



# **Correctional Systems, Inc.**

**Consolidated Financial Statements**  
Years Ended December 31, 2002 and 2001

# Correctional Systems, Inc.

## Contents

<b>Independent Auditors' Report</b>	3
<b>Consolidated Financial Statements</b>	
Consolidated Balance Sheets	4
Consolidated Statements of Operations	5
Consolidated Statements of Shareholders' Equity	6
Consolidated Statements of Cash Flows	7 – 8
Notes to Consolidated Financial Statements	9 – 26

## **Independent Auditors' Report**

To the Board of Directors and Shareholders of  
Correctional Systems, Inc.

We have audited the accompanying consolidated balance sheet of Correctional Systems, Inc. and subsidiaries (the "Company") as of December 31, 2002, and the related consolidated statements of operations, shareholders' equity and cash flows for the year then ended. 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. The consolidated financial statements of Correctional Systems, Inc. and subsidiaries as of and for the year ended December 31, 2001, were audited by other auditors whose report dated April 19, 2002 expressed an unqualified opinion on those consolidated financial statements.

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

In our opinion, the 2002 consolidated financial statements referred to above present fairly, in all material respects, the financial position of Correctional Systems, Inc. and subsidiaries as of December 31, 2002, and the results of their operations and their cash flows for the year then ended, in conformity with accounting principles generally accepted in the United States.

As described in Note 2 to the consolidated financial statements, the Company adopted the provisions of SFAS No. 142, "*Goodwill and Other Intangible Assets*", effective January 1, 2002.

Costa Mesa, California  
April 22, 2003, except as  
to Note 11, which  
is as of May 21, 2003

<i>December 31,</i>	<b>2002</b>	2001
<b>Assets</b>		
Cash	\$ 466,342	\$ 504,472
Accounts receivable, net of allowance for doubtful accounts of \$19,810 and \$25,000, respectively	2,498,083	1,359,029
Other current assets	269,290	117,770
Related party notes and interest receivable	130,333	-
<b>Total current assets</b>	<b>3,364,048</b>	1,981,271
<b>Property and equipment</b>		
Land	321,408	255,278
Buildings and improvements	1,734,197	1,609,939
Furniture and equipment	1,056,228	582,137
Less – accumulated depreciation	(583,686)	(332,295)
<b>Total property and equipment</b>	<b>2,528,147</b>	2,115,059
Related party note and interest receivable	-	123,333
Goodwill	278,624	278,624
Other intangibles, net of accumulated amortization of \$106,260 and \$52,807, respectively	1,228,740	1,282,193
Deposits and other assets	12,797	18,667
	<b>\$ 7,412,356</b>	<b>\$ 5,799,147</b>

# Correctional Systems, Inc.

## Consolidated Balance Sheets

<i>December 31,</i>	<b>2002</b>	<b>2001</b>
<b>Liabilities and Shareholders' Equity</b>		
Line of credit	\$ 600,000	\$ -
Accounts payable	407,193	199,394
Accrued liabilities	384,561	307,813
Accrued compensation	522,633	388,831
Current portion of capital lease obligations	63,535	-
Current portion of long-term debt	270,330	271,596
Deferred revenue	53,433	80,460
Income taxes payable	225,000	-
<b>Total current liabilities</b>	<b>2,526,685</b>	<b>1,248,094</b>
Long-term debt, net of current portion	1,926,340	2,133,507
Capital lease obligations, net of current portion	98,593	-
<b>Total liabilities</b>	<b>4,551,618</b>	<b>3,381,601</b>
Commitments and contingencies		
<b>Shareholders' equity</b>		
Convertible preferred stock, \$.001 par value, 10,000,000 shares authorized, 3,363,636 shares of Series A issued and outstanding (aggregate liquidation preference of \$2,200,000)	3,364	3,364
Common stock, \$.001 par value, 40,000,000 shares authorized, 3,644,400 shares issued and outstanding	3,644	3,644
Additional paid-in capital	3,691,317	3,691,317
Accumulated deficit	(837,587)	(1,280,779)
<b>Total shareholders' equity</b>	<b>2,860,738</b>	<b>2,417,546</b>
<b>Total liabilities and shareholders' equity</b>	<b>\$ 7,412,356</b>	<b>\$ 5,799,147</b>

