INC Research Holdings, Inc.
Form 10-Q
July 30, 2015

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended June 30, 2015

or

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

For the transition period from to .

Commission File Number: 001-36730

INC RESEARCH HOLDINGS, INC.
(Exact name of registrant as specified in its charter)

Delaware	27-3403111
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification Number)

3201 Beechleaf Court, Suite 600, Raleigh, North Carolina 27604-1547
(Address of principal executive offices and Zip Code)
(919) 876-9300
(Registrant’s telephone number, including area code)

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate website, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes ý No ¨

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See definition of “large accelerated filer,” “accelerated filer” and “smaller reporting company” in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer	¨	Accelerated filer	¨
Non-accelerated filer	x (Do not check if a smaller reporting company)	Smaller reporting company	¨

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes ¨ No ý

As of July 23, 2015, there were approximately 56,253,165 shares of the registrant's common stock outstanding.

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INC RESEARCH HOLDINGS, INC.
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PART I. FINANCIAL INFORMATION
Item 1. Condensed Consolidated Financial Statements

INC RESEARCH HOLDINGS, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(Unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2015	2014	2015	2014
	(In thousands, except per share data)			
Net service revenue	$227,376	$203,540	$438,890	$388,240
Reimbursable out-of-pocket expenses	109,916	82,203	207,319	164,280
Total revenue	337,292	285,743	646,209	552,520
Costs and operating expenses:				
Direct costs	138,010	130,781	263,458	251,545
Reimbursable out-of-pocket expenses	109,916	82,203	207,319	164,280
Selling, general and administrative	37,125	33,962	72,925	66,147
Restructuring and other costs	2,012	2,417	1,594	3,175
Transaction expenses	397	—	519	2,042
Asset impairment charges	—	17,245	3,931	17,245
Depreciation	4,420	5,025	9,186	11,894
Amortization	9,473	6,238	18,951	13,740
Total operating expenses	301,353	277,871	577,883	530,068
Income from operations	35,939	7,872	68,326	22,452
Other income (expense), net:				
Interest income	45	18	129	200
Interest expense	(4,233)	(12,841)	(9,622)	(28,924)
Loss on extinguishment of debt	(9,795)	—	(9,795)	—
Other income (expense), net	1,675	(337)	5,141	1,041
Total other expense, net	(12,308)	(13,160)	(14,147)	(27,683)
Income (loss) before provision for income taxes	23,631	(5,288)	54,179	(5,231)
Income tax benefit (expense)	(310)	20,595	(5,602)	18,986
Net income	23,321	15,307	48,577	13,755
Class C common stock dividends	—	(125)	—	(250)
Net income attributable to common stockholders	$23,321	$15,182	$48,577	$13,505
Earnings per share attributable to common stockholders:				
Basic	$0.40	$0.29	$0.81	$0.26
Diluted	$0.39	$0.29	$0.79	$0.26
Weighted average common shares outstanding:				
Basic	58,231	51,898	59,731	51,897
Diluted	60,464	52,185	61,805	52,066

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

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INC RESEARCH HOLDINGS, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
(Unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2015	2014	2015	2014
	(In thousands)			
Net income	$23,321	$15,307	$48,577	$13,755
Foreign currency translation adjustments, net of tax benefit of $0, $346, $0 and $1,325, respectively	(2,176)	(501)	(11,394)	(2,102)
Comprehensive income	$21,145	$14,806	$37,183	$11,653

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

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INC RESEARCH HOLDINGS, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED BALANCE SHEETS
(Unaudited)

	June 30, 2015	December 31, 2014
	(In thousands, except share data)	
ASSETS		
Current assets:		
Cash and cash equivalents	$98,511	$126,453
Restricted cash	478	505
Accounts receivable:		
Billed, net	143,617	130,270
Unbilled	132,650	118,101
Current portion of deferred income taxes	16,965	16,177
Prepaid expenses and other current assets	34,466	35,393
Total current assets	426,687	426,899
Property and equipment, net	40,469	43,725
Goodwill	553,584	556,863
Intangible assets, net	171,323	190,359
Deferred income taxes, less current portion	12,221	15,665
Other long-term assets	11,460	11,576
Total assets	$1,215,744	$1,245,087
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$14,756	$16,548
Accrued liabilities	100,271	111,655
Deferred revenue	297,093	246,902
Current portion of long-term debt	—	4,250
Current portion of capital lease obligations	111	441
Total current liabilities	412,231	379,796
Long-term debt, less current portion	475,000	415,277
Capital lease obligations, less current portion	—	11
Deferred income taxes	27,236	30,368
Other long-term liabilities	20,909	27,426
Total liabilities	935,376	852,878
Commitments and contingencies (Note 15)		
Stockholders' equity:		
Preferred stock, $0.01 par value; 30,000,000 authorized, 0 shares issued and outstanding at June 30, 2015 and December 31, 2014, respectively	—	—
Common stock, $0.01 par value; 600,000,000 and 600,000,000 shares authorized; 56,253,165 and 61,233,850 shares issued and outstanding at June 30, 2015 and December 31, 2014, respectively	563	612
Additional paid-in-capital	583,453	634,946
Accumulated other comprehensive loss	(37,594)	(26,200)
Accumulated deficit	(266,054)	(217,149)
Total stockholders' equity	280,368	392,209

Total liabilities and stockholders' equity	$1,215,744	$1,245,087

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

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INC RESEARCH HOLDINGS, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited)

	Six Months Ended June 30,	
	2015	2014
	(In thousands)	
Operating activities		
Net income	$48,577	$13,755
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	28,137	25,634
Loss on extinguishment of debt	9,795	—
Stock repurchase costs	519	—
Amortization of capitalized loan fees	812	3,844
Stock-based compensation	1,620	1,424
Allowance for doubtful accounts	(145)	1,536
Deferred income taxes	(283)	(22,442)
Foreign currency adjustments	(4,463)	(4,941)
Asset impairment charges	3,931	17,245
Other adjustments	(163)	231
Changes in operating assets and liabilities:		
Accounts receivable billed and unbilled	(28,808)	(34,145)
Accounts payable and accrued expenses	(10,211)	16,970
Deferred revenue	51,946	61,657
Other assets and liabilities	(5,989)	(372)
Net cash provided by operating activities	95,275	80,396
Investing activities		
Acquisition of business, net of cash acquired	—	(2,302)
Purchase of property and equipment	(7,669)	(12,939)
Net cash used in investing activities	(7,669)	(15,241)
Financing activities		
Payments on long-term debt	(475,001)	(5,453)
Proceeds from issuance of long-term debt	525,000	—
Payments of debt financing costs	(4,987)	—
Payments related to business combinations	(901)	—
Principal payments toward capital lease obligations	(341)	(1,613)
Payments of stock repurchase costs	(519)	—
Payments for repurchase of common stock	(150,000)	(19)
Payments related to tax withholding for stock-based compensation	(644)	—
Proceeds from the exercise of stock options	—	12
Dividends paid	—	(250)
Net cash used in financing activities	(107,393)	(7,323)
Effect of exchange rate changes on cash and cash equivalents	(8,155)	745
Net change in cash and cash equivalents	(27,942)	58,577
Cash and cash equivalents at the beginning of the period	126,453	96,972
Cash and cash equivalents at the end of the period	$98,511	$155,549

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

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INC RESEARCH HOLDINGS, INC. AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

1. Basis of Presentation and Changes in Significant Accounting Policies

Principal Business

INC Research Holdings, Inc. (the "Company") is a Contract Research Organization ("CRO") providing a comprehensive range of clinical development services for the biopharmaceutical and medical device industries to its customers across various therapeutic areas. The international infrastructure of the Company’s development business enables it to conduct Phase I to Phase IV clinical trials globally for pharmaceutical, biotechnology and medical device companies.

Unaudited Interim Financial Information

The Company prepared the accompanying unaudited condensed consolidated financial statements in accordance with generally accepted accounting principles in the United States of America ("U.S. GAAP") for interim financial information. The significant accounting policies followed by the Company for interim financial reporting are consistent with the accounting policies followed for annual financial reporting. The unaudited condensed consolidated financial statements, in management’s opinion, include all adjustments of a normal recurring nature necessary for a fair presentation. The information included in this Quarterly Report on Form 10-Q should be read in conjunction with the Company's audited consolidated financial statements and notes thereto included in the Company's Annual Report on Form 10-K for the year ended December 31, 2014 filed with the Securities and Exchange Commission on February 24, 2015. The results of operations for the three and six months ended June 30, 2015 are not necessarily indicative of the results to be expected for the year ending December 31, 2015 or any other future period. The amounts in the December 31, 2014 consolidated condensed balance sheet are derived from the audited financial statements for the year ended December 31, 2014.

Recently Issued Accounting Standards

In May 2014, the FASB issued ASU No. 2014-09, Revenue from Contracts with Customers. ASU 2014-09 will eliminate transaction- and industry-specific revenue recognition guidance under current U.S. GAAP and replace it with a principle based approach for determining revenue recognition. ASU 2014-09 will require that companies recognize revenue based on the value of transferred goods or services as they occur in the contract. The ASU also will require additional disclosure about the nature, amount, timing and uncertainty of revenue and cash flows arising from customer contracts, including significant judgments and changes in judgments and assets recognized from costs incurred to obtain or fulfill a contract. In July 2015, the FASB delayed the effective date of ASU 2014-09 by one year and modified the standard to allow the early adoption. For public entities, the standard is now effective for reporting periods beginning after December 15, 2017. Earlier application is permitted only as of annual reporting periods beginning after December 15, 2016, including interim reporting periods within that reporting period. Entities can transition to the standard either retrospectively or as a cumulative-effect adjustment as of the date of adoption. The Company is currently evaluating the impact of the adoption of this standard on its consolidated financial statements.

In April 2015, the FASB issued ASU No. 2015-03, Interest - Imputation of Interest (Subtopic 835-30): Simplifying the Presentation of Debt Issuance Costs. The amendments in this ASU require that debt issuance costs related to a recognized debt liability be presented in the balance sheet as a direct deduction from the carrying amount of that debt liability, consistent with debt discounts, and is to be applied on a retrospective basis. ASU 2015-03 is effective for financial statements issued for fiscal years beginning after December 15, 2015, and interim periods within those fiscal years. Early adoption of the amendments is permitted. As of June 30, 2015, the Company had debt issuance costs related to its term loans of $0.8 million in prepaid expenses and other current assets and $2.6 million in other long-term assets that would be reclassified to long-term debt, net.

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In April 2015, the FASB issued ASU No. 2015-05, Customer's Accounting For Fees Paid In A Cloud Computing Arrangement, which provides guidance for a customer's accounting for cloud computing costs. Under ASU 2015-05, if a software cloud computing arrangement contains a software license, customers should account for the license element of the arrangement in a manner consistent with the acquisition of other software licenses. If the arrangement does not contain a software license, customers should account for the arrangement as a service contract. This standard may be applied either prospectively to all arrangements entered into or materially modified after the effective date, or retrospectively. ASU 2015-05 is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2015, and early adoption is permitted. The Company is currently evaluating the impact of the adoption of this standard on its consolidated financial statements.

2. Financial Statement Details

Accounts receivable billed, net

Accounts receivable, net of allowance for doubtful accounts, consisted of the following (in thousands):

	June 30, 2015	December 31, 2014
Accounts receivable, billed	$147,260	$133,997
Less allowance for doubtful accounts	(3,643)	(3,727)
Accounts receivable billed, net	$143,617	$130,270

Goodwill and Long-Lived Assets

In connection with the annual goodwill impairment analysis performed in the fourth quarter of 2014, the Company's Phase I Services reporting unit failed Step I of the goodwill impairment test. The Company performed Step II of the goodwill impairment test to asses if the goodwill has been impaired, which resulted in no further impairment during 2014. During the first quarter of 2015, the Company continued to observe deteriorating performance due to reduced revenue resulting from cancellations and lower than expected new business awards in its Phase I Services asset group and reporting unit. This resulted in a triggering event requiring an evaluation of both long-lived assets and goodwill for potential impairment. As of the date of this evaluation, there were no remaining intangible assets associated with Phase I Services.

In accordance with the authoritative guidance for Intangibles - Goodwill and Other under ASC 350, the impairment test of goodwill was performed at the reporting unit level and involved a two-step process. The first step involved comparing the fair value of the Phase I Services reporting unit with the carrying amount of its assets and liabilities, including goodwill, as goodwill was specifically assigned to this reporting unit. This impairment test of goodwill determined that the Phase I Services reporting unit’s fair value was less than the carrying amount of its assets and liabilities, requiring the Company to proceed with the second step of the goodwill impairment test. In the second step of the testing process, the impairment loss was determined by comparing the implied fair value of the Phase I Services reporting unit’s goodwill to the recorded amount of goodwill. The implied fair value was calculated based on discounted estimated future cash flows. The estimated future cash flows were based upon, among other things, certain assumptions about expected future operating performance, growth rates and other factors. This first quarter evaluation resulted in a $2.9 million impairment charge, which represented the remaining goodwill balance of the Phase I Services reporting unit.

