

CORRECTIONS CORP OF AMERICA

Form 8-K

July 24, 2003

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**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION**

WASHINGTON, D.C. 20549

FORM 8-K

CURRENT REPORT

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

Date of Report (Date of earliest event reported): July 18, 2003 (July 17, 2003)

Corrections Corporation of America

(Exact name of registrant as specified in its charter)

Maryland

001-16109

62-1763875

(State or other jurisdiction of incorporation)

(Commission File Number)

(Employer Identification No.)

10 Burton Hills Boulevard, Nashville, Tennessee 37215

(Address of principal executive offices, including zip code)

Registrant's telephone number, including area code: (615) 263-3000

Not Applicable

(Former name or former address, if changed since last report)

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ITEM 5. Other Events and Regulation FD Disclosure.

Corrections Corporation of America, a Maryland corporation (the Company), is reissuing its consolidated financial statements as of December 31, 2002 and 2001 and for the two years ended December 31, 2002 to include the reclassification of the 2002 and 2001 financial information of the Okeechobee Juvenile Offender Correctional Center and The Lawrenceville Correctional Center, both of which had management contracts that expired during the first quarter of 2003 and which were not renewed, as discontinued operations under Statement of Financial Accounting Standards No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets* (SFAS 144). SFAS 144 requires that previously issued financial statements presented for comparative purposes be reclassified, if material, to reflect the application of provisions of SFAS 144. In accordance with SFAS 144, the Company has reclassified the 2002 and 2001 financial information to present its discontinued operations.

In April 2002, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 145, *Rescission of FASB Statements No. 4, 44, and 64, Amendment of FASB Statement No. 13, and Technical Corrections*, or SFAS 145. SFAS 145 rescinds Statement of Financial Accounting Standards No. 4, *Reporting Gains and Losses from Extinguishment of Debt*, which required all gains and losses from extinguishment of debt to be aggregated and, if material, classified as an extraordinary item, net of the related income tax effect. The provisions of SFAS 145 are effective for financial statements issued for fiscal years beginning after May 15, 2002, and interim periods within those fiscal years. During May 2002, the Company reported an extraordinary charge of \$36.7 million associated with a comprehensive refinancing of its senior indebtedness. Under SFAS 145, any gain or loss on extinguishment of debt that was classified as an extraordinary item in prior periods that does not meet the criteria in Accounting Principles Board Opinion No. 30, *Reporting the Results of Operations - Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual, and Infrequently Occurring Events and Transactions*, for classification as an extraordinary item shall be reclassified. Accordingly, the Company reclassified the extraordinary charge to a component of income from continuing operations before cumulative effect of accounting change in the accompanying financial statements reissued for the year ended December 31, 2002.

The reclassifications have no effect on the Company's reported income (loss) available to common stockholders.

The reissued consolidated financial statements also include Note 21 for events subsequent to December 31, 2002.

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MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion should be read in conjunction with the financial statements and notes thereto appearing elsewhere in this report.

This current report on Form 8-K contains statements as to our beliefs and expectations of the outcome of future events that are forward-looking statements as defined within the meaning of the Private Securities Litigation Reform Act of 1995. All statements other than statements of current or historical fact contained herein, including statements regarding our future financial position, business strategy, budgets, projected costs and plans and objectives of management for future operations, are forward-looking statements. The words anticipate, believe, continue, estimate, expect, intend, may, plan, projects, will, and similar expressions, as they relate to us, are intended to identify forward-looking statements. Forward-looking statements are subject to risks and uncertainties that could cause actual results to differ materially from the statements made. These include, but are not limited to, the risks and uncertainties associated with:

fluctuations in operating results because of changes in occupancy levels, competition, increases in cost of operations, fluctuations in interest rates and risks of operations;

changes in the privatization of the corrections and detention industry and the public acceptance of our services;

our ability to obtain and maintain correctional facility management contracts, including as the result of sufficient governmental appropriations, and the timing of the opening of new facilities;

changes in government policy and in legislation and regulation of the corrections and detention industry that adversely affect our business;

the availability of debt and equity financing on terms that are favorable to us;

tax related risks, particularly with respect to our operation so as to preserve our ability to qualify as a real estate investment trust for the year ended December 31, 1999; and

general economic and market conditions.

Any or all of our forward-looking statements in this report may turn out to be inaccurate. We have based these forward-looking statements largely on our current expectations and projections about future events and financial trends that we believe may affect our financial condition, results of operations, business strategy and financial needs. They can be affected by inaccurate assumptions we might make or by known or unknown risks, uncertainties and assumptions, including the risks, uncertainties and assumptions described in risk factors disclosed in detail in our annual report on Form 10-K for the fiscal year ended December 31, 2002, filed with the Securities and Exchange Commission (the SEC) on March 28, 2003 (File No. 001-16109) (the 2002 Form 10-K) and in other reports we file with the SEC from time to time. Readers are cautioned not to place undue reliance on these forward-looking statements, which speak only as of the date hereof. We undertake no obligation to publicly revise these forward-looking statements to reflect events or circumstances occurring after the date hereof or to reflect the occurrence of unanticipated events. All subsequent written and oral forward-looking statements attributable to us or persons acting on our behalf are expressly qualified in their entirety by the cautionary statements contained in this report and in the 2002 Form 10-K.

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OVERVIEW

The Company

We are the nation's largest owner and operator of privatized correctional and detention facilities and one of the largest prison operators in the United States, behind only the federal government and four states. As of December 31, 2002, we owned 40 correctional, detention and juvenile facilities, three of which we lease to other operators, and one additional facility which is not yet in operation. As of December 31, 2002, we operated 60 facilities (including 37 facilities that we owned), with a total design capacity of approximately 59,000 beds in 21 states and the District of Columbia.

We specialize in owning, operating and managing prisons and other correctional facilities and providing inmate residential and prisoner transportation services for governmental agencies. In addition to providing the fundamental residential services relating to inmates, our facilities offer a variety of rehabilitation and education programs, including basic education, religious services, life skills and employment training and substance abuse treatment. These services are intended to reduce recidivism and to prepare inmates for their successful re-entry into society upon their release. We also provide health care (including medical, dental and psychiatric services), food services and work and recreational programs.