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

# Correctional Systems, Inc.

## Consolidated Statements of Operations

<i>For the years ended December 31,</i>	<b>2002</b>	<b>2001</b>
<b>Revenues</b>	<b>\$ 14,025,046</b>	<b>\$ 10,366,934</b>
<b>Expenses</b>		
Salaries and wages	<b>6,132,109</b>	4,437,542
Depreciation and amortization	<b>309,983</b>	241,304
Other operating expenses	<b>5,400,740</b>	3,988,960
General and administrative expenses	<b>1,289,243</b>	1,326,123
Impairment of long-lived assets	<b>-</b>	872,249
<b>Total expenses</b>	<b>13,132,075</b>	10,866,178
Operating income (loss)	<b>892,971</b>	(499,244)
<b>Other income (expense)</b>		
Interest income and expense, net	<b>(216,159)</b>	(128,117)
Other income (expenses)	<b>(8,620)</b>	21,188
<b>Total other expense</b>	<b>(224,779)</b>	(106,929)
Income (loss) before provision for income taxes	<b>668,192</b>	(606,173)
Provision for income taxes	<b>225,000</b>	62,821
<b>Net income (loss)</b>	<b>\$ 443,192</b>	<b>\$ (668,994)</b>

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

# Correctional Systems, Inc.

## Consolidated Statements of Shareholders' Equity

	Preferred Stock		Common Stock		Additional	Accumulated	Total
	Shares	Amount	Shares	Amount	Paid-in Capital	Deficit	
<b>Balance, December 31, 2000</b>	3,363,636	\$ 3,364	3,644,400	\$ 3,644	\$ 3,691,317	\$ (611,785)	\$ 3,086,540
Net loss	-	-	-	-	-	(668,994)	(668,994)
<b>Balance, December 31, 2001</b>	3,363,636	3,364	3,644,400	3,644	3,691,317	(1,280,779)	2,417,546
Net income	-	-	-	-	-	443,192	443,192
<b>Balance, December 31, 2002</b>	3,363,636	\$ 3,364	3,644,400	\$ 3,644	\$ 3,691,317	\$ (837,587)	\$ 2,860,738

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

# Correctional Systems, Inc.

## Consolidated Statements of Cash Flows

<i>For the years ended December 31,</i>	<b>2002</b>	<b>2001</b>
<b>Cash flows from operating activities</b>		
Net income (loss)	\$ 443,192	\$ (668,994)
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Depreciation and amortization	309,983	241,304
Impairment of long-lived assets	-	872,249
Gain on sale of fixed assets	-	(2,000)
Gain on discount of note payable	-	(27,549)
Changes in operational assets and liabilities:		
Accounts receivable	(1,139,054)	(216,799)
Other current assets	(151,520)	(69,710)
Deposits and other assets	5,870	9,154
Accounts payable	207,799	5,865
Accrued liabilities	76,748	60,950
Accrued compensation	133,802	132,714
Deferred revenue	(27,027)	(38,519)
Income taxes payable	225,000	(6,658)
Net cash provided by operating at activities	<b>84,793</b>	292,007
<b>Cash flows from investing activities</b>		
Purchase of property and equipment	(414,753)	(1,386,966)
Increase in related party receivable	(7,000)	-
Proceeds on sale of fixed assets	-	2,000
Net cash used in investing activities	<b>(421,753)</b>	(1,384,966)
<b>Cash flows from financing activities</b>		
Proceeds on line of credit	600,000	-
Payments on capital lease obligations	(60,966)	-
Borrowings on notes payable	-	1,866,568
Payments on notes payable	(240,204)	(634,504)
Net cash provided by financing activities	<b>298,830</b>	1,232,064

