

CORRECTIONAL SYSTEMS, INC.

Consolidated Financial Statements

As of and for the Years Ended December 31, 2001 and 2000

Together with Report of Independent Public Accountants

Report of Independent Public Accountants

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

We have audited the accompanying consolidated balance sheets of CORRECTIONAL SYSTEMS, INC. (a Delaware corporation) and subsidiaries as of December 31, 2001 and 2000, and the related consolidated statements of operations, shareholders' equity and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits 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 audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Correctional Systems, Inc. and subsidiaries as of December 31, 2001 and 2000, and the results of their operations and their cash flows for the years then ended in conformity with accounting principles generally accepted in the United States.

San Diego, California
April 19, 2002

CORRECTIONAL SYSTEMS, INC. AND SUBSIDIARIES

Consolidated Balance Sheets – December 31, 2001 and 2000

	2001	2000
<u>Assets</u>		
Cash	\$ 504,472	\$ 365,367
Accounts receivable, net of allowance for doubtful accounts of \$25,000 and \$25,000, respectively	1,359,029	1,142,230
Other current assets	117,770	48,060
	-----	-----
Total current assets	1,981,271	1,555,657
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Property and equipment:		
Land	255,278	105,278
Building	1,609,939	1,337,142
Furniture and equipment	582,137	444,484
Less – accumulated depreciation	(332,295)	(212,509)
	-----	-----
Total property and equipment	2,115,059	1,674,395
	-----	-----
Related party notes and interest receivable	123,333	116,333
Goodwill, net of accumulated amortization of \$56,551 and \$156,428, respectively	278,624	1,165,547
Other intangibles, net of accumulated amortization of \$67,807 and \$47,479, respectively	1,282,193	562,521
Deposits and other assets	18,667	34,821
	-----	-----
	\$5,799,147	\$5,109,274
	=====	=====
<u>Liabilities and Shareholders' Equity</u>		
Accounts payable	\$ 199,394	\$ 193,529
Accrued liabilities	307,813	246,863
Accrued compensation	388,831	256,117
Current portion of long-term debt	271,596	148,396
Deferred revenue	80,460	118,979
	-----	-----
Total current liabilities	1,248,094	963,884
	-----	-----
Long-term debt, net of current portion	2,133,507	1,052,192
Deferred income taxes	-	6,658
	-----	-----
Total liabilities	3,381,601	2,022,734
	-----	-----
Commitments and Contingencies		
Shareholders' equity:		
Convertible preferred stock, \$.001 par value, 10,000,000 shares authorized, 3,363,636 shares of Series A issued and outstanding	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	(1,280,779)	(611,785)
	-----	-----
Total shareholders' equity	2,417,546	3,086,540
	-----	-----
Total liabilities and shareholders' equity	\$5,799,147	\$5,109,274
	=====	=====

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

CORRECTIONAL SYSTEMS, INC. AND SUBSIDIARIESConsolidated Statements of Operations
For the Years Ended December 31, 2001 and 2000

	2001	2000
Revenues	\$10,366,934	\$8,714,644
Expenses:		
Salaries and wages	4,437,542	3,489,313
Depreciation and amortization	241,304	200,890
Other operating expenses	3,988,960	3,498,526
General and administrative expenses	1,326,123	1,331,358
Impairment of long lived assets	872,249	-
Total expenses	10,866,178	8,520,087
Operating (loss) income	(499,244)	194,557
Other income (expense):		
Interest income and expense, net	(128,117)	(96,779)
Other income (expenses)	21,188	(19,469)
Total other expense	(106,929)	(116,248)
Income before income taxes	(606,173)	78,309
Provision for income taxes	62,821	12,404
Net (loss) income	(668,994)	65,905

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

CORRECTIONAL SYSTEMS, INC. AND SUBSIDIARIES

Consolidated Statements of Shareholders' Equity
For the Years Ended December 31, 2001 and 2000