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The changes in carrying amount of goodwill for the six months ended June 30, 2015 were as follows (in thousands):

	Total	Clinical Development Services	Phase I Services	Global Consulting
Balance at December 31, 2014:				
Gross goodwill	$570,106	$542,683	$8,142	$19,281
Accumulated impairment losses	(13,243)	—	(5,219)	(8,024)
Total goodwill and accumulated impairment losses	556,863	542,683	2,923	11,257
2015 Activity:				
Impairment of goodwill	(2,923)	—	(2,923)	—
Impact of foreign currency translation	(356)	(356)	—	—
Balance at June 30, 2015:				
Gross goodwill	569,750	542,327	8,142	19,281
Accumulated impairment losses	(16,166)	—	(8,142)	(8,024)
Total goodwill and accumulated impairment losses	$553,584	$542,327	$—	$11,257

The Company also performed an impairment test of the long-lived assets by comparing the carrying amount of Phase I Services asset group to the sum of their undiscounted expected future cash flows. In accordance with the authoritative guidance for Property, Plant and Equipment under ASC 360, impairment exists if the sum of the undiscounted expected future cash flows is less than the carrying amount of its related group of assets. If impairment exists, the impairment loss is measured and recorded based on the amount by which the carrying amount of the long-lived asset (asset group) exceeds its fair value. The indirect cost valuation approach was used to estimate the fair value. Under this valuation approach, the Company estimated the fair value by applying an index or trend factor to the historical cost. As a result of this evaluation, the Company recorded a long-lived assets impairment charge during the first quarter of 2015 of $1.0 million. As part of this evaluation, the Company also reviewed the estimated useful lives assigned to long-lived assets and determined no adjustment was deemed necessary at that time.

As a result of these evaluations, the Company recorded total asset impairment charges of $3.9 million for the six months ended June 30, 2015.

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Accrued liabilities

Accrued liabilities consisted of the following (in thousands):

	June 30, 2015	December 31, 2014
Compensation, including bonuses, fringe benefits, and payroll taxes	$53,884	$64,555
Accrued interest	550	2,678
Accrued taxes	10,048	10,784
Accrued rebates to customers	6,080	7,742
Accrued professional services	4,407	6,614
Accrued restructuring costs, current portion	3,578	1,777
Contingent consideration payable on acquisitions	72	1,113
Current portion of deferred income tax liability	384	319
Other liabilities	21,268	16,073
Total accrued liabilities	$100,271	$111,655

Other long-term liabilities

Other long-term liabilities consisted of the following (in thousands):

	June 30, 2015	December 31, 2014
Uncertain tax positions	$10,140	$13,012
Accrued restructuring costs, less current portion	3,269	4,367
Other liabilities	7,500	10,047
Total other long-term liabilities	$20,909	$27,426

Other income (expense), net

Other income (expense), net consisted of the following (in thousands):

	Three Months Ended		Six Months Ended	
	June 30, 2015	June 30, 2014	June 30, 2015	June 30, 2014
Net realized foreign currency gain (loss)	$(785)	$(3,002)	$7	$(4,092)
Net unrealized foreign currency gain (loss)	2,074	2,613	4,463	4,941
Other, net	386	52	671	192
Total other income (expense), net	$1,675	$(337)	$5,141	$1,041

3. Business Combinations

Acquisition of MEK Consulting

On March 5, 2014, the Company acquired stock and assets of MEK Consulting, consisting of MEK Consulting Egypt Ltd., MEK Consulting Danismanlik Ltd. Sti., MEK Consulting Hellas EPE, and MEK Consulting SARL (MEK Consulting), collectively referred to as MEK. MEK is a full service CRO with operations in Egypt, Greece, Jordan, Lebanon, and Turkey. The aggregate purchase price for the acquisition totaled $4.0 million, which consisted of (i) $3.0 million cash, of which $0.5 million was placed

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in escrow for the one year period following the closing date for the satisfaction of potential indemnification claims, and (ii) $1.0 million contingent consideration, payable, if earned, during the one year period following the closing date. In addition, the purchase agreement included provisions for $2.0 million of retention payments to certain key employees that will be accounted for as compensation expense and expensed as earned during the three year period following the closing date.

During the second quarter of 2015, the Company finalized the amount of the contingent consideration based on the achievement of the pre-agreed targets. The final contingent consideration totaled $0.8 million and, as a result, the Company released $0.2 million of accrued liabilities. The reduction in the contingent consideration was recorded in the "Other income (expense), net" line item in the Condensed Consolidated Statements of Operations. Additionally, the Company released $0.5 million of cash previously withheld to cover potential indemnification claims.

Since the period of acquisition, the Company has recognized a total of $1.2 million of compensation expense for successful retention of operational staff and certain key employees, including $0.1 million and $0.2 million in the three months ended June 30, 2015 and 2014, and $0.3 million and $0.4 million in the six months ended June 30, 2015 and 2014, respectively. This compensation expense is included within "Direct costs" line item in the Condensed Consolidated Statements of Operations. The remaining $0.8 million of the retention payments will be accrued and expensed ratably over the remaining contingent employment periods, to the extent it is earned.

4. Long-Term Debt

2015 Credit Agreement

On May 14, 2015, the Company entered into a five-year $675.0 million credit agreement ("2015 Credit Agreement") which is comprised of a $525.0 million term loan A ("2015 Term Loan") and a $150.0 million revolving line of credit ("2015 Revolver"). All obligations under the 2015 Credit Agreement are guaranteed by the Company and certain of the Company's direct and indirect wholly-owned domestic subsidiaries. The obligations under the 2015 Credit Agreement are secured by substantially all of the assets of the Company and the guarantors.

As of June 30, 2015, $475.0 million was outstanding on the 2015 Term Loan. Beginning on September 30, 2015 and continuing through March 31, 2020, the 2015 Term Loan has scheduled quarterly principal payments of the initial principal borrowed of 1.25%, or $6.6 million per quarter in year 1; 1.875%, or $9.8 million per quarter in years 2 and 3; 2.50%, or $13.1 million per quarter in year 4; and 3.125%, or $16.4 million per quarter in year 5; with the remaining outstanding principal due on May 14, 2020. On June 15, 2015, the Company made a $50.0 million prepayment on the term loan which will be applied against the regularly-scheduled quarterly principal payments. As such, the Company will not be required to make a mandatory principal payment until March 31, 2017.

The 2015 Credit Agreement provides Eurodollar Rate and Base Rate term loans. Eurodollar Rate term loans are one-, two-, three-, or six-month loans (or, with permission, twelve-month) and interest is due on the last day of each three-month period of the loans. Base Rate term loans have interest due on the last day of each calendar quarter. In advance of the last day of the then-current type of loan, the Company may select a new type of loan, so long as it does not extend beyond May 14, 2020.

The 2015 Revolver includes letters of credit (LOC) and swingline loans available in an amount not to exceed $15.0 million each. Fees are charged on all outstanding LOCs at an annual rate equal to the margin in effect on Eurodollar Rate revolving loans plus fronting fees. The fee is payable quarterly in arrears on the last day of the calendar quarter after the issuance date until the LOC expires. As of June 30, 2015, there were approximately $1.0 million of LOCs and no swingline loans outstanding, leaving $149.0 million in available borrowings under the 2015 Revolver.

The 2015 Term Loan and 2015 Revolver bear interest at a rate per annum equal to, at the Borrower's option, either: (i) a base rate determined by reference to the highest of: (a) the Prime Rate in effect on such date, (b) the Federal Funds Effective Rate in effect on such day plus 1/2 of 1.00%; and (c) the sum of (1) the Eurodollar Rate that would be payable on such day for the Eurodollar Rate Loan with a one-

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month interest period, and (2) 1.00%; or (ii) a LIBOR rate determined by reference to the costs of funds for Eurodollar deposits for the interest period relevant to such borrowing adjusted for certain reserve requirements (Eurodollar Rate). The applicable margin with respect to Base Rate is between 0.50% and 1.25% and the applicable margin with respect to the Eurodollar Rate borrowings is between 1.50% and 2.25% depending on the "Secured Net Leverage Ratio" (as defined in the 2015 Credit Agreement). The Company also pays a quarterly Commitment Fee between 0.20% and 0.35% on the average daily unused balance of the 2015 Revolver depending on the Secured Net Leverage Ratio at the adjustment date. As of June 30, 2015, the interest rate on the 2015 Term Loan was 2.19%.

The 2015 Credit Agreement permits the Borrower to increase term loan or revolving commitments under the term loan facility and/or revolving credit facility and/or to request the establishment of one or more new term loan facilities and/or revolving facilities in an aggregate amount not to exceed $150.0 million if certain net leverage requirements are met. The availability of such additional capacity is subject to, among other things, receipt of commitments from existing lenders or other financial institutions.

The Company's maturities of obligations under the 2015 Credit Agreement for the years ending December 31, are as follows (in thousands):

2015 (remaining 6 months)	$—
2016	—
2017	35,313
2018	45,938
2019	59,062
2020	334,687
Total long-term debt	$475,000

2015 Refinancing

On May 14, 2015, the Company entered into the 2015 Credit Agreement and repaid all of its outstanding obligations under the existing 2014 Credit Agreement and paid transaction costs associated with the 2015 Credit Agreement. In addition, the Company recognized a $9.4 million loss on extinguishment of the 2014 Credit Agreement which was comprised of $5.1 million of unamortized discount and $4.3 million of unamortized debt issuance costs. In June 2015, the Company made a prepayment of $50.0 million under the 2015 Credit Agreement. As a result, the Company recognized an additional $0.4 million loss on extinguishment of debt.

The 2014 Credit Agreement was comprised of a $425.0 million term loan B, a $100.0 million revolving line of credit, and letter of credit and swingline facilities. The term loan had scheduled quarterly principal payments of 0.25% of the aggregate initial principal borrowed, or $1.1 million per quarter, with the remaining outstanding principal due on November 13, 2021. The 2014 Credit Agreement bore interest at approximately 4.5% during 2015 prior to repayment.

For the six months ended June 30, 2014, the Company had outstanding debt under the 2011 Credit Agreement which was comprised of a $300.0 million term loan, a $75.0 million revolving line of credit and a letter of credit and swingline facilities. As of June 30, 2014, the interest rate on the 2011 Term Loan was 4.25%. Additionally, at June 30, 2014 the Company had an outstanding principal balance of $300.0 million in secured Senior Notes bearing interest of 11.5% annually. In connection with the Company's initial public offering in November 2014, the Company repaid the outstanding balances on the 2011 Credit Agreement and Senior Notes and entered into the 2014 Credit Agreement.

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Debt Covenants

The 2015 Credit Agreement contains usual and customary restrictive covenants that, among other things, place limitations on the Company's ability to pay dividends or make other restricted payments; prepay, redeem or purchase debt; incur liens; make loans and investments; incur additional indebtedness; amend or otherwise alter debt and other material documents; make acquisitions and dispose of assets; transact with affiliates; and engage in businesses that are not related to the Company's existing business.

In addition, the 2015 Credit Agreement contains financial covenants which require the Company to maintain a Secured Net Leverage Ratio and Interest Coverage Ratio as of the last day of any four consecutive fiscal quarters. The Secured Net Leverage Ratio is a relationship between the level of secured outstanding borrowings, net of a certain amount of cash not to exceed $75.0 million, and Consolidated EBITDA. The Interest Coverage Ratio is a relationship between the level Consolidated EBITDA and Consolidated Interest Expense. Specifically, these covenants require the Company to maintain a maximum Secured Net Leverage Ratio of no more than 4 to 1 and a minimum Interest Coverage Ratio of no less than 3 to 1. The Company was in compliance with its debt covenants for all periods through June 30, 2015.

Debt Discounts and Debt Issuance Costs

The Company had recorded debt issuance costs of approximately $4.5 million and $4.6 million as of June 30, 2015 and December 31, 2014, respectively. These costs are included as a component of other assets and are being amortized as a component of interest expense using the effective interest method over the term of the debt arrangements.

Borrowings under the Company’s 2014 Credit Agreement were issued net of a discount. As a result, the Company had a net discount balance of $5.5 million as of December 31, 2014. The discount was recorded as a reduction of the principal balance and was accreted up as a component of interest expense using the effective interest method over the term of the debt arrangement.

5. Fair Value Measurements

At June 30, 2015 and December 31, 2014, the Company’s financial instruments included cash and cash equivalents, restricted cash, accounts receivable, accounts payable and debt. The fair value of the cash and cash equivalents, restricted cash, accounts receivable and accounts payable approximate their respective carrying amounts based on the liquidity and short-term nature of these instruments.

The fair value of the long-term debt is determined based on market prices for identical or similar financial instruments or model-derived valuations based on observable inputs and falls under Level 2 of the fair value hierarchy as defined in the authoritative guidance. The estimated fair value of the long-term debt was $475.0 million and $423.4 million at June 30, 2015 and December 31, 2014, respectively.

The Company does not have any recurring fair value measurements. There were no transfers between Level 1, Level 2 or Level 3 during the six months ended June 30, 2015.

Non-Recurring Fair Value Measurements

Certain assets, including goodwill and identifiable intangible assets, are carried on the accompanying condensed consolidated balance sheets at cost and are not remeasured to fair value on a recurring basis. These assets are tested for impairment annually and when a triggering event occurs. As of June 30, 2015 and December 31, 2014, assets carried on the balance sheet and not remeasured to fair value on a recurring basis total $724.9 million and $747.2 million, respectively. The fair value of these assets falls under Level 3 of the fair value hierarchy as defined in the authoritative guidance and the fair value is estimated as follows:

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Goodwill – As of June 30, 2015 and December 31, 2014, the Company had recorded goodwill of $553.6 million and $556.9 million, respectively. Goodwill represents the difference between the purchase price and the fair value of the identifiable tangible and intangible net assets when an acquisition is accounted for using the purchase method. The Company performs a quantitative goodwill impairment assessment on each reporting unit. The Company derives each reporting unit's fair value through a combination of the market approach (the guideline publicly traded company method) and the income approach (a discounted cash flow analysis). The Company then compares the carrying value of each reporting unit, inclusive of its assigned goodwill, to its fair value.