# Correctional Systems, Inc.

## Consolidated Statements of Cash Flows

<i>For the years ended December 31,</i>	<b>2002</b>	2001
(Decrease) increase in cash	<b>(38,130)</b>	139,105
Cash, beginning of year	<b>504,472</b>	365,367
Cash, end of year	<b>\$ 466,342</b>	\$ 504,472
<b>Supplemental disclosure of non-cash financing and investing activities</b>		
Assets acquired under capital leases and notes payable	\$ <b>254,865</b>	\$ 135,506
Beaumont Treatment Center Assets acquired by issuance of note payable	\$ -	\$ 1,000,000
<b>Supplemental disclosure of cash flow information</b>		
<b>Cash paid during the year for</b>		
Interest	\$ <b>226,682</b>	\$ 148,431
Income taxes	\$ -	\$ 8,367

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

# Correctional Systems, Inc.

## Notes to Consolidated Financial Statements

**1. Description of Business and Concentration of Credit Risk**

*Description of Business*

Correctional Systems, Inc. and subsidiaries (“CSI” or the “Company”) was incorporated in the state of California on March 31, 1994. In October 1999, the Company reincorporated in the state of Delaware. CSI operates correctional facilities on behalf of cities and counties under the terms of multi-year contracts with local governmental agencies. The population of the correctional facilities typically consists of arrestees, self-pay inmates, sentenced county work furlough inmates, sentenced federal inmates serving short-term sentences and individuals requiring detoxification. As a result of an acquisition in 1998 (see Note 3), the Company also operates five pre-release centers in Texas and Kansas, commonly referred to as community correction facilities, which primarily provides work furlough programs and counseling, funded by both the Federal Bureau of Prisons and the State of Texas, depending on location. The Company’s subsidiary, Sentencing Concepts, Inc. (SCI), also acquired in 1998, provides non-imprisonment alternatives to individuals who would have otherwise been subject to standard judicial punishment. SCI’s services include electronic home monitoring; drug, alcohol, and anger management counseling; and drug use testing. The Company has contracts with various municipal judicial systems to provide these services.

# Correctional Systems, Inc.

## Notes to Consolidated Financial Statements

**1. Description of Business and Concentration of Credit Risk (Continued)**

***Concentration of Credit Risk***

The Company's largest customer is the Federal Bureau of Prisons (BOP) which accounted for nearly 31% and 38% of the Company's total net revenue for the years ended December 31, 2002 and 2001, respectively. This customer accounted for approximately 30% and 29% of the Company's total accounts receivable at December 31, 2002 and 2001, respectively. At December 31, 2002, the Company had 4 separate community pre-release center contracts with the BOP. If the Company were to experience difficulty in continuing to provide services to this customer, or collecting these accounts receivable, it could have a material adverse effect on the Company's business, financial condition and results of operations. In addition, a loss of this customer could materially and adversely affect the Company's net revenue.

**2. Summary of Significant Accounting Policies**

***Consolidation***

The consolidated financial statements include the accounts of Correctional Systems, Inc. and its wholly-owned subsidiaries, SCI and Reality House, Inc. (RHI). All significant intercompany accounts and transactions have been eliminated.

***Cash and Cash Equivalents***

Cash and cash equivalents consist of cash on hand and on deposit in banks and interest bearing money market accounts.

# Correctional Systems, Inc.

## Notes to Consolidated Financial Statements

### 2. Summary of Significant Accounting Policies (Continued)

#### *Property and Equipment*

Property and equipment are stated at cost. Depreciation and amortization is calculated using the straight-line method over estimated useful lives of the assets as shown below. Leasehold improvements are amortized over the shorter of their useful lives or lease term. Maintenance and repairs are charged to expense when incurred. Significant renewals and betterments are capitalized.

Buildings	40 years
Building improvements	5 years
Furniture and equipment	3 to 5 years

Depreciation expense for the years ended December 31, 2002 and 2001, was approximately \$271,529 and \$154,436, respectively, which includes amortization expense for equipment held under capital leases.