	Preferred Stock		Common Stock		Additional Paid-in Capital	Accumulated Deficit	Total
	Shares	Amount	Shares	Amount			
BALANCE December 31, 1999	3,363,636	\$3,364	3,644,400	\$3,644	\$3,691,317	\$ (677,690)	\$3,020,635
Net income	-	-	-	-	-	65,905	65,905
BALANCE December 31, 2000	3,363,636	3,364	3,644,400	3,644	3,691,317	(611,785)	3,086,540
Net loss	-	-	-	-	-	(668,994)	(668,994)
BALANCE December 31, 2001	3,363,636	\$3,364	3,644,400	\$3,644	\$3,691,317	\$(1,280,779)	\$2,417,546

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

CORRECTIONAL SYSTEMS, INC. AND SUBSIDIARIES

Consolidated Statements of Cash Flows
For the Years Ended December 31, 2001 and 2000

	2001	2000
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net (loss) income	\$(668,994)	\$ 65,905
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	241,304	200,890
Impairment of long lived assets	872,249	-
Gain on sale of fixed assets	(2,000)	-
Gain on retirement of ARC note payable	(27,549)	-
Changes in operational assets and liabilities:		
Accounts receivable	(216,799)	(349,484)
Other current assets	(69,710)	15,015
Deposits and other assets	9,154	(24,447)
Accounts payable	5,865	5,248
Accrued liabilities	60,950	107,724
Accrued compensation	132,714	38,863
Deferred revenue	(38,519)	35,857
Deferred income taxes	(6,658)	4,037
	292,007	99,608
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchase of property and equipment	(1,386,966)	(118,466)
Proceeds on sale of fixed assets	2,000	-
	(1,384,966)	(118,466)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Borrowings on notes payable	1,866,568	58,703
Payments on notes payable	(634,504)	(146,966)
	1,232,064	(88,263)
INCREASE (DECREASE) IN CASH	139,105	(107,121)
CASH, beginning of year	365,367	472,488
CASH, end of year	\$ 504,472	\$ 365,367
SUPPLEMENTAL DISCLOSURE OF NON-CASH FINANCING AND INVESTING ACTIVITIES:		
Assets acquired under capital leases and notes payable	\$ 135,506	\$ -
Beaumont Treatment Center assets acquired by issuance of note payable	\$1,000,000	\$ -
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:		
Cash paid during the year for:		
Interest	\$ 148,431	\$ 107,504
Income taxes	\$ 8,367	\$ 30,535

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

CORRECTIONAL SYSTEMS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements
December 31, 2001 and 2000

1. Description of Business and Risk Factors

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 a community correction facility known as Reality House, Inc. (RHI). RHI primarily provides work furlough programs and counseling, funded by the Federal Bureau of Prisons. The Company's subsidiary, Sentencing Concepts, Inc. (SCI), also acquired in 1998 (see Note 3), 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.

Concentration of credit risk

The Company's largest customer is the Federal Bureau of Prisons ("BOP") which accounted for nearly 38% and 34% of the Company's total net revenue for the years ended December 31, 2001 and 2000, respectively. This customer accounted for approximately 29% and 32% of the Company's total accounts receivable at December 31, 2001 and 2000, respectively. At December 31, 2001, the Company had 3 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 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.

Property and Equipment

Property and equipment are stated at cost and depreciated over the estimated useful lives of the assets using the straight-line method as follows:

Building	40 years
Furniture and equipment	3 to 5 years

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. Other intangibles, which represent certain operating rights that do not have a stated expiration date. However, such rights are 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. As of December 31, 2001 the Company had goodwill, net of accumulated amortization, of \$278,624 related to the acquisition of RHI. During the year ended December 31, 2001, the Company recorded a impairment writedown of \$820,383 related to the remaining book value of SCI's goodwill based on an impairment analysis pursuant to SFAS No. 121.