If the carrying value of the net assets assigned to the reporting unit exceeds the estimated fair value of the reporting unit, the Company performs the second step of the impairment test to determine the implied estimated fair value of the reporting unit's goodwill. The Company determines the implied estimated fair value of goodwill by determining the present value of the estimated future cash flows for each reporting unit and comparing the reporting unit's risk profile and growth prospects to selected, reasonably similar publicly traded companies. During the first quarter of 2015, the Company recognized a $2.9 million impairment charge related to goodwill, as discussed in Note 2 "Financial Statement Details."

Finite-lived Intangible Assets – As of June 30, 2015 and December 31, 2014, the Company had recorded finite-lived intangible assets of $136.3 million and $155.4 million, respectively. If a triggering event occurs, the Company determines the estimated fair value of finite-lived intangible assets by determining the present value of the expected cash flows.

Indefinite-lived Intangible Assets – As of June 30, 2015 and December 31, 2014, the Company had recorded indefinite-lived intangible assets of $35.0 million. When evaluating indefinite-lived intangible assets for impairment, the Company performs a quantitative impairment analysis. The Company determines the estimated fair value of the indefinite-lived intangible asset (trademark) by determining the present value of the estimated royalty payments on an after-tax basis that it would be required to pay the owner for the right to use such trade name. If the carrying amount exceeds the estimated fair value, an impairment loss is recognized in an amount equal to the excess.

6. Restructuring and Other Costs

During the second quarter of 2015, the Company initiated restructuring activities to better align its resources worldwide. Specifically, the Company initiated a plan to reduce its workforce by approximately 60 employees, primarily in the United States and certain countries in Europe and principally within the Clinical Development Services operations group and several corporate administrative functions. The Company completed the majority of these actions in June and July of 2015 and expects to complete the remaining activities by the end of 2015. For the six months ended June 30, 2015, the Company incurred $1.9 million of severance costs related to these activities.

For the six months ended June 30, 2015, the Company recorded a net reduction in facility closure expenses of $0.3 million primarily related to the reversal of previously accrued liabilities related to completing negotiations with respect to exiting certain facilities during the first quarter of 2015. As a result of these negotiations, the Company revised its exit cost estimates related to the corresponding lease agreements resulting in a reduction in expenses of approximately $0.7 million which was partially offset by expenses of $0.4 million primarily related to early lease termination fees.

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The costs related to all restructuring plans are included in the "Restructuring and other costs" line item in the Condensed Consolidated Statements of Operations. Restructuring costs are not allocated to the Company’s reportable segments because they are not part of the segment performance measures regularly reviewed by management. During the six months ended June 30, 2015, the Company made payments and provision adjustments for all plans as presented below (in thousands):

	Employee Severance Costs	Facility Closure Charges	Total
Balance at December 31, 2014	$—	$6,144	$6,144
Expenses incurred, net	1,901	(307)	1,594
Payments made	(119)	(772)	(891)
Balance at June 30, 2015	$1,782	$5,065	$6,847

7. Stockholders' Equity

In May 2015, the Company repurchased 5,053,482 shares of its Class A common stock pursuant to an agreement with investment funds affiliated with its Sponsors, Avista Capital Partners, L.P. ("Avista") and Ontario Teachers' Pension Plan Board ("OTPP"), in a private transaction at a price of $29.68 per share, after deducting underwriting discounts, commissions and related expenses, resulting in a total purchase price of approximately $150.0 million. In conjunction with this transaction, the Company's Sponsors and certain other stockholders sold 8,050,000 shares of the Company's common stock, including 1,050,000 shares that were offered and sold pursuant to the underwriters' exercise in full of its option to purchase additional shares.

The following is a summary of the Company's authorized, issued and outstanding shares:

	June 30, 2015	December 31, 2014
Shares Authorized:		
Class A common stock	300,000,000	300,000,000
Class B common stock	300,000,000	300,000,000
Preferred stock	30,000,000	30,000,000
Total shares authorized	630,000,000	630,000,000
Shares Issued:		
Class A common stock	53,085,726	51,199,856
Class B common stock	3,167,439	10,033,994
Preferred stock	—	—
Total shares issued	56,253,165	61,233,850
Shares Outstanding:		
Class A common stock	53,085,726	51,199,856
Class B common stock	3,167,439	10,033,994
Preferred stock	—	—
Total shares outstanding	56,253,165	61,233,850

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8. Earnings Per Share

The following table provides a reconciliation of the numerators and denominators of the basic and diluted earnings per share computations for the three and six months ended June 30, 2015 and June 30, 2014 (in thousands, except per share data):

	Net Income (Numerator)	Number of Shares (Denominator)	Per-Share Amount
For the three months ended June 30, 2015			
Basic net income per share	$23,321	58,231	$0.40
Effect of dilutive securities	—	2,233	
Diluted net income per share	$23,321	60,464	$0.39
For the three months ended June 30, 2014			
Basic net income per share	$15,182	51,898	$0.29
Effect of dilutive securities	—	287	
Diluted net income per share	$15,182	52,185	$0.29

	Net Income (Numerator)	Number of Shares (Denominator)	Per-Share Amount
For the six months ended June 30, 2015			
Basic net income per share	$48,577	59,731	$0.81
Effect of dilutive securities	—	2,074	
Diluted net income per share	$48,577	61,805	$0.79
For the six months ended June 30, 2014			
Basic net income per share	$13,505	51,897	$0.26
Effect of dilutive securities	—	169	
Diluted net income per share	$13,505	52,066	$0.26

The computation of diluted earnings per share excludes unexercised stock options and unvested restricted stock units("RSUs") that are anti-dilutive. The following common stock equivalents were excluded from the earnings per share computation as their inclusion would have been anti-dilutive (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2015	2014	2015	2014
Weighted average number of stock options and RSUs calculated using the treasury stock method that were excluded due to the exercise/threshold price exceeding the average market price of our common stock during the period	23	669	15	909

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9. Stock-Based Compensation

The following table summarizes option activity as of and for the period ending June 30, 2015:

	Number of Options	Weighted Average Exercise Price	Weighted Average Grant Date Fair Value
Outstanding at December 31, 2014	3,930,220	$11.64	
Granted	162,510	$39.00	$12.99
Exercised	(131,859)	$9.09	
Forfeited	(41,419)	$10.57	
Expired	—	$—	
Outstanding at June 30, 2015	3,919,452	$12.87	
Vested and exercisable at June 30, 2015	1,486,069	$10.38	

The following table sets forth a summary of RSUs outstanding as of June 30, 2015 and changes during the period:

	Number of RSUs	Weighted Average Grant Date Fair Value
Non-vested at December 31, 2014	674	
Granted	81,254	$39.00
Vested	—	
Forfeited	—	
Non-vested at June 30, 2015	81,928	

Total stock-based compensation expense recognized in the Condensed Consolidated Statements of Operations for the three and six months ended June 30, 2015 and 2014 was as follows (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2015	2014	2015	2014
Direct costs	$353	$296	$736	$535
Selling, general and administrative	560	597	884	889
Total stock-based compensation expense	$913	$893	$1,620	$1,424

10. Income Taxes

The Company's effective tax rate for the three and six months ended June 30, 2015 and 2014 was lower than the U.S. federal statutory rate primarily due to (i) income or losses generated in jurisdictions where the income tax expense or benefit was offset by a corresponding change in the valuation allowance on net deferred tax assets, (ii) the geographic split of pre-tax income, and (iii) discrete tax adjustments related to the release of valuation allowances and unrecognized tax benefits.

The Company recognizes a tax benefit from an uncertain tax position only if the Company believes it is more likely than not to be sustained upon examination based on the technical merits of the position. Judgment is required in determining what constitutes an individual tax position, as well as the assessment of the outcome of each tax position. The Company considers many factors when evaluating and

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estimating tax positions and tax benefits. In addition, the calculation of tax liabilities involves dealing with uncertainties in the application of complex tax regulations in domestic and foreign jurisdictions. If events occur and the payment of these amounts ultimately proves to be unnecessary, the reversal of liabilities would result in tax benefits being recognized in the period when it is determined the liabilities are no longer necessary. If the calculation of liability related to uncertain tax positions proves to be more or less than the ultimate assessment, a tax expense or benefit to expense, respectively, would result.

As of June 30, 2015 and December 31, 2014, the Company had gross unrecognized tax benefits of $20.9 million and $21.6 million, respectively. The total amount of unrecognized tax benefit that, if recognized, would impact the effective tax rate was $10.1 million and $13.0 million, respectively. During the three months ended June 30, 2015, the Company released $2.6 million in uncertain tax benefits. The release of the benefits was recorded as a discrete adjustment to income tax expense. The Company believes it is reasonably possible that approximately $2.1 million of gross unrecognized tax benefits related to intercompany transactions will be released in the next twelve months due to statute of limitations expirations.

11. Segment Information

The Company is managed through three reportable segments: Clinical Development Services, Phase I Services and Global Consulting. Clinical Development Services offers a variety of clinical development services including full-service global studies, as well as ancillary services such as clinical monitoring, investigator recruitment, patient recruitment, data management and study reports to assist customers with their drug development process. Phase I Services focuses on clinical development services for Phase I trials that include scientific exploratory medicine, first-in-human studies through proof-of-concept stages, and support for Phase I studies in established compounds. Global Consulting provides consulting services regarding clinical trial regulatory affairs, regulatory consulting services, quality assurance audits and pharmacovigilance consulting, non-clinical consulting and medical writing consulting.

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The Company’s Chief Operating Decision Maker (Company's CODM) reviews segment performance and allocates resources based upon segment revenue and segment contribution margin. The Company’s CODM does not review inter-segment revenue when evaluating segment performance and allocating resources to each segment. Thus, inter-segment revenue is not included in the segment revenues presented in the table below. As such, total segment revenue in the table below is equal to the Company’s consolidated net service revenue. All direct costs are allocated to the Company’s segments, and as such, segment total direct costs are equal to the Company’s consolidated direct costs and consolidated gross margin. Revenue, direct costs and contribution margin for each of our segments were as follows (in thousands):

	Three Months Ended		Six Months Ended	
	June 30, 2015	June 30, 2014	June 30, 2015	June 30, 2014
Revenue:				
Clinical Development Services	$221,277	$199,500	$428,052	$379,425
Phase I Services	3,764	2,128	6,866	4,595
Global Consulting	2,335	1,912	3,972	4,220
Segment revenue	227,376	203,540	438,890	388,240
Reimbursable out-of-pocket expenses not allocated to segments	109,916	82,203	207,319	164,280
Total revenue	$337,292	$285,743	$646,209	$552,520
Direct costs:				
Clinical Development Services	$133,431	$126,519	$254,656	$242,582
Phase I Services	2,784	2,003	5,315	4,557
Global Consulting	1,795	2,259	3,487	4,406
Segment direct costs	138,010	130,781	263,458	251,545
Reimbursable out-of-pocket expenses not allocated to segments	109,916	82,203	207,319	164,280
Direct costs and reimbursable out-of-pocket expenses	$247,926	$212,984	$470,777	$415,825
Segment contribution margin:				
Clinical Development Services	$87,846	$72,981	$173,396	$136,843
Phase I Services	980	125	1,551	38
Global Consulting	540	(347)	485	(186)
Segment contribution margin	89,366	72,759	175,432	136,695
Less expenses not allocated to segments:				
Selling, general and administrative	37,125	33,962	72,925	66,147
Restructuring and other costs	2,012	2,417	1,594	3,175
Transaction expenses	397	—	519	2,042
Asset impairment charges	—	17,245	3,931	17,245
Depreciation and amortization	13,893	11,263	28,137	25,634
Consolidated income from operations	$35,939	$7,872	$68,326	$22,452

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12. Operations by Geographic Location

The Company conducts operations in North America, Europe, Middle East and Africa, Asia-Pacific, and Latin America through wholly-owned subsidiaries and representative sales offices. The Company attributes net service revenues to geographical locations based upon the location of the customer (i.e., the location to which the Company invoices the end customer). The following table summarizes total revenue by geographic area (in thousands and all intercompany transactions have been eliminated):

	Three Months Ended		Six Months Ended	
	June 30, 2015	June 30, 2014	June 30, 2015	June 30, 2014
Net service revenue:				
North America(1)	$167,822	$142,734	$319,451	$273,302
Europe, Middle East and Africa	55,426	54,733	110,793	102,428
Asia-Pacific	4,068	6,045	8,585	12,481
Latin America	60	28	61	29
Total net service revenue	227,376	203,540	438,890	388,240
Reimbursable-out-of-pocket expenses	109,916	82,203	207,319	164,280
Total revenue	$337,292	$285,743	$646,209	$552,520

(1) Net service revenue for the North America region includes revenue attributable to the U.S. of $163.3 million and $142.4 million, or 71.8% and 70.0% of net service revenue, for the three months ended June 30, 2015 and 2014, respectively. Net service revenue for the North America region includes revenue attributable to the U.S. of $311.1 million and $272.7 million, or 70.9% and 70.2% of net service revenue, for the six months ended June 30, 2015 and 2014, respectively. No other countries represented more than 10% of net service revenue for any period.

The following table summarizes long-lived assets by geographic area (in thousands and all intercompany transactions have been eliminated):

	June 30, 2015	December 31, 2014
Total property and equipment, net:		
North America(1)	$26,703	$28,287
Europe, Middle East, and Africa(2)	8,756	10,212
Asia-Pacific	4,424	4,473
Latin America	586	753
Total property and equipment, net	$40,469	$43,725

(1) Long-lived assets for the North America region include property and equipment, net attributable to the U.S. of $26.3 million and $26.6 million as of June 30, 2015 and December 31, 2014, respectively.

(2) Long-lived assets for the Europe, Middle East, and Africa regions include property and equipment, net attributable to Spain of $4.1 million and $4.5 million as of June 30, 2015 and December 31, 2014, respectively.