Our website address is www.correctionscorp.com. We make our Form 10-K, Form 10-Q, and Form 8-K reports available on our website, free of charge, as soon as reasonably practicable after these reports are filed with or furnished to the SEC. Information contained on our website is not part of this report.

CRITICAL ACCOUNTING POLICIES

The consolidated financial statements are prepared in conformity with accounting principles generally accepted in the United States. As such, we are required to make certain estimates, judgments and assumptions that we believe are reasonable based upon the information available. These estimates and assumptions affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the reporting period. A summary of our significant accounting policies is described in Note 3 to our financial statements. The significant accounting policies and estimates which we believe are the most critical to aid in fully understanding and evaluating our reported financial results include the following:

Asset impairments. As of December 31, 2002, we had approximately \$1.6 billion in long-lived assets. We evaluate the recoverability of the carrying values of our long-lived assets, other than intangibles, when events suggest that an impairment may have occurred. In these circumstances, we utilize estimates of undiscounted cash flows to determine if an impairment exists. If an impairment exists, it is measured as the amount by which the carrying amount of the asset exceeds the estimated fair value of the asset.

Goodwill impairments. Effective January 1, 2002, we adopted Statement of Financial Accounting Standards No. 142, Goodwill and Other Intangible Assets, or SFAS 142, which established new accounting and reporting requirements for goodwill and other intangible assets. Under SFAS 142, all goodwill amortization ceased effective January 1, 2002 (for the year ended December 31, 2001 goodwill amortization was \$7.6 million) and goodwill attributable to each of our reporting units was tested for impairment by comparing the fair value of each reporting unit with its carrying value. Fair value was determined using a collaboration of various common valuation techniques, including market multiples, discounted cash flows, and replacement cost methods. These impairment tests are required to be performed at adoption of SFAS 142 and at least annually thereafter. On an ongoing basis (absent any impairment indicators), we expect to continue to perform our impairment tests during the fourth quarter, in connection with our annual budgeting process.

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Based on our initial impairment tests, we recognized an impairment of \$80.3 million to write-off the carrying value of goodwill associated with our locations included in the owned and managed reporting segment during the first quarter of 2002. This goodwill was established in connection with the acquisition of Correctional Management Services Corporation, which is referred to herein as Operating Company. The remaining goodwill, which is associated with the facilities we manage but do not own, was deemed to be not impaired, and remains recorded on the balance sheet at December 31, 2002. This remaining goodwill was established in connection with the acquisitions of Prison Management Services, Inc., or PMSI, and Juvenile and Jail Facility Management Services, Inc., or JJFMSI, both of which were privately-held service companies which are referred to herein as the Service Companies, that managed certain government-owned adult and juvenile prison and jail facilities. The implied fair value of goodwill of the locations included in the owned and managed reporting segment did not support the carrying value of any goodwill, primarily due to the highly leveraged capital structure. No impairment of goodwill allocated to the locations included in the managed-only reporting segment was deemed necessary, primarily because of the relatively minimal capital expenditure requirements, and therefore indebtedness, in connection with obtaining such management contracts. Under SFAS 142, the impairment recognized at adoption of the new rules was reflected as a cumulative effect of accounting change in our statement of operations for the first quarter of 2002. Impairment adjustments recognized after adoption, if any, are required to be recognized as operating expenses.

Income taxes. As of December 31, 2002, we had approximately \$141.4 million in gross deferred tax assets. Deferred income taxes reflect the net tax effect of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes. Realization of the future tax benefits related to deferred tax assets is dependent on many factors, including our ability to generate taxable income within the net operating loss carryforward period. Since the change in tax status in connection with the restructuring in 2000, and as of December 31, 2002, we have provided a valuation allowance to substantially reserve the deferred tax assets in accordance with Statement of Financial Accounting Standards No. 109, Accounting for Income Taxes, or SFAS 109. The valuation allowance is recognized based on the weight of available evidence indicating that it is more likely than not that the deferred tax assets will not be realized. This evidence primarily consists of, but is not limited to, recurring operating losses for federal tax purposes.

Our assessment of the valuation allowance could change in the future based upon our actual and projected taxable income. Removal of the valuation allowance in whole or in part would result in a non-cash reduction in income tax expense during the period of removal. In addition, because a portion of the valuation allowance as of December 31, 2002 was established to reserve certain deferred tax assets upon the acquisitions of PMSI and JJFMSI, in accordance with SFAS 109, removal of the valuation allowance would result in a reduction to any remaining goodwill recorded in connection with such acquisitions to the extent the reversal relates to the valuation allowance applied to deferred tax assets existing at the date PMSI and JJFMSI were acquired. If the valuation allowance as of December 31, 2002 were to be removed in its entirety, the reduction to goodwill would amount to approximately \$4.5 million. To the extent no valuation allowance is established for our deferred tax assets, future financial statements would reflect a provision for income taxes at the applicable federal and state tax rates on income before taxes.

On October 24, 2002, we entered into a definitive settlement with the Internal Revenue Service, or the IRS, in connection with the IRS's audit of our predecessor's 1997 federal income tax return. Under the terms of the settlement, in consideration for the IRS's final determinations with respect to the 1997 tax year, in December 2002 we paid approximately \$52.2 million in cash to satisfy federal and state taxes and interest.

Pursuant to the terms of the settlement, the audit adjustments agreed to for the 1997 tax year did not trigger any additional distribution requirements by us in order to preserve our status as a real estate investment trust for federal income tax purposes for the 1999 tax year. The adjustments will, however,

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serve to increase our accumulated earnings and profits in 2002 and therefore will affect the taxability of dividends paid on our Series A and Series B Preferred Stock in 2002 and later years.

In addition, due to a change in tax law created by the Job Creation and Worker Assistance Act of 2002, which was signed into law in March 2002, the settlement created an opportunity to utilize any 2002 tax losses to claim a refund of a portion of the taxes paid. We experienced tax losses during 2002 primarily resulting from a cumulative effect of accounting change in depreciable lives for tax purposes. Under terms of the new law, we utilized our net operating losses to offset taxable income generated in 1997, which was increased substantially in connection with the settlement with the IRS. As a result of the tax law change in 2002, combined with the adoption of an accounting change in the depreciable lives of certain tax assets, as of December 31, 2002, we were due an income tax refund of approximately \$32.1 million, which was received during the second quarter of 2003. While we do not currently expect the IRS to challenge the deduction associated with the change in depreciable lives of certain tax assets, the disallowance of all or a substantial portion of this deduction by the IRS would have a material adverse impact on our results of operations and expected cash flows.