#### *Internal Software Costs*

The Company capitalizes internal use software development costs in accordance with Statement of Position No. 98-1, "Accounting for Costs of Computer Software Developed or Obtained for Internal Use." Capitalized internal software development costs are included in property and equipment and depreciated using the straight-line method over an estimated useful life of five years. During 2002, the Company capitalized payroll expenses for an employee who was directly responsible for developing and implementing internal use software primarily associated with the management of facilities. As of December 31, 2002, the net carrying value of the internal use software was approximately \$43,000.

# Correctional Systems, Inc.

## Notes to Consolidated Financial Statements

### 2. Summary of Significant Accounting Policies (Continued)

#### *Goodwill and Intangibles*

Goodwill was amortized on a straight-line basis over a period not to exceed 20 years. In accordance with SFAS No. 142, beginning January 1, 2002, the Company discontinued amortizing its goodwill. The Company has chosen December 31 as the date for its annual internal valuation. The Company completed its evaluation of the impact of SFAS 142 on its financial position and results of operations for the year ended December 31, 2002. No impairment loss was recorded for the year ended December 31, 2002. Amortization expense for the year ended December 31, 2001 totaled \$66,540. During the year ended December 31, 2001, the Company recorded an impairment charge write down of \$820,383 related to the remaining book value of SCI's goodwill based on an impairment analysis.

Other intangibles, which represent certain operating rights (see Note 3), are amortized on a straight-line basis over a period not to exceed 40 years. Other intangibles do not have a stated expiration date. However, such rights are potentially revocable at the discretion of the issuing municipality and, consequently, the Company amortizes these assets on a straight-line basis over a period not to exceed 40 years. Amortization expense relating to other intangibles was \$38,454 and \$20,328 for the years ended December 31, 2002 and 2001, respectively.

# Correctional Systems, Inc.

## Notes to Consolidated Financial Statements

### 2. Summary of Significant Accounting Policies (Continued)

Intangible assets consisted of the following:

	December 31, 2002		
	Gross Carrying Amount	Accumulated Amortization	Net
Amortized intangible assets:			
RHI Bureau of Prisons contract	\$ 610,000	\$ (88,135)	\$ 521,865
CSI Conditional Use Permit and contract	725,000	(18,125)	706,875
	<u>\$ 1,335,000</u>	<u>\$ (106,260)</u>	<u>\$ 1,228,740</u>

	December 31, 2001		
	Gross Carrying Amount	Accumulated Amortization	Net
Amortized intangible assets:			
RHI Bureau of Prisons contract	\$ 610,000	\$ (52,807)	\$ 557,193
CSI Conditional Use Permit and contract	725,000	-	725,000
	<u>\$ 1,335,000</u>	<u>\$ (52,807)</u>	<u>\$ 1,282,193</u>

Estimated annual amortization expense relating to other intangibles is \$38,500 until the intangibles are fully amortized.

### *Long-Lived Assets*

The Company reviews the carrying values of its long-lived and identifiable intangible assets for possible impairment whenever events or changes in circumstances indicate that the carrying amount of the assets may not be recoverable. Any long-lived assets held for disposal are reported at the lower of their carrying amounts or fair value less costs to sell.

# Correctional Systems, Inc.

## Notes to Consolidated Financial Statements

### 2. Summary of Significant Accounting Policies (Continued)

#### *Revenue Recognition*

Revenue is generally recognized as services are provided under the provisions of contracts entered into with governmental agencies, either at a fixed monthly rate or at a net rate per day per inmate or both.

Under contracts entered into by SCI, the Company must provide services to all clients referred by the judicial process, regardless of the client's ability to pay. Further, the contracts allow for SCI to charge its clients fees based on a prearranged sliding fee schedule. SCI contracts do not guarantee a specified level of revenue nor do they provide for reimbursement for losses relating to servicing clients who are unable to pay. As a result, portions of SCI's clients receive services for nominal or no fees. Accordingly, losses for services provided are recognized when identified. Fees received in advance of services are recorded as deferred revenue until services are rendered.