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13. Concentration of Credit Risk

Financial assets that subject the Company to credit risk primarily consist of cash and cash equivalents and billed and unbilled accounts receivable. The Company's cash and cash equivalents consist principally of cash and are maintained at several financial institutions with reputable credit ratings. The Company believes these instruments bear minimal credit risk. There is no state insurance coverage on bank balances of $1.0 million at June 30, 2015 and $1.2 million at December 31, 2014, held in the Netherlands.

Substantially all of the Company's net service revenue is earned by performing services under contracts with pharmaceutical and biotechnology companies. The concentration of credit risk is equal to the outstanding billed and unbilled accounts receivable, less deferred revenue related thereto. The Company does not require collateral or other securities to support customer receivables. The Company maintains a credit approval process and makes significant judgments in connection with assessing customers' ability to pay throughout the contractual obligation. Despite this assessment, from time to time, customers are unable to meet their payment obligations. The Company continuously monitors customers' credit worthiness and applies judgment in establishing a provision for estimated credit losses based on historical experience and any specific customer collection issues that have been identified.

For the six months ended June 30, 2015 and June 30, 2014, various subsidiaries of Astellas Pharma, Inc. (Astellas) accounted for 10% and 12% of total net service revenue, respectively. Additionally, for the three months ended June 30, 2014, Astellas accounted for 12% of total net service revenue. For the three and six months ended June 30, 2014, various subsidiaries of Otsuka Holdings Co., Ltd. accounted for 14% of total net service revenue. No customer accounted for 10% or more of total net service revenues for the three months ended June 30, 2015.

At June 30, 2015 and December 31, 2014, no customer accounted for more than 10% of billed and unbilled accounts receivable.

14. Related-Party Transactions

Through November 7, 2014, the Company had an agreement with a significant stockholder for the stockholder to perform certain consulting services. In conjunction with the corporate reorganization in November 2014, the Company paid cash of approximately $3.4 million to terminate this agreement. Prior to the termination of this agreement, the Company recognized $0.1 million and $0.3 million of consulting services expense for the three and six months ended June 30, 2014, respectively. There were no material transactions with related parties in the three and six months ended June 30, 2015.

15. Commitments and Contingencies

The Company records accruals for claims, suits, investigations and proceedings when it is probable that a liability has been incurred and the amount of the loss can be reasonably estimated. The Company reviews claims, suits, investigations and proceedings at least quarterly and records or adjusts accruals related to such matters to reflect the impact and status of any settlements, rulings, advice of counsel or other information pertinent to a particular matter.

In the normal course of business, the Company periodically becomes involved in various claims and lawsuits that are incidental to its business. While the outcome of these matters could differ from management's expectations, the Company does not believe the resolution of these matters will have a material effect upon the Company's financial statements.

The Company currently maintains insurance for risks associated with the operation of its business, provision of professional services and ownership of property. These policies provide coverage for a variety of potential losses, including loss or damage to property, bodily injury, general commercial liability, professional errors and omissions, and medical malpractice.

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The Company is self-insured for certain losses relating to health insurance claims for the majority of its employees located within the United States. The Company purchases stop-loss coverage from third party insurance carriers to limit individual or aggregate loss exposure with respect to the Company's health insurance claims.
Accrued insurance liabilities and related expenses are based on estimates of claims incurred but not reported. Incurred but not reported claims are generally determined by taking into account historical claims payments and known trends such as claim frequency and severity. The Company makes estimated judgments and assumptions with respect to these calculations, including but not limited to, estimated healthcare cost trends, estimated lag time to report any paid claims, average cost per claim and other factors. The Company believes the estimates of future liability are reasonable based on its methodology; however, changes in claims activity (volume and amount per claim) could materially affect the estimate for these liabilities. The Company continually monitors claim activity and incidents and makes necessary adjustments based on these evaluations. As of June 30, 2015, the Company had accrued self-insurance reserves of $2.5 million.

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Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations.

Forward Looking Statements

You should read the following discussion and analysis of our financial condition and results of operations in conjunction with our condensed consolidated financial statements and the notes thereto included elsewhere in this Quarterly Report on Form 10-Q and with our audited consolidated financial statements and the notes thereto included in our Annual Report on Form 10-K for the fiscal year ended December 31, 2014.

In addition to historical condensed consolidated financial information, the following discussion contains forward-looking statements that reflect, among other things, our current expectations and anticipated results of operations, all of which are subject to known and unknown risks, uncertainties and other factors that may cause our actual results, performance or achievements, market trends, or industry results to differ materially from those expressed or implied by such forward-looking statements. Therefore, any statements contained herein that are not statements of historical fact may be forward-looking statements and should be evaluated as such. Without limiting the foregoing, the words “anticipates,” “believes,” “estimates,” “expects,” “intends,” “may,” “plans,” “projects,” “should,” “targets the negative thereof and similar words and expressions are intended to identify forward-looking statements. Unless legally required, we assume no obligation to update any such forward-looking information to reflect actual results or changes in the factors affecting such forward-looking information.

We caution you that any such forward-looking statements are further qualified by important factors that could cause our actual operating results to differ materially from those in the forward-looking statements, including without limitation, regional, national or global political, economic, business, competitive, market and regulatory conditions and the following: our potential failure to generate a large number of new business awards and the risk of delay, termination, reduction in scope or failure to go to contract of our business awards; our potential failure to convert backlog to revenue; the impact of underpricing our contracts, overrunning our cost estimates or failing to receive approval for or experiencing delays with documentation of change orders; the risks associated with our information systems infrastructure; any adverse effects from customer or therapeutic area concentration; the risks associated with doing business internationally; our potential failure to successfully increase our market share, grow our business, and execute our growth strategies; our failure to perform our services in accordance with contractual requirements, regulatory standards and ethical considerations; the risk of litigation and personal injury claims; the impact of unfavorable economic conditions and exchange rate and effective income tax rate fluctuations; the risks associated with potential future acquisitions or investments in our customers' businesses or drugs; the impact of changes in government regulations and healthcare reform; and our ability to service our substantial indebtedness. For a further discussion of the risks relating to our business, see “Risk Factors” in our Annual Report on Form 10-K for the fiscal year ended December 31, 2014 and in our Form 10-Q for the quarter ended March 31, 2015.

Overview of our Business and Services

We are a leading global CRO, based on revenues, and are exclusively focused on Phase I to Phase IV clinical development services for the biopharmaceutical and medical device industries. We provide our customers highly differentiated therapeutic alignment and expertise, with a particular strength in central nervous system, or CNS, oncology and other complex diseases. We consistently and predictably deliver clinical development services in a complex environment and offer a proprietary, operational approach to clinical trials through our Trusted Process® methodology. Our service offerings focus on optimizing the development of and, therefore, the commercial potential for, our customers’ new biopharmaceutical compounds, enhancing returns on their research and development, or R&D, investments, and reducing their overhead by offering an attractive variable cost alternative to fixed cost, in-house resources.

Our extensive range of services supports the entire drug development process from Phase I to Phase IV and allows us to offer our customers an integrated suite of investigative site support and clinical

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development services. We offer these services across a wide variety of therapeutic areas with deep clinical expertise with a primary focus on Phase II to Phase IV clinical trials. We provide total biopharmaceutical program development while also providing discrete services for any part of a trial. Our combination of service area experts and depth of clinical capability allows for enhanced protocol design and actionable trial data.

We have three reportable segments: Clinical Development Services, Phase I Services and Global Consulting. Clinical Development Services offers a variety of clinical development services, including full-service global studies, as well as ancillary services such as clinical monitoring, investigator recruitment, patient recruitment, data management and study reports to assist customers with their drug development process. Phase I Services focuses on clinical development services for Phase I trials that include scientific exploratory medicine, first-in-human studies through proof-of-concept stages, and support for Phase I studies in established compounds. Global Consulting provides consulting services regarding clinical trial regulatory affairs, regulatory consulting services, quality assurance audits and pharmacovigilance consulting, non-clinical consulting and medical writing consulting. For financial information regarding revenue and long-lived assets by geographic areas, please see Note 12 - Operations by Geographic Location in our condensed consolidated financial statements included in Item 1 of this Quarterly Report on Form 10-Q.

Our discussion and analysis of our financial condition and results of operations herein is presented on a consolidated basis. Because our Clinical Development Services segment accounts for substantially all of our business operations, we believe that a discussion of our reportable segments' operations would not be meaningful disclosure for investors. See further discussion in Note 11 - Segment Information to our unaudited condensed consolidated financial statements.

We earn net service revenue primarily for services performed under contracts for global clinical drug trials, based upon a combination of milestones and output measures that are specific to the services performed and defined by the contract. Engagements for Phase II to Phase IV clinical trials, which represent the majority of our revenue, are typically long duration contracts ranging from several months to several years. The contracts for these engagements typically cover the detailed scope of work, phases, milestones, billing schedules and processes for review of work and clinical results. Contracts are individually priced and negotiated based on the anticipated level of effort required to complete the project, the complexity and performance risks, and the level of competition in the market.

Direct costs associated with these contracts consist principally of compensation expense and benefits associated with our employees and other employee-related costs. While we can manage the majority of these costs relative to the amount of contracted services we have during any given period, direct costs as a percentage of net service revenue can vary from period to period. Such fluctuations are due to a variety of factors, including, among others: (i) the level of staff utilization created by our ability to effectively manage our workforce, (ii) adjustments to the timing of work on specific customer contracts, (iii) the experience mix of personnel assigned to projects, and (iv) the service mix and pricing of our contracts. In addition, as global projects wind down or as delays and cancellations occur, staffing levels in certain countries or functional areas can become misaligned with the current business volume.

New Business Awards and Backlog

We add new business awards to backlog when we enter into a contract or when we receive a written commitment from the customer selecting us as its service provider, provided that (i) the customer has received appropriate internal funding approval, (ii) the project or projects are not contingent upon completion of another trial or event, (iii) the project or projects are expected to commence within the next 12 months and (iv) the customer has entered or intends to enter into a comprehensive contract as soon as practicable. Contracts generally have terms ranging from several months to several years. We recognize revenue on these awards as services are performed, provided we have entered into a contractual commitment with the customer.

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Our new business awards, net of cancellations of prior awards, for the three months ended June 30, 2015 and June 30, 2014 were $295.9 million and $103.4 million, respectively. Our new business awards, net of cancellations of prior awards, for the six months ended June 30, 2015 and June 30, 2014 were $551.4 million and $384.3 million, respectively. Net new business awards were higher in the first half of 2015 compared to the first half of 2014, primarily due to (i) the 2014 periods including a cancellation valued at approximately $132 million, (ii) the continued growth of our business across therapeutic areas, and (iii) the timing of the conversion of our relationship with a major customer from primarily a functional service provider relationship to a more traditional full service arrangement. New business awards have varied and will continue to vary significantly from quarter to quarter. Fluctuations in our reported backlog and net new business award levels often result from the fact that we may receive a small number of relatively large orders in any given reporting period. Because of these large orders, our backlog and net new business awards in that reporting period might reach levels that are not sustained in subsequent reporting periods.

The dollar amount of our backlog consists of anticipated future net service revenue from business awards that either have not started but are anticipated to begin in the future, or that are in process and have not been completed. Our backlog also reflects any cancellation or adjustment activity related to these contracts. The average duration of our contracts will fluctuate from period to period in the future based on the contracts comprising our backlog at any given time. The majority of our contracts can be terminated by our customers with 30 days' notice. The dollar amount of our backlog is adjusted each quarter for foreign currency fluctuations. For the six and twelve months ended June 30, 2015, fluctuations in foreign currency exchange rates resulted in an unfavorable impact on our June 30, 2015 backlog in the amount of $25.9 million and $73.2 million, respectively, primarily due to the weakening of the Euro and British Pound against the U.S. dollar. However, for the three months ended June 30, 2015, backlog was favorably impacted by $12.9 million as a result of a slight recovery of the Euro and British Pound against the U.S. dollar. As of June 30, 2015 and 2014, our backlog was $1.7 billion and $1.5 billion, respectively. Included within backlog at June 30, 2015 is approximately $0.4 billion that we expect to generate revenue from in 2015.

We believe that backlog and net new business awards might not be consistent indicators of future revenue because they have been, and likely will be, affected by a number of factors, including the variable size and duration of projects, many of which are performed over several years, and cancellations and changes to the scope of work during the course of projects. Additionally, projects may be canceled or delayed by the customer or delayed by regulatory authorities. Projects that have been delayed for less than 12 months remain in backlog, but the anticipated timing of the recognition of revenue is uncertain. We generally do not have a contractual right to the full amount of the revenue reflected in our backlog. If a customer cancels an award, we might be reimbursed for the costs we have incurred. As we increasingly compete for and enter into large contracts that are more global in nature, we expect the rate at which our backlog and net new business awards convert into revenue to decrease, or lengthen. See "Risk Factors - Risks Related to Our Business - Our Backlog might not be indicative of our future revenues, and we might not realize all of the anticipated future revenue reflected in our backlog" in our Annual Report on Form 10-K for the fiscal year ended December 31, 2014 and in our Form 10-Q for the quarter ended March 31, 2015.