The cumulative effect of accounting change in tax depreciation resulted in the establishment of a significant deferred tax liability for the tax effect of the book over tax basis of certain assets. The creation of such a deferred tax liability, and the improvement in our tax position since the original valuation allowance was established to reserve our deferred tax assets, resulted in the reduction of the valuation allowance, generating an income tax benefit of approximately \$30.3 million during the fourth quarter of 2002, as we determined that substantially all of these deferred tax liabilities will be utilized to offset the reversal of deferred tax assets during the net operating loss carryforward periods. We continue to evaluate additional tax strategies to maximize the opportunities created by the new law, which could result in an additional income tax refund and income tax benefits, although we can provide no assurance that any such tax strategies will come to fruition.

The IRS has also completed auditing our federal tax return for the taxable year ended December 31, 2000. The IRS has proposed the disallowance of a loss we claimed as the result of our forgiveness in September 2000 of certain indebtedness of Operating Company. This finding is currently being protested with the Appeals Office of the IRS. In the event, after seeking all available remedies, the IRS is to prevail, we will be required to pay the IRS in excess of \$56.0 million in cash plus potential penalties and interest. This adjustment would also substantially eliminate our net operating loss carryforward. We believe that we have meritorious defenses of our positions. We have not established a reserve for this matter. However, no assurance can be given that the IRS will not make such an assessment and prevail in any such claim against us.

Self-funded insurance reserves. As of December 31, 2002, we had approximately \$25.6 million in accrued liabilities for employee health, workers' compensation, and automobile insurance. We are significantly self-insured for employee health, workers' compensation, and automobile liability insurance. As such, our insurance expense is largely dependent on claims experience and our ability to control our claims. We have consistently accrued the estimated liability for employee health insurance based on our history of claims experience and time lag between the incident date and the date the cost is paid by us. We have accrued the estimated liability for workers' compensation and automobile insurance based on a third-party actuarial valuation of the outstanding liabilities. These estimates could change in the future.

Legal reserves. As of December 31, 2002, we had approximately \$20.7 million in accrued liabilities for litigation for certain legal proceedings in which we are involved. We have accrued our estimate of the probable costs for the resolution of these claims based on a range of potential outcomes. In addition, we are subject to current and potential future legal proceedings for which little or no accrual has been reflected because our current assessment of the potential exposure is nominal. These estimates have

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been developed in consultation with our General Counsel's office and, as appropriate, outside counsel handling these matters, and are based upon an analysis of potential results, assuming a combination of litigation and settlement strategies. It is possible, however, that future cash flows and results of operations could be materially affected by changes in our assumptions, new developments, or by the effectiveness of our strategies.

LIQUIDITY AND CAPITAL RESOURCES

Our principal capital requirements are for working capital, capital expenditures and debt service payments. Capital requirements may also include cash expenditures associated with our outstanding commitments and contingencies, as further described in the notes to our financial statements. In addition, we may incur capital expenditures to expand the design capacity of our facilities in order to retain management contracts, or when the economics of an expansion are compelling. In addition, with lender consent, we may acquire additional correctional facilities that we believe have favorable investment returns and increase value to our stockholders. We have financed, and intend to continue to finance, the working capital and capital expenditure requirements with existing cash balances and net cash provided by operations, although we may also utilize our senior bank credit facility, as further described below. We may also sell non-strategic assets and apply the net proceeds to pay-down our outstanding indebtedness.

As of December 31, 2002, our liquidity was provided by cash on hand of approximately \$65.4 million and \$58.0 million available under the \$75.0 million revolving portion of our senior bank credit facility. During the year ended December 31, 2002, we generated \$101.4 million in cash through operating activities, and as of December 31, 2002, we had net working capital of \$68.4 million, including an income tax refund receivable of \$32.1 million, which was received during the second quarter of 2003. We currently expect to be able to meet our cash expenditure requirements for the next year.

During the fourth quarter of 2000, as a result of our financial condition existing at that time, including: (i) the pending maturity of the loans under the then existing senior secured bank credit facility, referred to herein as the Old Senior Bank Credit Facility; (ii) our negative working capital position; and (iii) our highly leveraged capital structure, our new management conducted strategic assessments; developed revised financial projections; evaluated the utilization of existing facilities, projects under development and excess land parcels; identified certain of these non-strategic assets for sale; and identified various potential transactions that could improve our financial position.

During 2001, we were successful in repositioning our capital structure for a comprehensive refinancing of our senior indebtedness, including primarily the Old Senior Bank Credit Facility. We paid-down \$189.0 million in total debt through a combination of \$138.7 million in cash generated from asset sales and internally generated cash. We improved operating margins, increased occupancy rates, and settled a number of significant outstanding legal matters on terms we believe were favorable.

In May 2001, we completed a one-for-ten reverse stock split of our common stock, which satisfied a condition of continued listing of our common stock on the New York Stock Exchange, or NYSE. During December 2001, we completed an amendment and restatement of our Old Senior Bank Credit Facility. As part of the December 2001 amendment and restatement, the existing \$269.4 million revolving portion of the Old Senior Bank Credit Facility, which was to mature on January 1, 2002, was replaced with a term loan of the same amount maturing on December 31, 2002, to coincide with the maturity of the other loans under the Old Senior Bank Credit Facility. Pursuant to terms of the December 2001 amendment and restatement, all loans under the Old Senior Bank Credit Facility accrued interest at a variable rate of 5.5% over LIBOR, or 4.5% over the base rate, at our option.