Long-Lived Assets

The Company accounts for long-lived assets in accordance with Statement of Accounting Standards No. 121, "Accounting for the Impairment of Long-Lived Assets" ("SFAS No. 121"). SFAS No. 121 requires that long-lived assets and certain identifiable intangibles to be held by an entity be reviewed for possible impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be fully recoverable. The Company periodically re-evaluates the carrying value and estimated lives of its long-lived assets based on expected undiscounted cash flows and recognizes impairments, if any.

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.

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 difference 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 new 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).

Use of Estimates

The preparation of 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 financial statements and the reported amounts of revenues and expenses during the reported period. Actual results could differ from those estimates.

Fair Value of Financial Instruments

The carrying value amounts of cash, accounts receivable, other current assets, accounts payable, and accrued liabilities approximate fair value because of the short-term nature of those instruments. Based on borrowing rates currently available to the Company for credit arrangements with similar terms, the carrying amounts of balances under capital lease and notes payable obligations approximate fair value.

New Accounting Standards

In June 2001, the Financial Accounting Standards Board ("FASB") issued SFAS No. 141, "Business Combinations" ("SFAS No. 141"). This statement addresses financial accounting and reporting for business combinations and supersedes APB Opinion No. 16, "Business Combinations," and FASB Statement No. 38, "Accounting for Preacquisition Contingencies of Purchased Enterprises." All business combinations in the scope of this Statement are to be accounted for using one method, the purchase method. The Company adopted the provisions of SFAS No. 141 for all business combinations initiated after June 30, 2001.

In June 2001, the FASB issued SFAS No. 142 "Goodwill and Other Intangible Assets" ("SFAS No. 142"). This statement addresses financial accounting and reporting for acquired goodwill and other intangible assets and supersedes APB Opinion No. 17, "Intangible Assets." SFAS No. 142 addresses how intangible assets that are acquired individually or with a group of other assets (but not those acquired in a business combination) should be accounted for in financial statements upon their acquisition. This statement also addresses how goodwill and other intangible assets should be accounted for after they have been initially recognized in the financial statements. Upon adoption of SFAS No. 142 goodwill is no longer subject to amortization over its estimated useful life, which would

have been \$16,764 for the year 2002. Rather, goodwill will be subject to at least an annual assessment for impairment by applying a fair value test. The Company adopted these standards effective January 1, 2002 and does not believe that the adoption of this statement will have a material impact on its financial position or results of operations.

In August 2001, the FASB issued SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets." SFAS No. 144 addresses financial accounting and reporting for the impairment or disposal of long-lived assets. SFAS No. 144 supersedes SFAS No. 121, "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of," and the accounting and reporting provisions of APB 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 the disposal of a segment of a business (as previously defined in that Opinion). The provisions of SFAS No. 144 are effective for financial statements issued for fiscal years beginning after December 15, 2001, with early application encouraged and generally are to be applied prospectively. The Company adopted these standards effective January 1, 2002 and does not believe that the adoption of this statement will have a material impact on its financial position or results of operations.

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).

Longevity and Performance Period Options

The Company entered into employment agreements with the principals of SCI through August 2000. The agreements included base salaries and the issuance of 230,000 additional stock options with an exercise price of \$0.20 per share, of which 200,000 options were to have vested if profitability levels of SCI were achieved as defined during a pre-determined earn-out period subsequent to the acquisition; and 30,000 options that vested on July 31, 1999 as a result of continued employment at SCI by one of the principals, resulting in a compensation charge of \$16,500 in 1999. The required profitability level was not achieved and, consistent with the option agreement, these contingent stock options were terminated.

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 was payable under a secured promissory note to ARC with monthly payments due through July 2011. This transaction was accounted for using the purchase method and, accordingly, the results of operations of the Austin Recovery Center 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)." (see Note 11).