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Results of Operations

The following tables set forth amounts from our condensed consolidated financial statements along with the percentage changes for the three and six months ended June 30, 2015 and 2014 (in thousands, except percentages):

	Three Months Ended			
	June 30, 2015	June 30, 2014	Change	
Net service revenue	$227,376	$203,540	$23,836	11.7 %
Reimbursable out-of-pocket expenses	109,916	82,203	27,713	33.7 %
Total revenue	337,292	285,743	51,549	18.0 %
Direct costs	138,010	130,781	7,229	5.5 %
Reimbursable out-of-pocket expenses	109,916	82,203	27,713	33.7 %
Selling, general and administrative	37,125	33,962	3,163	9.3 %
Restructuring and other costs	2,012	2,417	(405)	(16.8)%
Transaction expenses	397	—	397	— %
Asset impairment charges	—	17,245	(17,245)	(100.0)%
Depreciation	4,420	5,025	(605)	(12.0)%
Amortization	9,473	6,238	3,235	51.9 %
Total operating expenses	301,353	277,871	23,482	8.5 %
Income from operations	35,939	7,872	28,067	356.5 %
Total other expense, net	(12,308)	(13,160)	(852)	(6.5)%
Income (loss) before provision for income taxes	23,631	(5,288)	28,919	546.9 %
Income tax benefit (expense)	(310)	20,595	(20,905)	(101.5)%
Net income	$23,321	$15,307	$8,014	52.4 %

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	Six Months Ended			
	June 30, 2015	June 30, 2014	Change	
Net service revenue	$438,890	$388,240	$50,650	13.0 %
Reimbursable out-of-pocket expenses	207,319	164,280	43,039	26.2 %
Total revenue	646,209	552,520	93,689	17.0 %
Direct costs	263,458	251,545	11,913	4.7 %
Reimbursable out-of-pocket expenses	207,319	164,280	43,039	26.2 %
Selling, general and administrative	72,925	66,147	6,778	10.2 %
Restructuring and other costs	1,594	3,175	(1,581)	(49.8)%
Transaction expenses	519	2,042	(1,523)	(74.6)%
Asset impairment charges	3,931	17,245	(13,314)	(77.2)%
Depreciation	9,186	11,894	(2,708)	(22.8)%
Amortization	18,951	13,740	5,211	37.9 %
Total operating expenses	577,883	530,068	47,815	9.0 %
Income from operations	68,326	22,452	45,874	204.3 %
Total other expense, net	(14,147)	(27,683)	13,536	48.9 %
Income (loss) before provision for income taxes	54,179	(5,231)	59,410	1,135.7 %
Income tax benefit (expense)	(5,602)	18,986	(24,588)	(129.5)%
Net income	$48,577	$13,755	$34,822	253.2 %

Net Service Revenue and Reimbursable Out-of-Pocket Expenses

For the three and six months ended June 30, 2015 and June 30, 2014, total revenue was comprised of the following (in thousands, except percentages):

	Three Months Ended			
	June 30, 2015	June 30, 2014	Change	
Net service revenue	$227,376	$203,540	$23,836	11.7 %
Reimbursable out-of-pocket expenses	109,916	82,203	27,713	33.7 %
Total revenue	$337,292	$285,743	$51,549	18.0 %

	Six Months Ended			
	June 30, 2015	June 30, 2014	Change	
Net service revenue	$438,890	$388,240	$50,650	13.0 %
Reimbursable out-of-pocket expenses	207,319	164,280	43,039	26.2 %
Total revenue	$646,209	$552,520	$93,689	17.0 %

For the three months ended June 30, 2015, net service revenue increased by $23.8 million, or 11.7%, to $227.4 million from $203.5 million for the three months ended June 30, 2014. For the six months ended June 30, 2015, net service revenue increased by $50.7 million, or 13.0%, to $438.9 million from $388.2 million for the six months ended June 30, 2014. These increases were primarily driven by continued strong awards over the last two years, a lower cancellation rate of previously awarded business and a positive revenue mix. In 2015, our revenue grew across all therapeutic areas and has been particularly

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strong in the CNS, Oncology and other complex therapeutic areas. During the three and six months ended June 30, 2015, fluctuations in foreign currency exchange rates resulted in an unfavorable impact of $11.3 million and $20.4 million, respectively, on net service revenue as compared to the three and six months ended June 30, 2014.

Net service revenue from our top five customers accounted for approximately 33.9% and 39.8% of total net service revenue for the three months ended June 30, 2015 and June 30, 2014, respectively. Net service revenue from our top five customers accounted for approximately 35.0% and 38.0% of total net service revenue for the six months ended June 30, 2015 and June 30, 2014, respectively.

For the six months ended June 30, 2015 and June 30, 2014, various subsidiaries of Astellas Pharma, Inc. (Astellas) accounted for 10% and 12% of total net service revenue, respectively. Additionally, for the three months ended June 30, 2014, Astellas accounted for 12% of total net service revenue. For the three and six months ended June 30, 2014, various subsidiaries of Otsuka Holdings Co., Ltd. accounted for 14% of total net service revenue. No customer accounted for 10% or more of total net service revenues for the three months ended June 30, 2015.

For the three months ended June 30, 2015, reimbursable out-of-pocket expenses, which represent expenses related to our clinical studies that are passed directly through to customers, increased by $27.7 million, or 33.7%, to $109.9 million from $82.2 million for the three months ended June 30, 2014. For the six months ended June 30, 2015, reimbursable out-of-pocket expenses, increased by $43.0 million, or 26.2%, to $207.3 million from $164.3 million for the six months ended June 30, 2014. The reimbursements are offset by an equal amount shown under the same caption in the "Costs and operating expenses" section in our Condensed Consolidated Statements of Operations and, accordingly, have no impact on gross margin. Reimbursable out-of-pocket expenses fluctuate significantly from period to period based on the timing of program initiation or closeout and the mix of program complexity and do not necessarily change in correlation to net service revenues.

Direct Costs and Reimbursable Out-of-pocket Expenses

For the three and six months ended June 30, 2015 and June 30, 2014, direct costs and reimbursable out-of-pocket expenses were as follows (in thousands, except percentages):

	Three Months Ended				
	June 30, 2015	June 30, 2014	Change		
Direct costs	$138,010	$130,781	$7,229	5.5	%
Reimbursable out-of-pocket expenses	109,916	82,203	27,713	33.7	%
Total direct costs and reimbursable out-of-pocket expenses	$247,926	$212,984	$34,942	16.4	%
	Six Months Ended				
	June 30, 2015	June 30, 2014	Change		
Direct costs	$263,458	$251,545	$11,913	4.7	%
Reimbursable out-of-pocket expenses	207,319	164,280	43,039	26.2	%
Total direct costs and reimbursable out-of-pocket expenses	$470,777	$415,825	$54,952	13.2	%

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The following is a summary of the year-over-year fluctuation in components of direct costs during the three and six months ended June 30, 2015 as compared to the three and six months ended June 30, 2014 (in thousands):

	Three Months Ended June 30, 2014 to 2015	Six Months Ended June 30, 2014 to 2015
Change in:		
Salaries, benefits, and incentive compensation	$9,887	$17,968
Other	(2,658)	(6,055)
Total	$7,229	$11,913

Our direct costs increased by $7.2 million, or 5.5%, to $138.0 million for the three months ended June 30, 2015 from $130.8 million for the three months ended June 30, 2014. Our direct costs increased by $11.9 million, or 4.7%, to $263.5 million for the six months ended June 30, 2015 from $251.5 million for the six months ended June 30, 2014. These increases were primarily driven by an increase in salaries and benefits as a result of the additions in personnel to support the growth of our business, partially offset by favorable fluctuations in foreign currency as discussed further below. In addition, we continue to see the benefits from a number of our cost saving initiatives including (i) leveraging our therapeutic management overhead infrastructure over the expanded revenue base, (ii) improving the utilization of our facilities, and (iii) the consolidation of our clinical trial management systems resulting in achieving better efficiencies due to standardization. As we continue to expand our business and initiate new studies, the increase in headcount-related expenses may outpace our revenue growth.

For the three months ended June 30, 2015, other direct costs decreased by $2.7 million compared to the three months ended June 30, 2014, primarily due to the three months ending June 30, 2014 including a provision for non-recoverable VAT taxes of $2.2 million.

During the six months ended June 30, 2015 other direct costs decreased by $6.1 million compared to the six months ended June 30, 2014, primarily due to (i) the 2014 period including a provision for non-recoverable VAT mentioned previously and (ii) certain one-time benefits realized in the first quarter of 2015. Specifically, during the first quarter of 2015 we realized benefits of $5.1 million related to (i) a favorable resolution of several VAT and other tax items, (ii) a change in estimate related to employee incentive compensation, and (iii) a favorable settlement of disputed pass through costs. Partially offsetting these decreases was an increase in expenses of $1.6 million related to IT and facility expenses.

During the three months ended June 30, 2015, fluctuations in foreign currency exchange rates resulted in a favorable impact of $10.1 million on direct costs as compared to the three months ended June 30, 2014. During the six months ended June 30, 2015, fluctuations in foreign currency exchange rates resulted in a favorable impact of $17.5 million on direct costs as compared to the six months ended June 30, 2014.

As noted above, reimbursable out-of-pocket expenses increased by 33.7% or $27.7 million, to $109.9 million for the three months ended June 30, 2015 from $82.2 million for the three months ended June 30, 2014. Reimbursable out-of-pocket expenses increased by 26.2% or $43.0 million, to $207.3 million for the six months ended June 30, 2015 from $164.3 million for the six months ended June 30, 2014. Reimbursable out-of-pocket expenses fluctuate significantly from period to period based on the timing of program initiation or closeout and the mix of program complexity and do not necessarily change in correlation to net service revenues.

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Selling, General and Administrative Expenses

For the three and six months ended June 30, 2015 and June 30, 2014, selling, general and administrative expenses were as follows (in thousands, except percentages):

	Three Months Ended						
	June 30, 2015		June 30, 2014		Change		
Selling, general and administrative	$37,125		$33,962		$3,163	9.3	%
Percentage of net service revenue	16.3	%	16.7	%			
	Six Months Ended						
	June 30, 2015		June 30, 2014		Change		
Selling, general and administrative	$72,925		$66,147		$6,778	10.2	%
Percentage of net service revenue	16.6	%	17.0	%			

The following is a summary of the year-over-year fluctuation in components of our selling, general and administrative expenses during the three and six months ended June 30, 2015 as compared to the three and six months ended June 30, 2014 (in thousands):

	Three Months Ended June 30, 2014 to 2015			Six Months Ended June 30, 2014 to 2015
Change in:				
Salaries, benefits, and incentive compensation	$	2,260	First Amendment to Operating Deficit Guaranty Agreement by and between ARV Assisted Living, Inc., Gary Davidson, John Booty and David Collins, and Rosewood Villas, L.P.	
	10.69		First Amendment to Tax Credit Reduction and Recapture Guaranty Agreement by and between ARV Assisted Living, Inc., Gary Davidson, John Booty and David Collins, and Rosewood Villas, L.P.	
	10.72		Agreement of Assignment of ARV Investment Group, Inc. (a wholly owned subsidiary of ARV Assisted Living, Inc.) partnership interest San Marcos, L.P. dated January 16, 2001.	
	10.73		Assignment of interest in the receivable obligation owed by San Marcos, L.P. to ARV Assisted Living, Inc. dated January 16, 2001.	
	10.74		Assignment of interest in management fees owed by San Marcos, L.P. to ARV Assisted Living, Inc. dated on January 16, 2001.	
	10.75		Deed of Trust Note of ARV Burlingame, L.P. to Red Mortgage Capital, Inc.	
	10.76		Allonge #1 to Deed of Trust Note of ARV Burlingame, L.P. to Red Mortgage Capital, Inc.	
	10.77		Deed of Trust between ARV Burlingame, L.P. and Fidelity National Title Insurance	
	10.78		Regulatory Agreement for U.S. Department of Housing Multifamily Housing Projects between ARV Burlingame, L.P. and Secretary of Housing and Urban Development	
	10.79		Regulatory Agreement Nursing Homes Projects between ARV Burlingame, L.P. and Federal Housing Commissioner	

10.80	Deed of Trust Note of ARV Campbell, L.P. to Red Mortgage Capital, Inc.
10.81	Allonge #1 to Deed of Trust Note of ARV Campbell, L.P. to Red Mortgage Capital, Inc.