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As a result of the December 2001 amendment and restatement, certain financial and non-financial covenants of the Old Senior Bank Credit Facility were amended, including the removal of prior restrictions on our ability to pay cash dividends on shares of our Series A Preferred Stock. Under the terms of the December 2001 amendment and restatement, we were permitted to pay quarterly dividends, when declared by the board of directors, on the shares of Series A Preferred Stock, including all dividends in arrears. On December 13, 2001, our board of directors declared a cash dividend on the shares of Series A Preferred Stock for the fourth quarter of 2001, and for all five quarters then unpaid and in arrears, payable on January 15, 2002 to the holders of record of Series A Preferred Stock on December 31, 2001. As a result of the board's declaration, we paid an aggregate of \$12.9 million to holders of the Series A Preferred Stock in January 2002.

We believed, and continue to believe, that a short-term extension of the revolving portion of our Old Senior Bank Credit Facility was in our best interest for a longer-term financing strategy, particularly due to difficult market conditions for the issuance of debt securities following the terrorist attacks on September 11, 2001, and during the fourth quarter of 2001. Additionally, we believed that certain terms of the December 2001 amendment and restatement, including primarily the removal of prior restrictions to pay cash dividends on our shares of Series A Preferred Stock, including all dividends in arrears, would result in an improvement to our credit ratings, thereby enhancing the terms of a more comprehensive refinancing.

After completing the amendment and restatement of the Old Senior Bank Credit Facility in December 2001, Moody's Investors Service upgraded the rating on our senior secured debt to B2 from B3, our senior unsecured debt to B3 from Caa1, and our preferred stock to Caa2 from Ca

Refinancing of Senior Indebtedness

On May 3, 2002, we completed a comprehensive refinancing of our senior indebtedness through the refinancing of our Old Senior Bank Credit Facility and the sale and issuance of \$250.0 million aggregate principal amount of 9.875% unsecured senior notes due 2009, referred to herein as the 9.875% Senior Notes. The proceeds from the sale of the 9.875% Senior Notes were used to repay a portion of amounts outstanding under the Old Senior Bank Credit Facility, to redeem approximately \$89.2 million of our existing \$100.0 million 12% Senior Notes due 2006, referred to herein as the 12% Senior Notes, pursuant to a tender offer and consent solicitation, and to pay related fees and expenses. Upon the completion of the refinancing, Moody's Investors Service upgraded its rating of our senior secured debt to B1 from B2, our senior unsecured debt to B2 from B3, and our preferred stock to Caa1 from Caa2, and Standard & Poor's upgraded our corporate credit rating and its rating of our senior secured debt to B+ from B and our senior unsecured debt to B- from CCC+.

Interest on the 9.875% Senior Notes accrues at the stated rate and is payable semi-annually on May 1 and November 1 of each year. The 9.875% Senior Notes mature on May 1, 2009. At any time before May 1, 2005, we may redeem up to 35% of the notes with the net proceeds of certain equity offerings, as long as 65% of the aggregate principal amount of the notes remains outstanding after the redemption. We may redeem all or a portion of the 9.875% Senior Notes on or after May 1, 2006. Redemption prices are set forth in the indenture governing the 9.875% Senior Notes. The 9.875% Senior Notes are guaranteed on an unsecured basis by all of our domestic subsidiaries.

The indenture governing the 9.875% Senior Notes contains certain customary covenants that, subject to certain exceptions and qualifications, restrict our ability to, among other things: make restricted payments; incur additional debt or issue certain types of preferred stock; create or permit to exist certain liens; consolidate, merge or transfer all or substantially all of our assets; and enter into transactions with affiliates. In addition, if we sell certain assets (and generally do not use the proceeds of such sales for certain specified purposes) or experience specific kinds of changes in control, we must offer to

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repurchase all or a portion of the 9.875% Senior Notes. The offer price for the 9.875% Senior Notes in connection with an asset sale would be equal to 100% of the aggregate principal amount of the notes repurchased plus accrued and unpaid interest and liquidated damages, if any, on the notes repurchased to the date of purchase. The offer price for the 9.875% Senior Notes in connection with a change in control would be 101% of the aggregate principal amount of the notes repurchased plus accrued and unpaid interest and liquidated damages, if any, on the notes repurchased to the date of purchase. The 9.875% Senior Notes are also subject to certain cross-default provisions with the terms of our other indebtedness.

As part of the refinancing, we obtained a new \$715.0 million senior secured bank credit facility, referred to herein as the New Senior Bank Credit Facility, which replaced the Old Senior Bank Credit Facility. Lehman Commercial Paper Inc. serves as administrative agent under the new facility, which was comprised of a \$75.0 million revolving loan with a term of approximately four years, referred to herein as the Revolving Loan, a \$75.0 million term loan with a term of approximately four years, referred to herein as the Term Loan A Facility, and a \$565.0 million term loan with a term of approximately six years, referred to herein as the Term Loan B Facility. The Term Loan B Facility was expanded by \$30.0 million during January of 2003 in connection with the purchase of the Crowley County Correctional Facility. All borrowings under the New Senior Bank Credit Facility bear interest at a base rate plus 2.5%, or LIBOR plus 3.5%, at our option. The applicable margin for the Revolving Loan and the Term Loan A Facility is subject to adjustment based on our leverage ratio. We are also required to pay a commitment fee on the difference between committed amounts and amounts actually utilized under the Revolving Loan equal to 0.50% per year subject to adjustment based on our leverage ratio.

Prepayments of loans outstanding under the New Senior Bank Credit Facility are permitted at any time without premium or penalty, upon the giving of proper notice. In addition, we are required to prepay amounts outstanding under the New Senior Bank Credit Facility in an amount equal to: (i) 50% of the net cash proceeds from any sale or issuance of our equity securities or any equity securities of our subsidiaries, subject to certain exceptions; (ii) 100% of the net cash proceeds from any incurrence of additional indebtedness (excluding certain permitted debt), subject to certain exceptions; (iii) 100% of the net cash proceeds from any sale or other disposition by us, or any of our subsidiaries, of any assets, subject to certain exclusions and reinvestment provisions and excluding certain dispositions in the ordinary course of business; and (iv) 50% of our excess cash flow (as such term is defined in the New Senior Bank Credit Facility) for each fiscal year. For the year ended December 31, 2002, excess cash flow, as defined in the New Senior Bank Credit Facility, totaled \$0.6 million, and was applied to the outstanding balance in 2003.

