhibit to the Company's Report on Form 10-K for the fiscal year ended December 31, 1998).
10.6	Employment Agreement, dated as of December 31, 1997, by and between the Company and Sandra Campbell (Incorporated by reference to the same titled exhibit to the Company's Report on Form 10-K for the fiscal year ended December 31, 1998).
10.7	Employment Agreement, dated as of February 3, 1998, by and between the Company and Nancy Gorshe (Incorporated by

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- reference to the same titled exhibit to the Company's Report on Form 10-K for the fiscal year ended December 31, 1998).
- 10.8 Separation and Consulting Agreement, dated as of March 3, 2000, by and between the Company and James Cruckshank (Incorporated by reference to the same titled exhibit to the Company's Report on Form 8-K dated March 3, 2000 File No. 001-13498).

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EXHIBIT NO. -----	DESCRIPTION -----
10.10	Employment Agreement, dated as of March 15, 1999, by and between the Company and Leslie Mahon (Incorporated by reference to the same titled exhibit to the Company's Report on Form 10-K for the fiscal year ended December 31, 1998).
10.11	Reimbursement Agreement, dated as of November 1, 1996, between the Company and U.S. Bank of Washington, National Association (Incorporated by reference to the same titled exhibit to the Company's Report on Form 10-K for the fiscal year ended December 31, 1998).
10.12	Reimbursement Agreement, dated as of July 1, 1997, between the Company and United States National Bank of Oregon (Incorporated by reference to the same titled exhibit to the Company's Report on Form 10-K for the fiscal year ended December 31, 1998).
10.13	Reimbursement Agreement, dated as of July 1, 1998, between the Company and U.S. Bank National Association (Incorporated by reference to the same titled exhibit to the Company's Report on Form 10-K for the fiscal year ended December 31, 1998).
10.14	Deed of Trust and Security Agreement, dated March 31, 1998, among DMG Texas ALC, Partners, L.P., American Title Company of Houston and Transatlantic Capital Company (Incorporated by reference to the same titled exhibit to the Company's Report on Form 10-K for the fiscal year ended December 31, 1998).
10.15	Mortgage and Security Agreement, dated November 12, 1998, between DMG New Jersey ALC, Inc. and Transatlantic Capital Company (Incorporated by reference to the same titled exhibit to the Company's Report on Form 10-K for the fiscal year ended December 31, 1998).
10.16	Deed of Trust and Security Agreement, dated July 10, 1998, among DMG Oregon ALC, Inc., Chicago Title Company and Transatlantic Capital Company (Incorporated by reference to the same titled exhibit to the Company's Report on Form 10-K for the fiscal year ended December 31, 1998).
10.17	Loan Agreement, dated as of September 3, 1998, by and between MLD Delaware Trust and the Company (Incorporated by reference to the same titled exhibit to the Company's Report on Form 10-K for the fiscal year ended December 31, 1998).
10.18	Loan Agreement, dated as of September 3, 1998, by and between MLD Delaware Trust and the Company (Incorporated by reference to the same titled exhibit to the Company's Report on Form 10-K for the fiscal year ended December 31, 1998).
10.19	Amendment and Modification of Reimbursement Agreements,



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- dated as of August 18, 1999, by and between the Company and U.S. Bank National Association (Incorporated by reference to the same titled exhibit to the Company's Report on Form 10-K for the fiscal year ended December 31, 1998).
- 10.20 Modification and Amendment to Employment Agreement, dated as of January 19, 2000, by and between the Company and Nancy Inez Gorshe.
  - 10.21 Modification and Amendment to Employment Agreement, dated as of January 1, 2000, by and between the Company and Sandra Campbell.
  - 10.22 Employment Agreement, dated as of November 1, 2000, by and between the Company and Wm. James Nicol.
  - 10.23 Loan Agreement, dated as of February 20, 2001, among Heller Healthcare Finance, Inc., as Agent and a Lender, the financial institutions who are or become parties thereto as Lenders, ALC Ohio, Inc. and ALC Pennsylvania, Inc., ALC Iowa, Inc., ALC Nebraska, Inc. and ALC New Jersey, Inc., as Borrowers, and the parties who are or become Borrowers thereunder. (Incorporated by reference to the same titled exhibit to the Company's Report on Form 8-K, dated May 9, 2001).
  - 10.24 Guaranty, dated as of February 20, 2001, by Assisted Living Concepts, Inc., for the benefit of Heller Healthcare Finance, Inc. (Incorporated by reference to the same titled exhibit to the Company's Report on Form 8-K, dated May 9, 2001).
  - 10.25 Third Amendment and Modification of Reimbursement Agreement, dated as of March 12, 2001, between the Company and U.S. Bank National Association.

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EXHIBIT

NO.

DESCRIPTION

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- 10.26 First Amendment to the Non-Executive Employee Equity Participation Plan (Incorporated by reference to the same titled exhibit to the Company's Registration Statement on Form S-8, dated March 12, 2001, Registration No. 333-56920).
- 12.1 Computation of Ratio of Earnings to Fixed Charges.
- 23.1 Report on Schedule and Consent of KPMG LLP.

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