#### *Income Taxes*

The Company accounts for income taxes in accordance with Statement of Financial Accounting Standards No. 109, "Accounting for Income Taxes" ("SFAS No. 109"). Under SFAS No. 109, deferred tax assets and liabilities reflect the future tax consequences of the temporary differences between the financial reporting and tax basis of assets and liabilities using current enacted tax rates.

#### *Stock-Based Compensation*

Statement of Financial Accounting Standards No. 123, "Accounting for Stock-Based Compensation," requires that the Company either recognize compensation expense for grants of stock, stock options, and other equity instruments to employees based on fair value accounting rules or using the intrinsic value method and provide proforma disclosure as if the fair value method had been applied. The Company has elected to use the intrinsic value method with proforma disclosure of the fair value method (see Note 7).

# Correctional Systems, Inc.

## Notes to Consolidated Financial Statements

### 2. Summary of Significant Accounting Policies (Continued)

#### *Use of Estimates*

The preparation of consolidated financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reported period. Actual results could differ from those estimates.

#### *Escrowed Shares*

A total of 270,000 shares issued to SCI principals were placed in escrow to be released to the principals of SCI as follows: i) 20,000 shares were released effective July 31, 1999, as a result of continued employment at SCI by one of the principals; ii) 100,000 shares were released effective July 31, 1999, as a result of no claims filed under the indemnity clause of the agreement; iii) 50,000 shares were released effective July 31, 2000 as a result of the principal being employed at SCI on that date; and iv) 100,000 shares will be released upon repayment in full of all amounts outstanding under notes receivable from the SCI principals (see Note 6).

#### *New Accounting Pronouncements*

In June 2002, the FASB issued SFAS No. 146, "*Accounting for Costs Associated with Exit or Disposal Activities*," which updates accounting and reporting standards for personnel and operational restructurings. The Company will be required to adopt SFAS No. 146 for exit, disposal or other restructuring activities that are initiated after December 31, 2002, with early application encouraged. The Company does not expect the adoption of SFAS No. 146 to have a material effect on the Company's consolidated financial position or results of operations.

# Correctional Systems, Inc.

## Notes to Consolidated Financial Statements

### 2. Summary of Significant Accounting Policies (Continued)

In December 2002, the FASB issued SFAS No. 148, *Accounting for Stock-Based Compensation – Transition and Disclosure – an Amendment to SFAS No. 123.* SFAS No. 148 provides alternative methods of transition for a voluntary change to the fair value based method on accounting for stock-based employee compensation. The Company currently does not intend to adopt SFAS No. 123 and accordingly does not expect the implementation of SFAS No. 148 to have a material effect on the Company's consolidated financial position or results of operations.

In May 2003, SFAS No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity* was issued. This statement establishes standards for how an issuer classifies and measures certain financial instruments with characteristics of both liabilities and equity. This statement is effective for financial instruments entered into or modified after May 31, 2003. The adoption of SFAS No. 150 is not expected to have a significant effect on the Company's consolidated financial position, results of operations, or cash flows.

### 3. Acquisitions

#### *Austin Recovery Center*

In July 1999, the Company entered into an asset purchase agreement with Austin Recovery Center, Inc. (ARC) under which certain assets of an operating subdivision of ARC known as the McCabe Center were acquired and certain contract rights were assumed by the Company with purchase price allocated to the land and building acquired based on independent appraisal. The consideration paid under the agreement was \$1,050,000, of which \$550,000 was paid in cash and \$500,000 is payable under a secured promissory note with monthly payments due through July 2011. This transaction was accounted for using the purchase method and, accordingly, the results of operations of the ARC are included in the consolidated results beginning in July 1999.

In March 2001, the ARC note was refinanced with a new note with Wells Fargo Bank Texas, N.A. The Company received a discount on the early retirement of the ARC note in the amount of \$27,549, which was recorded as a gain and is included in the consolidated statement of operations as "Other income (expenses)."