The credit agreement governing the New Senior Bank Credit Facility requires us to meet certain financial covenants, including, without limitation, a minimum fixed charge coverage ratio, a maximum leverage ratio and a minimum interest coverage ratio. In addition, the New Senior Bank Credit Facility contains certain covenants which, among other things, limit the incurrence of additional indebtedness, investments, payment of dividends, transactions with affiliates, asset sales, acquisitions, capital expenditures, mergers and consolidations, prepayments and modifications of other indebtedness, liens and encumbrances and other matters customarily restricted in such agreements. In addition, the New Senior Bank Credit Facility contains cross-default provisions with our other indebtedness.

The loans and other obligations under the New Senior Bank Credit Facility are guaranteed by each of our domestic subsidiaries. Our obligations under the New Senior Bank Credit Facility and the guarantees are secured by: (i) a perfected first priority security interest in substantially all of our tangible and intangible assets and substantially all of the tangible and intangible assets of our subsidiaries; and (ii) a pledge of all of the capital stock of our domestic subsidiaries and 65% of the capital stock of certain of our foreign subsidiaries.

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Pursuant to the terms of a tender offer and consent solicitation which expired on May 16, 2002, in connection with the refinancing, in May 2002, we redeemed approximately \$89.2 million in aggregate principal amount of our 12% Senior Notes with proceeds from the issuance of the 9.875% Senior Notes. The notes were redeemed at a price of 110% of par, which included a 3% consent payment, plus accrued and unpaid interest to the payment date. In connection with the tender offer and consent solicitation, we received sufficient consents and amended the indenture governing the 12% Senior Notes to delete substantially all of the restrictive covenants and events of default contained therein.

Subsequent to December 31, 2002 and pursuant to an offer to purchase the remaining balance of the 12% Senior Notes dated June 13, 2003, holders of approximately \$7.7 million of the notes tendered their notes at a price of 120% of principal, resulting in a charge of approximately \$1.5 million during the second quarter of 2003. Upon expiration of the offer to purchase on July 11, 2003, approximately \$3.1 million of the 12% Senior Notes remained outstanding. We are currently exploring additional potential transactions to either repay or defease the remaining notes outstanding, which could result in additional charges.

We are required to pay interest and principal upon maturity on the remaining 12% Senior Notes outstanding, in accordance with the original terms of such notes.

In connection with the refinancing, we also terminated an interest rate swap agreement at a price of approximately \$8.8 million. The swap agreement, which fixed LIBOR at 6.51% on outstanding balances of \$325.0 million through its expiration on December 31, 2002, had been entered into in order to satisfy a requirement of the Old Senior Bank Credit Facility. In addition, in order to satisfy a requirement of the New Senior Bank Credit Facility, we purchased an interest rate cap agreement, capping LIBOR at 5.0% on outstanding balances of \$200.0 million through the expiration of the cap agreement on May 20, 2004, for a price of \$1.0 million. The termination of the swap agreement and the purchase of the cap agreement were funded with cash on hand.

As a result of the early extinguishment of the Old Senior Bank Credit Facility and the redemption of substantially all of our 12% Senior Notes, we recorded expenses of approximately \$36.7 million during the second quarter of 2002, which included the write-off of existing deferred loan costs, certain bank fees paid, premiums paid to redeem the 12% Senior Notes, and certain other costs associated with the refinancing.

Recapitalization

On April 2, 2003, we initiated a series of transactions as described below intended to enhance our capital structure and to provide us with additional financing flexibility that we believe will enable us to more effectively execute our business objectives in the future.

Common Stock Offering. On May 7, 2003, we completed the sale and issuance of 6.4 million shares of common stock at a price of \$19.50 per share, resulting in net proceeds of approximately \$117.3 million after the estimated payment of costs associated with the issuance. A selling stockholder also sold 1.2 million shares of common stock in the same offering. In addition, the underwriters exercised an over-allotment option to purchase an additional 1.14 million shares from the selling stockholder. We did not receive any proceeds from the sale of shares from the selling stockholder.

The sales were completed pursuant to a prospectus supplement to a universal shelf registration that was filed with the SEC and declared effective on April 30, 2003 to register \$700.0 million of debt securities, guarantees of debt securities, preferred stock, common stock and warrants that we may issue from time to time.

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Note Offering. Concurrently with the common stock offering, we also completed the sale and issuance of \$250.0 million aggregate principal amount of senior notes under a separate prospectus supplement to the universal shelf registration. The new senior notes pay interest semi-annually at the rate of 7.5% per annum and will mature on May 1, 2011. The new senior notes are senior unsecured obligations and are guaranteed by our domestic subsidiaries.

As described below, proceeds from the common stock and note offerings were used to purchase shares of common stock issued upon the conversion of our \$40.0 million 10% convertible subordinated notes (and to pay accrued interest on the notes to the date of purchase), to purchase shares of our series B preferred stock that were tendered in the tender offer described below, to redeem shares of our series A preferred stock, and to pay-down a portion of the New Senior Bank Credit Facility.

Purchase of Shares of Common Stock Issuable Upon Conversion of the MDP Notes. Pursuant to the terms of an agreement by and among Income Opportunity Fund I, LLC, Millennium Holdings II LLC and Millennium Holdings III LLC, which are collectively referred to herein as MDP, and us, immediately following the completion of the common stock and notes offerings MDP converted the \$40.0 million aggregate principal amount of our convertible subordinated notes due 2008 with a stated rate of 10.0% plus contingent interest, and sold such shares to us. The aggregate purchase price for the 3,362,899 shares of common stock, inclusive of accrued interest of \$15.5 million, was approximately \$81.1 million. The shares purchased from MDP have been cancelled and under the terms of our charter and Maryland law now constitute authorized but unissued shares of our common stock.

Tender Offer for Series B Preferred Stock. On April 2, 2003, we announced an offer to purchase up to 90% of our 4.7 million shares of outstanding series B preferred stock at an offer price (inclusive of all accrued and unpaid dividends) of \$26.00 per share. Promptly following the expiration of the offer to purchase on May 13, 2003, we purchased approximately 3.7 million shares of series B preferred stock for approximately \$97.4 million. The payment of the difference between the tender price (\$26.00) and the liquidation preference (\$24.46) for the shares tendered will be reported as a preferred stock distribution in the second quarter of 2003.