Exhibit Number	Description
10.82	Deed of Trust between ARV Campbell, L.P. and Fidelity National Title Insurance
10.83	Regulatory Agreement for U.S. Department of Housing Multifamily Housing Projects between ARV Campbell, L.P. and Secretary of Housing and Urban Development
10.84	Regulatory Agreement Nursing Homes Projects between ARV Campbell, L.P. and Federal Housing Commissioner
10.85	Deed of Trust Note of ARV Sunnyvale, L.P. to Red Mortgage Capital, Inc.
10.86	Allonge #1 to Deed of Trust Note of ARV Sunnyvale, L.P. to Red Mortgage Capital, Inc.
10.87	Deed of Trust between ARV Sunnyvale, L.P. and Fidelity National Title Insurance
10.88	Regulatory Agreement for U.S. Department of Housing Multifamily Housing Projects between ARV Sunnyvale, L.P. and Secretary of Housing and Urban Development
10.89	Regulatory Agreement Nursing Homes Projects between ARV Sunnyvale, L.P. and Federal Housing Commissioner
10.90	Deed of Trust Note of ARV Valley View, L.P. to Red Mortgage Capital, Inc.
10.91	Deed of Trust between ARV Valley View, L.P. and Fidelity National Title Insurance
10.92	Regulatory Agreement for U.S. Department of Housing Multifamily Housing Projects between ARV Valley View, L.P. and Secretary of Housing and Urban Development
10.93	Regulatory Agreement Nursing Homes Projects between ARV Valley View, L.P. and Federal Housing Commissioner
10.94	Deed of Trust Note of ARV Fullerton, L.P. to Red Mortgage Capital, Inc. , incorporated by reference to the Companies 10K filed with the SEC on March 29, 2002.
10.95	Allonge #1 to Deed of Trust Note of ARV Fullerton, L.P. to Red Mortgage Capital, Inc. , incorporated by reference to the Companies 10K filed with the SEC on March 29, 2002.
10.96	Deed of Trust between ARV Fullerton, L.P. and Fidelity National Title Insurance, incorporated by reference to the Companies 10K filed with the SEC on March 29, 2002, incorporated by reference to the Companies 10K filed with the SEC on March 29, 2002.
10.97	Regulatory Agreement for U.S. Department of Housing Multifamily Housing Projects between ARV Fullerton, L.P. and Secretary of Housing and Urban Development, incorporated by reference to the Companies 10K filed with the SEC on March 29, 2002.
10.98	Regulatory Agreement Nursing Homes Projects between ARV Fullerton, L.P. and Federal Housing Commissioner, incorporated by reference to the Companies 10K filed with the SEC on March 29, 2002.
10.99	Deed of Trust Note of ARV Acacia, L.P. to Red Mortgage Capital, Inc. , incorporated by reference to the Companies 10K filed with the SEC on March 29, 2002.
10.100	Allonge #1 to Deed of Trust Note of ARV Acacia, L.P. to Red Mortgage Capital, Inc. , incorporated by reference to the Companies 10K filed with the SEC on March 29, 2002.
10.101	Deed of Trust between ARV Acacia, L.P. and Fidelity National Title Insurance, incorporated by reference to the Companies 10K filed with the SEC on March 29, 2002.
10.102	Regulatory Agreement for U.S. Department of Housing Multifamily Housing Projects between ARV Acacia, L.P. and Secretary of Housing and Urban Development, incorporated by reference to the Companies 10K filed with the SEC on March 29, 2002.
10.103	Regulatory Agreement Nursing Homes Projects between ARV Acacia, L.P. and Federal Housing Commissioner, incorporated by reference to the Companies 10K filed with the SEC on March 29, 2002.
10.104*	Promissory Note of ARV Hillcreek, LLC to GMAC Commercial Mortgage Corporation
10.105*	Deed of Trust Note of Hillcreek, LLC to First American Title Company of Los Angeles for the benefit of GMAC Commercial Mortgage Corporation
10.106*	Debt Service Reserve Escrow and Security Agreement between ARV Hillcreek, LLC and GMAC Commercial Mortgage Corporation

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Exhibit Number	Description
10.107*	Loan Agreement between ARV Hillcreek, LLC and GMAC Commercial Mortgage Corporation
10.108*	Payment and Performance Guaranty Agreement, by ARV Assisted Living, Inc. for the benefit of GMAC Commercial Mortgage Corporation
23.1*	Consent of KPMG LLP.
99.1	Complaint in ARV Assisted Living, Inc. v. Lazard Freres Real Estate Investors LLC, et al., case no. 787788, incorporated by reference to the Company s 8-K filed with the Securities and Exchange Commission on May 26, 1998.
99.2	Settlement Agreement dated as of January 2, 2003, by and between the United States of America and ARV Assisted Living, Inc. incorporated by reference to the Company s 8-K filed with the Securities and Exchange Commission on January 13, 2003.
99.3*	Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
99.4*	Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

* included herewith

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SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities and Exchange Act of 1934, as amended, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

ARV ASSISTED LIVING, INC.

By: /s/ DOUGLAS M. PASQUALE

Douglas M. Pasquale
Chief Executive Officer

Date: March 27, 2003

Pursuant to the requirements of the Securities Act of 1934, as amended, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

Signature	Title	Date
/s/ DOUGLAS M. PASQUALE **Douglas M. Pasquale**	Chief Executive Officer (Principal Executive Officer)	March 27, 2003
/s/ ABDO H KHOURY **Abdo H. Khoury**	President and Chief Financial Officer (Principal Financial Officer)	March 27, 2003
/s/ JOHN A. MOORE **John A. Moore**	Director	March 27, 2003
/s/MAURICE J. DEWALD **Maurice J. DeWald**	Director	March 27, 2003
/s/D AVID P. COLLINS **David P. Collins**	Director	March 27, 2003
/s/ ROBERT C. LARSON **Robert C. Larson**	Director	March 27, 2003

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CERTIFICATIONS

I, Douglas M. Pasquale, certify that:

1. I have reviewed this annual report on Form 10-K of ARV Assisted Living, Inc.;
2. Based on my knowledge, this annual report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this annual report;
3. Based on my knowledge, the financial statements, and other financial information included in this annual report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this annual report;
4. The registrant s other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and we have:

a) designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this annual report is being prepared;

b) evaluated the effectiveness of the registrant s disclosure controls and procedures as of a date within 90 days prior to the filing date of this annual report (the Evaluation Date); and

c) presented in this annual report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;

5. The registrant s other certifying officers and I have disclosed, based on our most recent evaluation, to the registrant s auditors and the audit committee of registrant s board of directors (or persons performing the equivalent function):

a) all significant deficiencies in the design or operation of internal controls which could adversely affect the registrant s ability to record, process, summarize and report financial data and have identified for the registrant s auditors any material weaknesses in internal controls; and

b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant s internal controls; and

6. The registrant s other certifying officers and I have indicated in this annual report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

Date: March 27, 2003

By: /s/ DOUGLAS M. PASQUALE

Douglas M. Pasquale
Chief Executive Officer of
ARV Assisted Living, Inc.

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I, Abdo H. Khoury, certify that:

1. I have reviewed this annual report on Form 10-K of ARV Assisted Living, Inc.;
2. Based on my knowledge, this annual report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this annual report;
3. Based on my knowledge, the financial statements, and other financial information included in this annual report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this annual report;
4. The registrant s other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and we have:
a) designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this annual report is being prepared;
b) evaluated the effectiveness of the registrant s disclosure controls and procedures as of a date within 90 days prior to the filing date of this annual report (the Evaluation Date); and
c) presented in this annual report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;
5. The registrant s other certifying officers and I have disclosed, based on our most recent evaluation, to the registrant s auditors and the audit committee of registrant s board of directors (or persons performing the equivalent function):
a) all significant deficiencies in the design or operation of internal controls which could adversely affect the registrant s ability to record, process, summarize and report financial data and have identified for the registrant s auditors any material weaknesses in internal controls; and
b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant s internal controls; and
6. The registrant s other certifying officers and I have indicated in this annual report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

Date: March 27, 2003

By: /s/ Abdo H. Khoury

Abdo H. Khoury
President and Chief Financial Officer of
ARV Assisted Living, Inc.

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Independent Auditors Report

The Board of Directors
ARV Assisted Living, Inc.:

We have audited the accompanying consolidated balance sheets of ARV Assisted Living, Inc. and subsidiaries as of December 31, 2002 and 2001, and the related consolidated statements of operations, shareholders equity, and cash flows for each of the years in the three-year period ended December 31, 2002. In connection with our audits of the consolidated financial statements, we have also audited the financial statement schedule described in Item 15(a)(2). These consolidated financial statements and financial statement schedule are the responsibility of the Company s management. Our responsibility is to express an opinion on these consolidated financial statements and financial statement schedule based on our audits.

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

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of ARV Assisted Living, Inc. and subsidiaries as of December 31, 2002 and 2001, and the results of their operations and their cash flows for each of the years in the three-year period ended December 31, 2002 in conformity with accounting principles generally accepted in the United States of America. Also in our opinion, the related financial statement schedule, when considered in relation to the basic consolidated financial statements taken as a whole, presents fairly, in all material respects, the information set forth therein.

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

/s/ KPMG LLP

Orange County, California
February 28, 2003

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ARV ASSISTED LIVING, INC.
AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS
December 31, 2002 and 2001
(In thousands)

	2002	2001
ASSETS		
Current assets:		
Cash and cash equivalents	$ 14,347	$ 13,234
Accounts receivable and amounts due from affiliates, net	920	744
Prepaids and other current assets	4,485	2,614
Impounds	4,440	3,779
Properties held for sale, net		763
Total current assets	24,192	21,134
Property, furniture and equipment	116,269	116,929
Goodwill, net	18,354	18,354
Operating lease security deposits	9,285	9,414
Other non-current assets	18,466	11,346
	$ 186,566	$ 177,177
LIABILITIES AND SHAREHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 2,363	$ 2,212
Accrued payroll costs	4,240	4,055
Other accrued liabilities	10,835	6,659
Notes payable, current portion	2,269	7,269
Accrued interest payable	833	823
Total current liabilities	20,540	21,018
Notes payable, less current portion	118,701	105,062
Lease liabilities	2,109	1,995
Other non-current liabilities	494	641
	141,844	128,716
Minority interest in majority owned entities	145	621
Shareholders equity:		
Series A Preferred stock, convertible and redeemable; 2,000 shares authorized, none issued or outstanding at December 31, 2002 and 2001		
Preferred stock, no par value. 8,000 shares authorized, none issued and outstanding		
Common stock, $0.01 par value. Authorized 100,000 shares; 17,460 shares issued and outstanding at December 31, 2002 and 2001	175	175
Additional paid in capital	145,337	145,337
Accumulated deficit	(100,935)	(97,672)
Total shareholders equity	44,577	47,840
Commitments and contingent liabilities	$ 186,566	$ 177,177

See accompanying notes to consolidated financial statements.

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**ARV ASSISTED LIVING, INC.
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**CONSOLIDATED STATEMENTS OF OPERATIONS
For the years ended December 31, 2002, 2001 and 2000
(In thousands, except per share data)**

	2002	2001	2000
Revenue:			
Assisted living community revenue:			
Rental revenue	$ 126,041	$ 117,249	$ 112,073
Assisted living and other services	28,135	24,668	24,024
Skilled nursing facility revenue	3,152	2,323	1,960
Management fees	1,050	1,155	808
Total revenue	158,378	145,395	138,865
Operating expenses:			
Assisted living community operating expense	95,033	88,185	87,130
Skilled nursing facility expenses	3,075	2,507	1,901
Community lease expense	31,900	30,943	31,571
General and administrative	10,521	9,874	12,288
Impairment loss			6,187
Depreciation and amortization	7,753	7,878	8,483
Total operating expenses	148,282	139,387	147,560
Income (loss) from operations	10,096	6,008	(8,695)
Other income (expense):			
Interest income	426	1,010	1,532
Other income (expense), net	82	681	244
Equity in income (loss) of partnerships	(793)	(1,798)	791
Gain on sale of properties and partnership interests	54	2,887	500
Interest expense	(9,620)	(8,949)	(8,368)
Litigation judgement	(1,699)		
Merger costs	(1,144)		
Total other income (expense)	(12,694)	(6,169)	(5,301)
Loss before income tax expense (benefit), minority interest in (income) loss of majority owned entities, and extraordinary gain	(2,598)	(161)	(13,996)
Income tax expense (benefit)	(32)	151	160
Minority interest in (income) loss of majority owned entities	(697)	(778)	55
Loss before extraordinary gain	(3,263)	(1,090)	(14,101)

Extraordinary gain from early extinguishment of debt, net of income tax of $200 in 2000		2,062	20,613
Net income (loss)	$ (3,263)	$ 972	$ 6,512
Earnings (loss) per share information:			
Basic and diluted earnings (loss) per common share:			
Loss before extraordinary gain	$ (0.19)	$ (0.06)	$ (0.81)
Extraordinary gain from early extinguishment of debt, net of income tax		0.12	1.19
Net income (loss)	$ (0.19)	$ 0.06	$ 0.38
Weighted average common shares outstanding	17,460	17,460	17,357

See accompanying notes to consolidated financial statements.

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ARV ASSISTED LIVING, INC.
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CONSOLIDATED STATEMENT OF SHAREHOLDERS EQUITY
For the years ended December 31, 2002, 2001 and 2000

(In thousands)

	Common Stock			
	Shares	Amount	Accumulated Deficit	Total
Balance at December 31, 1999	16,679	144,280	(105,156)	39,124
Issuance of common stock	781	1,232		1,232
Net income			6,512	6,512
Balance at December 31, 2000	17,460	145,512	(98,644)	46,868
Net income			972	972
Balance at December 31, 2001	17,460	145,512	(97,672)	47,840
Net loss			(3,263)	(3,263)
Balance at December 31, 2002	17,460	$ 145,512	$ (100,935)	$ 44,577

See accompanying notes to consolidated financial statements.

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**ARV ASSISTED LIVING, INC.
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**CONSOLIDATED STATEMENTS OF CASH FLOWS
For the years ended December 31, 2002, 2001 and 2000
(In thousands)**

	2002	2001	2000
Cash flows provided by (used in) operating activities:			
Net income (loss)	$ (3,263)	$ 972	$ 6,512
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:			
Impairment loss			6,187
Extraordinary gain on debt retirement		(2,062)	(20,613)
Gain on sale of properties and partnership interest	(54)	(2,887)	(500)
Depreciation and amortization	7,753	7,878	8,483
Equity in (income) loss of partnerships	793	1,798	(791)
Minority interest in income (loss) of majority owned entities	697	778	(55)
Other	(132)	(80)	(23)
Changes in assets and liabilities, net of acquisitions:			
(Increase) decrease in:			
Accounts receivable and amounts due from affiliates	(84)	85	2,210
Prepaids and other assets	(2,532)	(1,009)	(2,775)
Other non-current assets	(2,542)	(178)	699
Increase (decrease) in:			
Accounts payable and accrued liabilities	4,512	(2,249)	(756)
Accrued interest payable	10	125	(693)
Lease liabilities	114	243	17
Net cash provided by (used in) operating activities	5,272	3,414	(2,098)
Cash flows provided by (used in) investing activities:			
Net cash paid in acquisition of American Retirement Villas Properties III, L.P partnership interest		(1,242)	
Proceeds from the sale of properties, net of selling cost	817	730	3,820
Proceeds from sale of partnerships, net of selling cost		2,887	
Additional investment in unconsolidated limited liability companies	(855)	(926)	
Additions to property, furniture and equipment	(6,572)	(6,110)	(5,187)
(Increase) decrease in security deposits	129	459	(498)
Increase in property held for sale		(90)	
Net cash used in investing activities	(6,481)	(4,292)	(1,865)
Cash flows provided by (used by) financing activities:			

Borrowing under refinancing for owned communities	30,386	17,660	
Borrowing under non-secured credit line			10,000
Borrowings under notes payable	1,000	1,000	40,987
Repayments of notes payable	(22,791)	(12,430)	(33,654)
Collateral deposit under refinancing	(2,000)		
Repurchase of subordinated debt		(5,720)	(9,598)
Distributions to minority partners	(3,391)	(2,513)	(247)
Loan fees	(882)	(702)	(1,278)
Net cash provided by (used in) financing activities	2,322	(2,705)	6,210
Net increase (decrease) in cash and cash equivalents	1,113	(3,583)	2,247
Cash and cash equivalents at beginning of year	13,234	16,817	14,570
Cash and cash equivalents at end of year	$ 14,347	$ 13,234	$ 16,817

See accompanying notes to consolidated financial statements.