# Correctional Systems, Inc.

## Notes to Consolidated Financial Statements

### 3. Acquisitions (Continued)

#### *Beaumont Treatment Center*

In October of 2001, the Company entered into an asset purchase agreement with Texson Management Group, Inc. (Texson) to acquire certain assets along with certain contract rights of the Beaumont Treatment Center, a subsidiary of Texson. The purchase price was allocated to land and buildings. The consideration paid was \$1,190,000, of which \$190,000 was paid in cash and \$1,000,000 is payable under a secured promissory note with monthly payments through November 2008. This transaction was accounted for as an asset purchase.

### 4. Preferred Stock

On July 31, 1998, the Company entered into a stock purchase agreement with First Analysis Securities Corporation (FASC), under which FASC purchased 3,363,636 shares of Series A preferred stock for \$2,200,000 in cash.

Series A preferred stock is convertible at the option of the shareholder, in whole or in part, at any time. The Series A preferred stock is automatically converted into common stock upon a conversion event, as defined by the agreement. Generally, a conversion event is a public offering of the Company's common stock in which gross proceeds are at least \$20,000,000. The conversion rate initially is one share of common stock for each share of Series A preferred stock. The number of shares of common stock issuable upon conversion of the preferred stock and the conversion price shall be adjusted from time to time, based upon certain events as defined by the agreement. Additionally, if at any time the Company issues additional shares of common stock, or securities convertible into common stock, for a consideration per share of common stock less than the conversion price in effect at the time of such issuance, then the conversion price in effect immediately prior to the issuance of such additional shares of common stock shall be reduced to a price per share equal to the consideration per share received for the additional shares of common stock.

# Correctional Systems, Inc.

## Notes to Consolidated Financial Statements

### 4. Preferred Stock (Continued)

The preferred stock has voting rights equal to the number of shares of common stock issuable upon conversion. As long as the preferred stock is outstanding, the Company is restricted from certain acts, as defined by the agreement, without the affirmative vote of a majority of Series A shareholders. Such restricted acts include, among other things, certain merger activity, limitations on indebtedness and certain types of equity transactions. If the Company is voluntarily or involuntarily liquidated, the preferred stockholders shall be entitled to receive, prior to distributions to any holder of common stock, a per share amount equal to the preferred stock original issue price in addition to all accrued but unpaid preferred dividends, if any. Upon distribution of the Series A liquidation preference, the remaining assets would be distributed to common and preferred shareholders on a pro rata basis.

The holders of the preferred stock are entitled to dividends or other distributions entitled to holders of common stock in the same amount as such holder would receive if preferred stock were converted to common stock.

### 5. Income Taxes

Significant components of the 2002 and 2001 income tax provision are as follows:

	2002	2001
Federal income tax provision:		
Current	\$ 198,000	\$ 51,308
Deferred	-	-
State income tax provision:		
Current	27,000	11,513
Deferred	-	-
	\$ 225,000	\$ 62,821

# Correctional Systems, Inc.

## Notes to Consolidated Financial Statements

### 5. Income Taxes (Continued)

Income taxes at the statutory rate is reconciled to the Company's actual provision as follows:

	2002		2001	
	Amount	Percent	Amount	Percent
Tax at federal statutory rates	\$ 227,000	34.0 %	\$ (206,099)	34.0 %
State income tax, net of federal tax benefit	26,000	4.0	7,599	1.2
Utilization of net operating loss	(3,000)	(0.0)	(2,176)	(0.0)
Non-deductible expenses	-	-	268,437	42.4
Other	(25,000)	(4.0)	(4,940)	(0.8)
<b>Provision for income tax</b>	<b>\$ 225,000</b>	<b>34.0 %</b>	<b>\$ 62,821</b>	<b>9.9 %</b>

Due to the change in ownership percentages as a result of the issuance of preferred stock to First Analysis Securities Corporation (see Note 4), in accordance with federal tax law, the utilization of the net operating losses incurred prior to the change in ownership will be limited to \$6,400 per year. The net operating loss carry forward for federal and state tax purposes is approximately \$102,000 and \$20,000, respectively. The Company's combined net operating losses expire in 2018. At December 31, 2002, the only significant deferred tax asset or liability is the asset related to the net operating loss carryforward. Due to uncertainty of future realization, the Company has recorded a full valuation allowance against this deferred tax asset.