Redemption of Series A Preferred Stock. Immediately following consummation of the common stock and notes offerings, we gave notice to the holders of our outstanding series A preferred stock that we would redeem 4.0 million shares of the 4.3 million shares of series A preferred stock outstanding, at a redemption price equal to \$25.00 per share, plus accrued and unpaid dividends to the redemption date. The redemption was completed in June 2003.

Payments on and Amendments to New Senior Bank Credit Facility. We used the estimated remaining net proceeds of the common stock and notes offerings after application as described above, combined with \$25.3 million of cash on hand, to pay-down \$100.0 million outstanding under the term loan portions of the New Senior Bank Credit Facility. Further, during May 2003, we used cash received from a federal income tax refund to pay-down an additional \$32.0 million outstanding under the term loan portions of the New Senior Bank Credit Facility. In connection with the common stock offering and the notes offering, the requisite lenders under the New Senior Bank Credit Facility consented to the issuance of the new senior notes and the use of all proceeds from the common stock and note offerings to purchase the shares of common stock issuable to MDP, redeem the series A preferred stock and purchase shares of series B preferred stock pursuant to the offer to purchase.

In connection with the consent, we also obtained modification to certain provisions of the New Senior Bank Credit Facility to generally provide us with additional borrowing capacity and operational flexibility, including, but not limited to, (i) providing for a future increase in the revolving credit portion of the facility from \$75.0 million to up to \$110.0 million at our request (subject to the receipt of lender commitments at the time of the increase), (ii) increasing our ability to incur certain indebtedness, (iii)

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increasing our permitted annual capital expenditures, and (iv) increasing our ability to assume indebtedness in connection with, and otherwise complete, acquisitions.

We expect to report a charge to other expenses in the statement of operations during the second quarter of 2003 of approximately \$2.6 million in connection with the tender offer for the series B preferred stock, the redemption of the series A preferred stock, and the write-off of existing deferred loan costs associated with the repayment of the term loan portions of the New Senior Bank Credit Facility made with proceeds from the common stock and note offerings.

On April 3, 2003, Standard & Poor's upgraded its rating of our senior secured debt to BB- from B+ and our senior unsecured debt to B from B-

On May 14, 2003, Moody's Investors Service upgraded its rating of our senior secured debt to Ba3 from B1, our senior unsecured debt to B1 from B2, and our preferred stock to B3 from Caa1.

Operating Activities

Our net cash provided by operating activities for the year ended December 31, 2002, was \$101.4 million, compared with \$92.8 million for the same period in the prior year. Cash provided by operating activities represents the year to date net income or loss plus depreciation and amortization, changes in various components of working capital, adjustments for various non-cash charges, including primarily the cumulative effect of accounting change in 2002 and the change in fair value of the interest rate swap agreement, and the charge related to the comprehensive refinancing completed on May 3, 2002. Income tax refunds of \$30.6 million during the first quarter of 2001 and \$32.2 million during the second quarter of 2002 contributed to the cash generated from operating activities in both years. As previously described herein, we also received an additional income tax refund of approximately \$32.1 million during the second quarter of 2003. The increase in cash provided by operating activities was also due to a significant reduction in interest, primarily resulting from the pay-down of debt balances, the successful refinancing completed in May 2002, and due to lower market interest rates. These increases in cash provided by operating activities were partially offset by the payment of \$52.2 million during the fourth quarter of 2002 in full satisfaction of the settlement with the IRS with respect to our predecessor's 1997 federal income tax return as previously discussed herein.

Investing Activities

Our cash flow used in investing activities was \$9.7 million for the year ended December 31, 2002, and was primarily attributable to capital expenditures during the period of \$17.1 million, net of proceeds received from the sale of our interest in a juvenile facility located in Dallas, Texas, on June 28, 2002, for \$4.3 million. Capital expenditures during 2002 included \$4.8 million for development and redevelopment activities, including primarily expenditures for our McRae Correctional Facility to meet specifications required by the Federal Bureau of Prisons, or BOP, in connection with a new contract award, and \$12.3 million for maintenance capital expenditures incurred for the betterment, renewal or significant repairs that extended the useful life of our correctional facilities, or for new furniture, fixtures and equipment. In addition, we received refunds of restricted cash totaling approximately \$5.2 million primarily used as collateral for workers' compensation claims. We elected to post letters of credit from the sub-facility under the revolving portion of our New Senior Bank Credit Facility to replace the cash collateral on such claims. Our cash flow provided by investing activities was \$130.9 million for the year ended December 31, 2001, and was primarily attributable to the proceeds received from the sales of our Mountain View Correctional Facility, located in Spruce Pine, North Carolina, on March 16, 2001, our Agcroft facility, located in Salford, England, on April 10, 2001, our Pamlico Correctional Facility, located in Bayboro, North Carolina, on June 28, 2001, and our Southern Nevada Women's Correctional Center, located in Las Vegas, Nevada, on October 3, 2001.

Table of Contents**Financing Activities**

Our cash flow used in financing activities was \$72.6 million for the year ended December 31, 2002, compared with \$198.3 million for the same period in the prior year. Proceeds from the issuance on May 3, 2002 of the 9.875% Senior Notes and the New Senior Bank Credit Facility were largely offset by the repayment of the Old Senior Bank Credit Facility and the redemption of substantially all of the 12% Senior Notes. However, we also paid debt issuance costs of \$37.5 million in connection with this comprehensive refinancing, and an additional \$8.8 million to terminate the interest rate swap agreement. Further, during the first quarter of 2002, we paid cash dividends of \$12.9 million on our series A preferred stock for the fourth quarter of 2001 and for all five quarters then in arrears, as permitted under the terms of an amendment to our Old Senior Bank Credit Facility obtained in December 2001. Additionally, we paid \$2.2 million in cash dividends on our series A preferred stock during each of the second, third and fourth quarters of 2002. Net payments on debt during 2001 totaled \$189.0 million and primarily consisted of the net cash proceeds received from the sale of the Mountain View Correctional Facility, the Agecroft facility, the Pamlico Correctional Facility, and the Southern Nevada Women's Correctional Center that were immediately applied to amounts outstanding under the Old Senior Bank Credit Facility. Net payments on debt also included a lump sum payment of \$35.0 million on the Old Senior Bank Credit Facility with cash on hand.