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ARV ASSISTED LIVING, INC.
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CONSOLIDATED STATEMENTS OF CASH FLOWS (Continued)
For the years ended December 31, 2002, 2001 and 2000
(In thousands)

	2002	2001	2000
Supplemental schedule of cash flow information:			
Cash paid during the year for:			
Interest	$ 9,610	$ 8,656	$ 9,061
Income taxes	$ 186	$ 151	$ 160
Supplemental schedule of non-cash investing and financing activities:			
Conversion of subordinated notes to common stock			1,232

See accompanying notes to consolidated financial statements.

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ARV ASSISTED LIVING, INC.
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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
Years ended December 31, 2002, 2001, and 2000

(1) Organization and Summary of Significant Accounting Policies
General

ARV Assisted Living, Inc. and subsidiaries (the Company) own, operate, acquire and develop assisted living communities that provide housing to senior citizens, some of whom require assistance with the activities of daily living such as bathing, dressing and grooming.

At December 31, 2002, we owned and or operated 60 assisted living communities (ALCs) in ten states including 18 which we own (Owned ALCs), 33 which we operate pursuant to long-term operating leases (Leased ALCs) and 9 in which we serve as the property manager (Managed ALCs). Limited partnerships or limited liability companies for which we serve as managing general partner or member and community manager and in which we have majority ownership interest are referred to as Affiliated Partnerships. Thirty-eight of the ALCs are located in California. We also manage 3 affordable senior and multifamily apartments (the Apartment Group), 2 of which we serve as the general partner.

Principles of Consolidation

The consolidated financial statements include the accounts of the Company and its subsidiaries. Subsidiaries, which include limited partnerships and limited liability companies in which we have controlling interests, have been consolidated into the financial statements. Through December 2002 we acquired 52.5% of the outstanding Partnership units of ARVP III. The consolidated balance sheets as of December 31, 2002 and 2001 include the accounts of ARVP III while the consolidated statements of operations include the operations from December 14, 2001, the date we acquired greater than 50% of the partnership units. All significant intercompany balances and transactions have been eliminated in consolidation.

Consolidated Partnerships

Included in the consolidated financial statements are partnerships in which we own less than 80% but more than 50%. The following is a recap of the assets and liabilities of those partnerships as of December 31, 2002 and 2001:

	2002	2001
Cash	$ 3,973	$ 7,668
Other current assets	4,050	3,954
Total assets	71,964	72,399
Current liabilities	4,061	4,194
Long term debt	63,931	60,675
Net equity	3,973	7,221

Use of Estimates

In the preparation of our consolidated financial statements in conformity with accounting principles generally accepted in the United States of America, we have made estimates and assumptions that affect the following:

reported amounts of assets and liabilities at the date of the consolidated financial statements;
disclosure of contingent assets and liabilities at the date of the consolidated financial statements; and
reported amounts of revenues and expenses during the reporting period

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Actual results could differ from those estimates.

Cash and Cash Equivalents

For purposes of reporting cash flows, we consider all highly liquid investments purchased with an original maturity of three months or less to be cash equivalents.

Impounds

Impounds consist of cash deposits for property taxes, insurance and replacement reserves made by the Company to certain lenders in accordance with the loan agreements governing the loans encumbering the Company s assisted living communities.

Advertising

Advertising costs are expensed as incurred.

Stock-based Compensation

The Company applies the provisions of Statement of Financial Accounting Standards (SFAS) SFAS No. 123, Accounting for Stock-Based Compensation . As permitted by SFAS No. 123, the Company continues to follow the guidance of Accounting Principles Board (APB) Opinion No. 25 Accounting for Stock Issued to Employees . Consequently, compensation related to stock options reflects the difference between the grant price and the fair value of the underlying common shares at the grant date. The Company issues stock options to employees with a grant price equal to the market value of common stock on the grant date. As required by SFAS No. 123, the Company discloses the pro forma effect on operations, as if compensation costs were recorded at the estimated fair value of the stock options granted.

If the Company had elected to recognize compensation cost based on the fair value at the date of grant, consistent with the method as prescribed by SFAS No. 123, net income (loss) would have changed to the pro forma amounts indicated below (in thousand, except per share data):

	2002	2001	2000
As reported	$ (3,263)	$ 972	$ 6,512
Pro forma net income (loss)	(3,738)	972	5,769
Basic and diluted pro forma earnings per share	$ (0.21)	$ 0.06	$ 0.33

Property, Furniture and Equipment

Property, furniture and equipment are stated at cost less accumulated depreciation which is charged to expense on a straight-line basis over the estimated useful lives of the assets as follows:

Buildings and improvements	27.5 to 35 years
Furniture, fixtures and equipment	3 to 7 years

Property, furniture and equipment consisted of the following (in thousands):

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	December 31,	
	2002	2001
Land	$ 21,664	$ 21,644
Buildings and improvements	106,751	104,982
Furniture, fixtures and equipment	17,107	18,251
	145,522	144,877
Accumulated depreciation	(29,253)	(27,948)
	$ 116,269	$ 116,929

Goodwill

Effective, January 1, 2002, the Company adopted Statement of Financial Accounting Standards (SFAS) No. 142, Goodwill and Other Intangible Assets, which requires that the Company prospectively cease amortization of goodwill and instead conduct periodic tests of goodwill for impairment. The Company has completed a transitional test for goodwill impairment and has determined that no goodwill impairment was indicated as of January 1, 2002.

The following table shows, on a pro-forma basis, what earnings and earnings per share would have been if the new accounting standards had been applied for the period indicated:

	For the years ended December 31,	
	2001	2000
Reported net income	$ 972	$ 6,512
Add back: goodwill amortization	585	595
Adjusted net income	$ 1,557	$ 7,107
Per share information:		
Reported net income	$ 0.06	$ 0.38
Goodwill amortization	0.03	0.03
Adjusted net income	$ 0.09	$ 0.41

Intangibles

SFAS No. 141 Business Combinations and SFAS No.142 also require that the Company disclose the following information related to the Company s intangible assets still subject to amortization. The following table details the balances of the amortizable intangible assets as of December 31, 2002 and 2001.

December 31, 2002

	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount
Leasehold interest	$ 10,319	$ 3,302	$ 7,017
Loan fees	2,785	818	1,967
Deferred lease costs	558	231	327

	December 31, 2001		
	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount
Leasehold interest	$ 10,319	$ 2,731	$ 7,588
Loan fees	2,337	806	1,531
Acquisition cost	1,567	1,519	48
Deferred lease costs	794	430	364

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Estimated aggregate amortization expense for intangible assets still subject to amortization for each of the five years ending December 31 are as follows:

2003	$	1,094
2004	$	1,094
2005	$	1,094
2006	$	1,094
2007	$	1,094

Accounting for Long-lived Assets

The Company reviews its long-lived assets for impairment when events or changes in circumstances indicate that the carrying amount of the assets may not be recoverable. In reviewing recoverability, the Company estimates the undiscounted future cash flows expected to result from using the assets and eventually disposing of them. Cash flows are reviewed at the community level, which is the lowest level of identifiable cash flows. If the sum of the expected future cash flows (undiscounted and without interest charges) is less than the carrying amount of the asset, an impairment loss is recognized based upon the asset s fair value. For long-lived assets held for sale, fair value is reduced for costs of sale.

In 1998, our board of directors decided to sell five Owned ALCs and five development land sites located outside of California. In addition, in 1999 we decided to sell twelve leased ALCs outside the Western United States. These decisions were in keeping with our strategy to focus our efforts on occupancy gains and to lease up ALCs faster. The fair value of the assets, based upon the offers we received from potential buyers, was below the carrying amount of the assets. We recorded an impairment loss of $6.2 million in 2000 on properties and investments that did not meet the Company s strategy of focusing in the western United States or were impaired based upon management s analysis described above. Due to market conditions no buyer could be found for the nine ALCs held for sale at December 31, 2000 and in June of 2001, the Company decided to retain these ALCs. The remaining land site that was previously held in property held for sale was sold during the quarter ended June 30, 2002.

Goodwill

Goodwill represents the excess of the purchase price over the estimated fair value of the tangible and intangible net assets acquired. Prior to the adoption of Statement of Financial Accounting Standards (SFAS) 142 Goodwill and Other Intangible Assets goodwill was being amortized on a straight-line basis over 35 years. Other intangible assets consist primarily of leasehold interests, loan fees and deferred lease costs which all have definite lives and are amortized on a straight-line basis over the estimated useful lives of the related assets.

Investment in Real Estate Entities

The Company serves as the general partner of five limited partnerships that operate assisted living communities (ALCs), four of which were consolidated for the entire 2001 year. The Company acquired a controlling interest in the fifth partnership in December 2001. The Company is also the general partner in two tax credit partnerships (ownership is less than 1%). The Company accounts for its investment in partnerships where it can exercise significant influence and owns more than 50% as consolidated entities. Under the terms of the subject partnership agreements, profits and losses are allocated to the general and limited partners in specified ratios. With the exception of non-recourse mortgage debt, the Company, in its capacity as general partner, is liable for all obligations of the limited partnerships. Liabilities under these obligations have generally not been significant. The Company is subject

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to liability under separate loan guarantees related to two of the partnership loans. Under Statement of Position No. 78-9, Accounting for Investments in Real Estate Ventures, the Company records its obligations under these agreements as a component of the Company s equity in the income or losses of these partnerships.

In 1998, the Company pursued an additional development strategy by entering into joint ventures (LLCs) designed to help us finance development and renovation projects and to mitigate the impact of start-up losses associated with the opening of newly constructed ALCs. The joint ventures were formed to finance and manage the substantial renovation of existing ALCs acquired in 1998 and to construct three new communities on land sites the Company owned. Participants in the joint ventures with us are a third-party investor and a third-party developer. The LLCs contracted with the developer to provide development services to perform the renovation and construction. The Company manages four of the properties operated by the joint ventures for a management fee equal to three percent of gross revenues. One property is managed by an unrelated third party. The Company accounts for its investment in the joint ventures using the equity method and losses incurred by the LLCs are allocated disproportionately to the LLC members based upon their assumption of risk. Income generated by the LLCs is allocated based on the percentage of losses previously allocated until the original capital accounts are restored and then based on ownership percentages. In 2000 and 2001, certain LLC members capital was reduced to zero, consequently, the losses from the joint venture were allocated to us based upon the Company s capital or percentage interest. The Company has agreed to fund any operating deficits incurred in connection with the operation of the five joint venture projects up to an aggregate amount of $6.0 million for all of the development properties and $6.0 million for all of the renovation properties, subject to a $9.0 million cap. The advances, which are considered capital contributions to the LLCs, are non-interest bearing and will be repaid only if sufficient funds are available in accordance with the terms of the operating agreements of the respective LLCs. The operating deficit payment agreement will remain in effect from the commencement of operations of a project until the earlier to occur of 18 months after the project has achieved stabilization, the sale of the project to a third-party, or the purchase by the Company of the membership interests of the project owner. In March 2001, the two renovation projects reached stabilization and consequently in September 2002, ARV was no longer required to make operating deficit payments on these two projects. The cessation of operating deficit payments on two of the LLCs will be May 2003 and September 2003. The remaining LLC has not reached stabilization, thus, no ending date can be computed as of December 31, 2002. The Company s current funding of operating deficits since inception in 1998 is $2.4 million. The LLC operating agreements grant the Company options to purchase the other members interest in the LLCs when the ALCs reach stabilization, at a purchase price that is the greater of fair market value or an amount that generates a guaranteed internal rate of return on the members capital contribution. In 2001, the Company declined to exercise the option to purchase two of the LLCs that had reached stabilization and in accordance with the LLCs operating agreement, the Company no longer serves as a manager of the two LLCs. In 2000 the Company determined that the value of certain of the LLCs was impaired based upon the Company s review of the projected cash flows, accordingly, the Company wrote down its investment by $5.7 million, to reflect the fair value. In February 2003, the Company was notified that it would no longer manage the remaining LLCs as a result of its election not to exercise the related purchase option. The Company felt the required purchase prices were excessive and, consequently, did not exercise their right to purchase the LLCs.

General Insurance Liability

The Company utilizes third-party insurance for losses and liabilities associated with general and professional liability claims subject to established deductible levels on a per occurrence basis. Losses up to these deductible levels are accrued based upon the Company s and a third party actuarial study of the estimate of the aggregate liability for claims incurred based on Company experience.

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ARV ASSISTED LIVING, INC.
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Revenue Recognition

The Company recognizes rental, assisted living services and skilled nursing facility revenue from owned and leased communities on a monthly basis as earned. The Company receives fees for property management and partnership administration services from managed communities and recognizes such fees as earned.