Beaumont Treatment Center

In October of 2001, the Company entered into an asset purchase agreement with Texon Management Group, Inc. ("Texon") to acquire certain assets along with certain contract rights of the Beaumont Treatment Center, a subsidiary of Texon. The purchase price was allocated to land, buildings and certain identifiable tangible and intangible assets. The total 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 equal monthly payments through November 2008. (see note 11). This transaction was accounted for using the purchase method and, accordingly, the results of operations of the Beaumont Treatment Center are included in the consolidated results beginning in October 2001. The Company's preliminary allocation of the purchase price resulted in an allocation of \$450,000 to land and buildings and \$740,000 to various intangible assets. The Company is in the process of determining the relative values of specific intangible assets. The final allocation of the intangible value is not expected to be materially different from the presentation as of December 31, 2001.

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. In connection with this transaction, the Company incurred \$52,395 in direct costs, which are netted against the proceeds in the statement of shareholders' equity. The agreement specified that \$500,000 of the \$2,200,000 be allocated to fund expansion activities by SCI.

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.

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 stockholders. 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 stockholders 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 2001 and 2000 income tax provision are as follows:

	2001	2000
Federal income tax provision:		
Current	\$51,308	\$ 4,675
Deferred	-	-
State income tax provision:		
Current	11,513	3,692
Deferred	-	4,037
	-----	-----
	\$62,821	\$ 12,404
	=====	=====

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

	2001		2000	
	Amount	Percent	Amount	Percent
Tax provision (benefit) at federal statutory rates	\$(206,099)	34.0%	\$26,625	34.0%
State income tax, net of federal tax benefit	7,599	1.2%	3,326	4.2%
Utilization of net operating loss	(2,176)	0.0%	(16,472)	(21.0%)
Non-deductible expenses	268,437	42.4%	1,700	2.2%
Other	(4,940)	(0.8%)	(2,775)	(3.6%)
	-----	-----	-----	-----
Provision for income tax	\$ 62,821	9.9%	\$ 12,404	15.8%
	=====	=====	=====	=====

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 \$107,200 and \$20,000, respectively. The Company's combined net operating losses expire in 2018. At December 31, 2001, 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, 2001, related party notes receivable consisted of two \$50,000 loans (plus accrued interest at 7%) due from 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 3). Principal and interest are due on July 31, 2003.

7. Employee Stock Option Plan

The Company has increased the reserved common stock for future issuance under the 1996 employee stock option plan from 1,500,000 to 1,700,000. Options are generally granted at fair market value at the date of grant, expire ten years after the date of grant and fully vest within four years of the date of grant.

The following table summarizes stock option plan activity for the years ended December 31, 2001 and 2000:

	Plan Options	Weighted Average Exercise Price
Outstanding, December 31, 1999	1,201,855	0.70
Granted	344,145	0.51
Forfeited	(308,750)	0.94

Outstanding, December 31, 2000	1,237,250	0.65
Granted	345,500	0.24
Forfeited	(18,600)	0.69

Outstanding, December 31, 2001	1,564,150	0.56
	=====	
Exercisable, December 31, 2001	1,038,125	0.59
	=====	

As permitted, the Company has adopted the disclosure only provisions SFAS No. 123. Accordingly, no compensation expense has been recognized for options granted, except for certain options granted to an SCI principal (see Note 3). Had compensation expense been determined based on the fair value accounting rules under SFAS No. 123 at date of grant for the 2001 and 2000 awards, the Company's net income (loss) would have been the pro forma amounts as follows:

	2001	2000
Net income (loss) - as reported	\$ (668,994)	\$ 65,905
Net income (loss) - pro forma	\$ (690,052)	\$ (28,444)

The fair value of each option grant was estimated on the date of grant using the Black-Scholes option-pricing model and using the following weighted average assumptions for grants in 2001 and 2000:

	2001	2000
Risk-free interest rate	3.92% - 4.99%	5.17% - 6.58%
Expected lives	4 Years	4 Years
Expected volatility	211.10%	0.00%
Expected dividend yield	0.00%	0.00%

8. Commitments and Contingencies

The Company leases certain office space, facilities, and equipment under operating lease agreements. The Company is obligated to make future minimum lease payments as of December 31, 2001 as follows:

2002	\$358,040
2003	355,306
2004	357,106
2005	361,785
2006	364,426

Total	\$1,796,663
	=====

Total rent expense for 2001 and 2000 was \$333,075 and \$253,352, 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.