### 6. Related Party Notes and Interest Receivable

As of December 31, 2002, related party notes receivable consisted of two \$50,000 loans (plus accrued interest at 7%) due from the previous officers (the President and Chief Operating Officer) of SCI. The loans are secured by CSI common stock owned by the officers and held in escrow (see Note 2). Principal and interest are due on July 31, 2003.

# Correctional Systems, Inc.

## Notes to Consolidated Financial Statements

### 7. Employee Stock Option

The Company grants stock options under an employee stock option plan (the "Plan"). Under the Plan, the Company is authorized to issue stock options to officers and employees to purchase a maximum of 1,700,000 shares of common stock. The stock options are generally granted with an exercise price no less than the fair market value of the stock at the date of grant, have contractual terms of ten years and fully vest within four years.

The following table summarizes stock option plan activity for the years ended December 31, 2002 and 2001:

	Plan Options	Weighted Average Exercise Price	Weighted Average Fair Value of Options Granted
Outstanding, December 31, 2000	1,237,250	\$ 0.65	
Granted	345,500	0.24	\$ 0.06
Forfeited	(18,600)	0.69	
Outstanding, December 31, 2001	1,564,150	0.56	
Granted	79,313	0.24	\$ 0.14
Forfeited	(1,500)	0.67	
Outstanding, December 31, 2002	1,641,963	\$ 0.54	

# Correctional Systems, Inc.

## Notes to Consolidated Financial Statements

### 7. Employee Stock Option (Continued)

The following table summarizes information about stock options outstanding at December 31, 2002:

	Options Outstanding			Options Exercisable	
	Number of Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life (Years)	Number of Shares	Weighted Average Exercise Price
\$ 0.01 - \$ 0.50	694,313	\$ 0.23	8.09	494,313	\$ 0.24
\$ 0.51 - \$ 1.00	942,250	\$ 0.76	5.02	940,500	\$ 0.76
\$ 1.01 - \$ 1.80	5,400	\$ 1.09	5.16	5,400	\$ 1.09
	1,641,963			1,440,213	

The following table summarizes stock option related to the SCI acquisition for the years ended December 31, 2002 and 2001.

	SCI Stock Options	Weighted Average Exercise Price
Outstanding, December 31, 2000	30,000	0.20
Granted	-	-
Forfeited	-	-
Outstanding, December 31, 2001	30,000	0.20
Granted	-	-
Forfeited	-	-
Outstanding, December 31, 2002	30,000	0.20
Exercisable, December 31, 2002	30,000	0.20

# Correctional Systems, Inc.

## Notes to Consolidated Financial Statements

### 7. Employee Stock Option (Continued)

The Company adopted SFAS No. 123 for disclosure purposes. Under SFAS No. 123, the Company provides pro forma disclosure of the effect on net income or loss as if the fair value based method prescribed in SFAS No. 123 has been applied in measuring compensation expense. The fair value for options granted was estimated at the date of grant using a Black-Scholes option pricing model with the following weighted-average assumptions for the years ended December 31, 2002 and 2001:

	2002	2001
Risk-free interest rate	4.50% - 4.00%	3.92% - 4.99%
Expected lives	4 years	4 years
Expected volatility	163.7%	211.10%
Expected dividend yield	0.00%	0.00%

For purposes of pro forma disclosure, the estimated fair value of the options is amortized to expense over the option's vesting period. The Company's pro forma information is as follows:

	2002	2001
Net income (loss), as reported	\$ 443,192	\$ (668,994)
Plus: Stock-based employee compensation expense included in reported net income (loss)	-	-
Less: Total stock-based employee compensation expense determined using the fair value based method	(10,712)	(21,058)
Pro forma net income (loss)	\$ 432,480	\$ (690,052)

# Correctional Systems, Inc.

## Notes to Consolidated Financial Statements

### 8. Commitments and Contingencies

#### *Leases*

The Company leases certain office space, facilities and equipment under non-cancelable operating lease arrangements. The following are aggregate future minimum lease payments required under operating and capital leases as of December 31, 2002:

<i>Year ending December 31,</i>	Operating Leases	Capital Leases
2003	\$ 737,206	\$ 80,360
2004	739,006	66,556
2005	743,686	46,746
2006	746,326	6,154
2007	733,365	1,633
Thereafter	1,728,000	-
	\$ 5,427,589	201,449
Less amounts representing interest (ranging from 14% to 29%)		(39,321)
Present value of net minimum lease payments		162,128
Less current portion		(63,535)
Long-term portion		\$ 98,593

Total rent expense for 2002 and 2001 was \$481,338 and \$333,075, respectively.