Contractual Obligations

The following schedule summarizes our contractual cash obligations by the indicated period as of December 31, 2002 (in thousands):

	Payments Due By Year Ended December 31,						Total
	2003	2004	2005	2006	2007	Thereafter	
Long-term debt	\$23,054	\$26,068	\$56,834	\$21,841	\$377,138	\$451,024	\$955,959
Contingent interest	17,064					16,726	33,790
Operating leases	1,260	638	91				1,989
Total Contractual Cash Obligations	\$41,378	\$26,706	\$56,925	\$21,841	\$377,138	\$467,750	\$991,738

As the result of a default during 2000 under the terms of our \$40.0 million convertible subordinated notes, we were required to pay the holders of the notes contingent interest sufficient to permit the holders to receive a 15.5% rate of return on such notes, retroactive to the date of issuance of the notes. The contingent interest was to be payable upon each of December 31, 2003 and upon repayment of the notes, unless the holders of the notes elected to convert the notes into common stock under the terms of the note purchase agreement or unless the price of our common stock met or exceeded a target price as defined in the note purchase agreement. As discussed previously, the contingent interest was paid upon the conversion of the notes in May 2003. As a result of MDP's conversion of the notes into common stock, no further contingent interest will be due.

We had \$17.3 million of letters of credit outstanding at December 31, 2002 primarily to support our requirement to repay fees under our workers compensation plan in the event we do not repay the fees due in accordance with the terms of the plan. The letters of credit are renewable annually. We did not have any draws under any outstanding letters of credit during 2002 and 2001.

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For the years ended December 31, 2002 and 2001, our consolidated results of operations and cash flows reflect our results as a business specializing in owning, operating and managing prisons and other correctional facilities and providing prisoner transportation services for governmental agencies.

Our 2002 and 2001 results of operations were impacted by, and the following table sets forth for the years ended December 31, 2002 and 2001, the number of facilities we owned and managed, the number of facilities we managed but did not own, the number of facilities we leased to other operators, and the facilities we owned that were not yet in operation.

	<u>Owned and Managed</u>	<u>Managed Only</u>	<u>Leased</u>	<u>Incomplete</u>	<u>Total</u>
Facilities as of December 31, 2000	40	28	4	2	74
Sale of the Mountain View Correctional Facility	(1)				(1)
Sale of Agecroft Properties, Inc., which owned an interest in the Agecroft facility located in Salford, England	(1)				(1)
Sale of the Pamlico Correctional Facility	(1)				(1)
Termination of the management contract for the Brownfield Intermediate Sanction Facility		(1)			(1)
Sale of the Southern Nevada Women's Correctional Center, and due to the amendment of the previous contract terms, continued management of the facility	(1)	1			
Facilities as of December 31, 2001	36	28	4	2	70
Termination of the management contract for the Southwest Indiana Regional Youth Village		(1)			(1)
Termination of the management contracts for facilities in Puerto Rico		(3)			(3)
Management contract award by the Federal Bureau of Prisons for the McRae Correctional Facility	1			(1)	
Sale of interest in a juvenile facility			(1)		(1)
Termination of the management contract for the Delta Correctional Facility		(1)			(1)
Facilities as of December 31, 2002	37	23	3	1	64

Year Ended December 31, 2002 Compared to Year Ended December 31, 2001

We incurred a net loss available to common stockholders of \$28.9 million, or \$0.82 per diluted share, for the year ended December 31, 2002, compared with net income available to common stockholders of \$5.7 million, or \$0.23 per diluted share, for the year ended December 31, 2001.

The net loss in 2002 resulted from the combined effects of a non-cash charge for the cumulative effect of accounting change for goodwill of \$80.3 million, or \$2.49 per diluted share, related to the adoption of SFAS 142 during the first quarter of 2002 and expenses associated with debt refinancings of \$36.7 million, or \$1.14 per diluted share, incurred in connection with the comprehensive refinancing completed during the second quarter of 2002. Offsetting these charges in 2002 was an aggregate income tax benefit of \$63.3 million, which included a cash income tax benefit of \$32.2 million recognized during the first quarter of 2002 related to a change in tax law that became effective in March 2002, which enabled us to utilize certain of our net operating losses to offset taxable income generated in 1997 and 1996. In addition, approximately \$30.3 million of the income tax benefit in 2002 was due to the reduction of the tax valuation allowance applied to certain deferred tax assets

arising primarily as a result

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of 2002 tax deductions based on a cumulative effect of accounting change for tax depreciation reported on our 2002 federal income tax return. Additionally, net interest expense decreased approximately \$38.8 million during 2002 compared with 2001 due to the comprehensive refinancing completed in May of 2002, as well as the reduction of debt balances outstanding through the sale of fixed assets and internally generated cash, and lower market interest rates.

The net income available to common stockholders during 2001 included a loss from continuing operations after preferred stock distributions of \$3.3 million, or \$0.14 per diluted share, while income from discontinued operations was \$9.0 million, or \$0.37 per diluted share. Contributing to the net income attributable to common stockholders during 2001 was a non-cash gain of \$25.6 million related to the extinguishment of a \$26.1 million promissory note issued in connection with our federal stockholder litigation settlement, as further discussed below under the caption change in fair value of derivative instruments. Results for 2001 also included the non-cash effect of an \$11.1 million charge associated with the accounting for an interest rate swap agreement required under prior terms of the Old Senior Bank Credit Facility.