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 \$11,436 related to the Plan for the year ended December 31, 2001 are reflected in the accompanying consolidated statements of operations.

10. Line of Credit

On December 2, 1999, the Company opened a line of credit with a bank, which provided for borrowings up to \$500,000 at an annual rate of 1% plus prime lending rate. At December 31, 2001, the Company was in violation of its net income financial covenant for which no waiver has been granted by the financial institution. As of December 31, 2001, the Company had not drawn on this line of credit. The line of credit expires in May 2002. The Company intends to enter into an annual line of credit arrangement to provide borrowings of \$1 million upon the expiration of the current line of credit, however, there can be no assurance that the Company will obtain a line of credit.

11. Long-Term Debt Obligations

As discussed in Note 3, during 1999, the Company entered into a promissory note agreement with Austin Recovery Center, Inc. ("ARC") for \$500,000 under which the real property acquired from ARC is secured as collateral. In March 2001, the ARC note, with a balance of \$455,496 was retired at discount of \$28,791 using proceeds from a new note with Wells Fargo Bank Texas, N.A. Proceeds from the new note totaled \$713,060 and replaced the original note as well as provided the Company with additional funds to expand the business. The Company is required to maintain compliance with certain covenants in connection with the note, including a debt service coverage ratio and a debt to net worth ratio. As of December 31, 2001 the Company was in compliance with all such ratios.

As is also discussed in Note 3, in October of 2001, the Company entered into an asset purchase agreement with Texon Management Group, Inc. ("Texon") to acquire certain assets along with certain contract rights of the Beaumont Treatment Center, a subsidiary of Texon. In connection with the purchase, the Company signed a \$1,000,000 secured promissory note, with Allstate Insurance Company, with monthly payments through November 2008.

The Company's long-term debt as of December 31, 2001 and 2000 consists of the following:

	<u>2001</u>	<u>2000</u>
ABN Amro, secured by real property with interest at 9.288% and monthly principal and interest payments of \$12,800, maturing July 2006	\$537,679	\$ 635,548
Austin Recovery Center, Inc., secured by real property with interest at 8% and monthly principal and interest payments of \$5,412, maturing July 2011	-	462,709
Wells Fargo, secured by real property with interest at 8.65%, payable in equal monthly principal and interest payments of \$7,085 over a 7 year period, maturing in May 2008, and a balloon payment of the remaining principal of \$489,589 due concurrently with the final payment	695,087	-
Allstate Insurance Company, secured by real property with interest at 7%, payable in equal monthly principal and interest payments of \$11,611 over a 7 year period, maturing November 2008, and a balloon payment of the remaining principal of \$376,034 due concurrently with the final payment	994,222	-
Other notes payable secured by equipment, with interest rates ranging from 6% to 26% and due at various dates through September 2004	178,115	102,331
Total	<u>2,405,103</u>	<u>1,200,588</u>
Less – current portion	(271,596)	(148,396)
Total long-term debt	<u>\$2,133,507</u> =====	<u>\$1,052,192</u> =====

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

	<u>Notes Payable</u>	<u>Capital Leases</u>	<u>Total</u>
2002	\$ 413,340	\$ 59,100	\$472,440
2003	413,340	59,100	472,440
2004	403,959	18,842	422,801
2005	383,048	8,592	391,640
2006	275,552	2,864	278,416
Thereafter	1,280,915	-	1,280,915
Total	<u>3,170,154</u>	<u>148,498</u>	<u>3,318,652</u>
Less – amount representing interest	852,763	60,786	913,549
Present value of payments	<u>2,317,391</u>	<u>87,712</u>	<u>2,405,103</u>
Less – current portion	225,856	45,740	271,596
Long-term obligations, net	<u>\$2,091,535</u> =====	<u>\$ 41,972</u> =====	<u>\$2,133,507</u> =====