The Company is involved in various legal matters in the ordinary course of its business activities. In the opinion of management, the outcome of such matters is not expected to have a material adverse impact on the Company's financial position or results of operations.

# Correctional Systems, Inc.

## Notes to Consolidated Financial Statements

- 9. Savings and Investment Plan** In May 1999, the Company began a savings and investment plan (the “Plan”) which allows participants to contribute up to 15 percent of their annual salary (subject to certain limitations). The Company matches employee contributions at its discretion.
- Expenses of approximately \$6,079 and \$11,436 related to the Plan for the years ended December 31, 2002 and 2001, respectively, are reflected in the accompanying consolidated statements of operations.
- 10. Line of Credit** In December 1999, as amended, the Company established a line of credit with a bank, which provided for borrowings up to \$750,000 at an annual rate of 1% plus prime (5.25% APR as of December 31, 2002). As of December 31, 2002, the Company has \$600,000 outstanding against the line of credit. At December 31, 2001, the Company had not drawn on this line of credit. The line expired in May 2003 and was replaced with a new revolving line of credit (Note 11).
- 11. Revolving Line of Credit** In May 2003, the Company established a revolving line of credit with an asset based lending group. As a result, the revolving line of credit replaced the Company’s expiring line of credit (Note 10). The revolving line of credit provides for borrowing up to the lesser of \$1,500,000 or 70% of the Company’s eligible accounts receivable balances. In general, eligible receivables are those amounts less than 90 days outstanding and amounts not specifically collateralized against other debt. Additionally, the revolving line of credit limits the available borrowings for a specific receivable account to not more than 10% to 30% of the total receivable balance depending on the account and customer. Company management expects that the revolving line of credit will provide approximately \$1,000,000 in available funds. Interest is applied at the higher of 8.25% or the Phoenix Bank One Prime Rate plus 4.00%. The revolving line of credit has an initial term of two years and automatically renews from year to year, thereafter. Among other provisions, the agreement requires both financial and non-financial covenants. The revolving line of credit is secured by substantially all of the Company’s assets.

# Correctional Systems, Inc.

## Notes to Consolidated Financial Statements

### 12. Long-Term Debt Obligations

The Company's long-term debt as of December 31, 2002 and 2001 consists of the following:

	2002	2001
ABN Amro, secured by real property with interest at 9.29% and monthly principal and interest payments of \$12,800, maturing July 2006	\$ 438,893	\$ 537,679
Wells Fargo, secured by real and personal property with interest at 8.65%, amortized over 15 years due in 7. Monthly principal and interest payments of \$7,085, maturing in May 2008	669,185	695,087
Allstate Insurance Company, secured by real property with interest at 7.00%, amortized over 10 years due in 7. Monthly principal and interest payments of \$11,611 maturing November 2008	915,975	994,222
Other notes payable secured by equipment, with interest rates ranging from 4.90% to 11.25% and due at various dates through September 2004	172,617	178,115
Total	2,196,670	2,405,103
Less – current portion	(270,330)	(271,596)
Total long-term debt	\$ 1,926,340	\$ 2,133,507

# Correctional Systems, Inc.

## Notes to Consolidated Financial Statements

### 12. Long-Term Debt Obligations (Continued)

A schedule of maturities long-term debt is as follows for the years ended December 31:

2003	\$	270,330
2004		288,635
2005		293,356
2006		206,094
2007		159,448
Thereafter		978,807
<b>Total</b>		<b>\$ 2,196,670</b>