Facility Operations

A key performance indicator we use to measure the revenue and expenses associated with the operation of the facilities we own or manage is expressed in terms of a compensated man-day, and represents the revenue we generate and expenses we incur for one inmate for one calendar day. Revenue and expenses per compensated man-day are computed by dividing facility revenue and expenses by the total number of compensated man-days during the period. A compensated man-day represents a calendar day for which we are paid for the occupancy of an inmate. We believe the measurement is useful because we are compensated for operating and managing facilities at an inmate per-diem rate based upon actual or minimum guaranteed occupancy levels. We also measure our ability to contain costs on a per-compensated man-day basis, which is largely dependent upon the number of inmates we accommodate. Further, per man-day measurements are also used to estimate our potential profitability based on certain occupancy levels relative to design capacity. Revenue and expenses per compensated man-day for all of the facilities we owned or managed, exclusive of those discontinued (see further discussion below regarding discontinued operations), were as follows for the years ended December 31, 2002 and 2001:

	For the Years Ended December 31,	
	2002	2001
Revenue per compensated man-day	\$ 49.59	\$ 48.37
Operating expenses per compensated man-day:		
Fixed expense	27.82	27.36
Variable expense	10.23	9.74
Total	38.05	37.10
Operating margin per compensated man-day	\$ 11.54	\$ 11.27
Operating margin	23.3%	23.3%
Average compensated occupancy	89.1%	88.0%

Management and other revenue consists of revenue earned from the operation and management of adult and juvenile correctional and detention facilities we own or manage and from our inmate transportation subsidiary, which, for the years ended December 31, 2002 and 2001, totaled \$934.1 million and \$906.2 million, respectively. Business from our federal customers, including the BOP, the United States Marshals Service, or the USMS, and the Bureau of Immigration and Customs Enforcement, or BICE, (formerly known as the Immigration and Naturalization Service, or the INS), remains strong, while many of our state customers are currently experiencing budget difficulties. Our federal customers generated approximately 33% of our total management revenue during 2002, compared with

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approximately 30% during 2001. While the budget difficulties experienced by our state customers present short-term challenges with respect to our per-diem rates resulting in pressure on our management revenue in future quarters, these governmental entities are also constrained with respect to funds available for prison construction. As a result, because we believe inmate populations will continue to rise, we currently expect the lack of new bed supply to lead to higher occupancies in the long-term. In addition, where customers have requested a reduction in per-diem rates, we have been somewhat successful in mitigating the reduction in revenue by obtaining the flexibility to reduce our operating expenses, such as through the reduction in the use of our various program services or through the consolidation of inmates into fewer facilities.

Operating expenses totaled \$721.4 million and \$698.9 million for the years ended December 31, 2002 and 2001, respectively. Operating expenses consist of those expenses incurred in the operation and management of adult and juvenile correctional and detention facilities, and for our inmate transportation subsidiary.

Salaries and benefits represent the most significant component of fixed operating expenses and was the primary cause of the increase in fixed expenses per compensated man-day. During 2002 and 2001, we have incurred wage increases due to tight labor markets for correctional officers and benefit increases due to surging healthcare costs. The increase in salaries and benefits contributed approximately \$0.53 per compensated man-day to the increase in fixed expenses per compensated man-day from \$27.36 during 2001 to \$27.82 during 2002. Further, the turnover rate for correctional officers for our company, and for the corrections industry in general, also remains high. We are developing strategies to reduce our turnover rate, but we can provide no assurance that these strategies will be successful. In addition, ten of our facilities currently have contracts with the federal government requiring that our wage and benefit rates comply with wage determination rates set forth, and as adjusted from time to time, under the Service Contract Act of the U.S. Department of Labor. Our contracts generally provide for reimbursement of a portion of the increased costs resulting from wage determinations in the form of increased per-diems, thereby mitigating the effect of increased salaries and benefits expenses at those facilities. We may also be subject to adverse claims, or government audits, relating to alleged violations of wage and hour laws applicable to us, which may result in adjustments to amounts previously paid as wages and, potentially interest and/or monetary penalties.

We also experienced a trend of increasing insurance expense during 2002 compared with 2001. Because we are significantly self-insured for employee health, workers' compensation, and automobile liability insurance, our insurance expense is dependent on claims experience and our ability to control our claims. Our insurance policies contain various deductibles and stop-loss amounts intended to limit our exposure for individually significant occurrences. However, the nature of our self-insurance provides little protection for a deterioration in claims experience or increasing employee medical costs in general. We continue to incur increasing insurance expense due to adverse claims experience primarily resulting from rising healthcare costs throughout the country. We continue to develop new strategies to improve the management of our future loss claims, but can provide no assurance that these strategies will be successful. Additionally, general liability insurance costs have risen substantially since the terrorist attacks on September 11, 2001, and other types of insurance, such as directors and officers liability insurance, are currently expected to increase due to several recent high profile business failures and concerns about corporate governance and accounting in the marketplace. Unanticipated additional insurance expenses resulting from adverse claims experience or a continued increasing cost environment for general liability and other types of insurance could result in increasing expenses in the future.

During the first quarter of 2001, we hired a General Counsel to manage our existing legal matters and to develop procedures to minimize the incidence of litigation in the future. We have been able to settle numerous cases on terms we believe are favorable. However, variable operating expenses included \$4.9 million during 2002, compared with \$0.3 million during 2001, for an overall increase in potential

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exposure for certain legal proceedings, none of which was individually significant. This increase of \$4.6 million contributed approximately \$0.25 per compensated man-day to the increase in variable expenses per compensated man-day from \$9.74 during 2001 to \$10.23 during 2002. Further, it is possible that future cash flows and results of operations could be materially affected by changes in our assumptions, new developments, or by the effectiveness of our litigation and settlement strategies.

The operation of the facilities we own carries a higher degree of risk associated with a management contract than the operation of the facilities we manage but do not own because we incur significant capital expenditures to construct or acquire facilities we own. Additionally, correctional and detention facilities have a limited or no alternative use. Therefore, if a management contract is terminated with respect to a facility we own, we continue to incur certain operating expenses, such as real estate taxes, utilities, and insurance, that we would not incur if a management contract was terminated for a managed-only facility. As a result, revenue per compensated man-day is typically higher for facilities we own and manage than for managed-only facilities. Because we incur higher expenses, such as repairs and maintenance, real estate taxes, and insurance, with respect to the facilities we own and manage, our cost structure for facilities we own and manage is also higher than the cost structure for the managed-only facilities. The following tables display the revenue and expenses per compensated man-day for the facilities we own and manage and for the facilities we manage but do not own:

	For the Years Ended December 31,	
	2002	2001
Owned and Managed Facilities:		
Revenue per compensated man-day	\$ 54.61	\$53.63
Operating expenses per compensated man-day:		
Fixed expense	29.62	29.16
Variable expense	11.34	11.03
Total	40.96	40.19