Assisted Living Community Sale-Leaseback Transactions

Certain ALCs were sold subject to leaseback provisions under operating leases. Gains, where recorded, were deferred and amortized into income over the lives of the leases.

Earnings (Loss) Per Share

We utilize SFAS No. 128 Earnings Per Share in determining earnings (loss) per share (EPS). Basic EPS are calculated by dividing net income (loss) by the weighted average number of common shares outstanding during the period. Diluted EPS are computed similar to EPS except that the weighted average shares outstanding are increased to include additional shares from the assumed exercise of securities or other contracts to issue common stock, if dilutive. The basic weighted average number of shares outstanding were 17,459,689 for the three-year period ended December 31, 2002. The number of potentially dilutive securities were 2,064,582, 1,504,003 and 1,729,870 for the years ended December 31, 2002, 2001, and 2000, respectively. Potentially dilutive securities include convertible notes, warrants and stock options which convert to shares of common stock. There were no incremental diluted securities for the years ended December 31, 2002, 2001, and 2000 as the Company had a loss from continuing operations for each of the three years then ended.

New Accounting Pronouncements Not Yet Adopted

In April 2002, the Financial Accounting Standards Board issued SFAS No. 145, Rescission of FASB Statements No. 4, 44, and 64, Amendment of FASB Statement No. 13, and Technical Corrections. SFAS No. 145 rescinds the automatic treatment of gains or losses from extinguishment of debt as extraordinary unless they meet the criteria for extraordinary items as outlined in 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 . SFAS No. 145 also requires sale-leaseback accounting for certain lease modifications that have economic effects that are similar to sale-leaseback transactions and makes various technical corrections to existing pronouncements. The provisions of SFAS No. 145 related to the rescission of FASB Statement 4 are effective for fiscal years beginning after May 15, 2002, with early adoption encouraged. All other provisions of SFAS No. 145 are effective for transactions occurring after May 15, 2002, with early adoption encouraged. The only impact the Company expects from the adoption of SFAS No. 145 is the reclassification of prior year extraordinary gains and losses to other income, interest expense and income taxes.

In July 2002, the FASB issued SFAS No. 146, Accounting for Costs Associated with Exit or Disposal Activities (SFAS No. 146). SFAS No. 146 requires companies to recognize costs associated with exit or disposal activities when they are incurred rather than at the date of a commitment to an exit or disposal plan. Examples of costs covered by the standard include lease termination costs and certain employee severance costs that are associated with a restructuring, discontinued operations, plant closing, or other exit or disposal activity. SFAS No. 146 is effective prospectively for exit or disposal activities initiated after December 31, 2002, with earlier adoption encouraged. As the provisions of SFAS No. 146 are required to be applied prospectively after the adoption date, we cannot determine the potential effects that adoption of SFAS No. 146 will have on our consolidated financial statements.

ARV ASSISTED LIVING, INC.
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In November 2002, the FASB issued Interpretation No. 45, Guarantor s Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others (FIN 45). FIN 45 elaborates on the existing disclosure requirements for most guarantees. FIN 45 requires that at the time a company issues certain guarantees, the company must recognize an initial liability for the fair value, or market value, of the obligations it assumes under that guarantee and must disclose that information in its interim and annual financial statements. The initial recognition and initial measurement provisions of FIN 45 are applicable on a prospective basis to guarantees issued or modified after December 31, 2002. FIN 45 s disclosure requirements are effective for financial statements of interim or annual periods ending after December 15, 2002 and are applicable to all guarantees issued by the guarantor subject to FIN 45 s scope, including guarantees issued prior to the issuance of FIN 45. The adoption of FIN 45 did not have a material impact on the Company s consolidated financial statements.

In November 2002, the Emerging Issues Task Force (EITF) finalized its consensus on EITF Issue 00-21, Revenue Arrangements with Multiple Deliverables (EITF 00-21), which provides guidance on the timing and method of revenue recognition for sales arrangements that include the delivery of more than one product or service. EITF 00-21 is effective prospectively for arrangements entered into in fiscal periods beginning after June 15, 2003. Under EITF 00-21, revenue must be allocated to all deliverables regardless of whether an individual element is incidental or perfunctory. The Company does not believe that the adoption of EITF 00-21 will have a material impact on the Company s consolidated financial statements.

In December 2002, SFAS No 148, Accounting for Stock-Based Compensation (SFAS No. 148), was issued. SFAS No. 148 amends the disclosure requirements, Accounting for Stock-Based Compensation (SFAS No. 123), to require prominent disclosures in both interim and annual financial statements about the method of accounting for stock-based employee compensation and the effect of the method used on reported results. SFAS No. 148 also amends SFAS No. 123 to provide alternative methods of transition for a voluntary change to the fair value based method of accounting for stock-based employee compensation. The Company will commence quarterly footnote disclosure of the fair value based method of accounting for stock-based employee compensation beginning in the first quarter ending March 31, 2003. As the Company has decided not to voluntarily adopt the SFAS No. 123 fair value method of accounting for stock-based employee compensation, the new transition alternatives of SFAS No. 148 will not have a material impact on the Company s consolidated financial statements.

In January 2003, the FASB issued Interpretation No. 46, Consolidation of Variable Interest Entities, an Interpretation of Accounting Research Bulletin No. 51 (FIN 46), which requires a variable interest entity to be consolidated by a company if that company is subject to a majority of the risk of loss from the variable interest entity s activities or is entitled to receive a majority of the entity s residual returns or both. Prior to FIN 46, a company included another entity in its consolidated financial statements only if it controlled the entity through voting interests. FIN 46 also requires disclosures about variable interest entities that the company is not required to consolidate but in which it has a significant variable interest. The consolidated requirements of FIN 46 apply immediately to variable interest entities created after January 31, 2003. The consolidated requirements apply to older entities in the first fiscal year or interim period beginning after June 15, 2003. Certain disclosure requirements apply in all financial statements issued after January 31, 2002, regardless of when the variable interest entity was established. The Company has not fully determined the impact on the consolidated financial statements upon adoption of FIN 46, although it is reasonably possible that the Company s joint venture investments will be consolidated no later than the quarter ending September 30, 2003.

Income Taxes

We account for income taxes using the asset and liability method whereby deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying

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Years ended December 31, 2002, 2001, and 2000**

amounts of existing assets and liabilities and their respective tax bases. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. A valuation allowance is recorded to adjust net deferred tax assets to the amount which management believes will more likely than not be recoverable. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date.

Segment Information

The Financial Accounting Standards Board has issued Statement of Financial Accounting Standards No. 131, Disclosure about Segments of an Enterprise and Related Information (SFAS 131). This standard requires that a public business enterprise report financial and descriptive information about its reportable operating segments. Operating segments are components of an enterprise about which separate financial information is available that is regularly evaluated by the chief operating decision maker in deciding how to allocate resources and in assessing performance. We evaluate performance and make resource allocation decisions on a community by community basis. Accordingly, each community is considered an operating segment under SFAS 131. However, SFAS 131 did not have an impact on the financial statements because the communities have similar economic characteristics, as defined by SFAS 131, and meet the criteria for aggregation into one reportable segment .

Reclassifications

We have reclassified certain prior period amounts to conform to the December 31, 2002 presentation.

(2) Acquisitions

In December 2001, the Company purchased a controlling interest in American Retirement Villas Properties III, L.P. (ARVP III). ARVP III owns two ALCs, one located in Arizona with 164 units and one located in California with 123 units. The Company accounted for this transaction using the purchase method and paid approximately $4.1 million in cash for the units acquired.

The following table summarizes the estimated fair value of the assets acquired and liabilities assumed at the date of acquisition:

Current Assets	$ 3,796
Property and equipment	15,230
Intangibles and other assets	289
Total assets	19,315
Current liabilities	1,057
Long-term debt	13,592
Total liabilities	14,649
Net assets acquired	4,666
Less minority interest	502
Net value to ARV	$ 4,164

The purchase price paid in excess of the book value of the net assets acquired required a $3.5 million step-up in basis. This amount is being depreciated over the remaining useful life of the underlying existing assets. The pro forma effect on the statement of operations for the acquisition is as if it had been acquired as of January 1, 2000 is as follows:

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	2001	2000
Revenue:		
Assisted living community revenue	$ 148,499	$ 144,934
Skilled nursing facility revenue	2,323	1,960
Management fees	1,155	188
Total revenue	151,977	147,082
Operating expenses:		
Assisted living community operating expense	92,911	92,348
Skilled nursing facility expenses	2,507	1,901
Community lease expense	30,943	31,571
General and administrative	9,874	12,288
Impairment loss		6,187
Depreciation and amortization	8,616	9,587
Total Operating Expenses	144,851	153,882
Income (loss) from operations	7,126	(6,800)
Other income (expense):		
Interest income	1,139	1,690
Other income, net	666	244
Equity in income (loss) of partnerships	(1,798)	791
Gain on sale of properties and partnership interests	2,887	5,323
Interest expense	(10,118)	(9,778)
Total Other Income (Expense)	(7,224)	(1,730)
Loss before income tax expense, minority interest in income of majority owned entities and extraordinary item	(98)	(8,530)
Income tax expense	(160)	(170)
Minority interest in (income) loss of majority owned entities	(784)	(3,259)
Loss before extraordinary items	(1,042)	(11,959)
Extraordinary gain from early extinguishment of debt, net of income tax of $200 in 2000	1,996	20,613

Net income	$	954	$	8,654
Earnings per share basic and diluted	$	0.05	$	0.50

(3) Notes Payable

Notes payable consist of the following at December 31 (in thousands, except share data):

	2002	2001
Convertible subordinated notes due April 2006 with interest at 6 3/4%. The notes require semi-annual payments of interest and are convertible to common stock at $18.57 per share. The notes may be called by us at declining premiums starting at 110% of the principal amount	$ 7,253	$ 7,253
Note payable, bearing interest at a fixed rate of 8.50% at December 31, 2002 and 9.15% at December 31, 2001 payable in monthly installments at December 31, 2002 of principal and interest totaling $96 collateralized by property with a maturity of January 2004	11,845	7,979
Note payable, bearing interest at a fixed rate of 9.15%, repaid in January 2002		2,057
Note payable, bearing interest at floating rate of 30 day LIBOR (1.38% as of December 31, 2002) plus 3.60% payable in monthly installments of principal and interest totaling $37 collateralized by property, maturing in September 2004	5,115	5,183
Note payable, bearing interest at floating rate of 30 day LIBOR (1.38% as of December 31, 2002) plus rates between 2.25% and 2.50% repaid in September 2002		18,583
Note payable, bearing interest at a floating rate of 30 day LIBOR ((1.38% as of December 31, 2002) plus 3.50%, with a minimum interest rate of 7%, payable interest only in monthly installments until November 1, 2003 at which point monthly installments of principal and interest totaling $169 will be due, collateralized by property, maturing August 2004	24,000	
Note payable, bearing interest at a fixed rate of 7.0%, payable in monthly installments of interest only with principal due in 2010; $3,000 remaining drawable at $1,500 in 2003, $500 in 2004 and $1,000 in 2005, unsecured	2,000	1,000
Notes payable, bearing interest at rates of 7.25% through 8.53%, payable in monthly installments of principal and interest totaling $446 collateralized by property, maturities ranging from July 2010 to February 2037	60,757	58,820
Notes payable to shareholder bearing interest at 30-day Treasury Rate, repaid on April 24, 2002		1,456
Note payable to shareholder bearing interest at 30 day LIBOR (1.38% as of December 31, 2002) plus 9.54% payable in monthly installments of interest only, principal payments of $1.5 million payable on each July 1, unsecured, maturing July 2004	10,000	
Notes payable to shareholder bearing interest at 30 day LIBOR (1.83% as of December 31, 2001) plus 10% payable in monthly installments of interest only, unsecured		10,000
	120,970	112,331
Less amounts currently payable	2,269	7,269
	$ 118,701	$ 105,062

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The future annual principal payments of the notes payable at December 31, 2002 are as follows (in thousands):

2003	$ 2,269
2004	49,715
2005	577
2006	8,878
2007	1,673
Thereafter	57,858
	$ 120,970

In 1998, we paid a lender approximately $1.7 million of fees for an interest rate lock and $0.2 million for loan commitment and other fees. The lender terminated the loan commitment and underlying interest rate lock in October 1998 due to adverse market conditions. The lender returned $0.4 million of the interest rate lock fees in January 1999 and $0.5 million in June 2000 as full and final settlement. We included the amounts received in June 2000 in interest expense in the accompanying consolidated statements of operations for the year ended December 31, 2000.

On July 18, 2002, the Company completed the refinancing of two loans collateralized by two owned ALCs in an aggregate amount of $24.0 million. The loan proceeds were used to satisfy existing loans totaling $18.3 million, with maturities of $6.2 million in August 2002 and $12.1 million in March 2003. The new loan matures in August 2004 and accrues interest at a rate of 30-day LIBOR plus 3.5%, with a minimum interest rate of 7%, payable in monthly interest only payments through October 1, 2003 with principal and interest payments beginning November 1, 2003.

In 1999, we began retiring portions of our 6 3/4% convertible subordinated debt. During 1999, we issued a total of 799,566 shares of our common stock and paid a total of $1.0 million to certain of our bondholders in exchange for a total of $9.2 million principal amount of the subordinated notes due 2006 that were held by those bondholders. These transactions resulted in an extraordinary gain of $7.0 million net of tax for the fiscal year ended December 31, 1999. During 2000, we issued a total of 781,025 shares of our common stock and paid a total of $9.6 million to

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additional bondholders in exchange for a total of $33.0 million in principal amount of the subordinated notes held by those bondholders. In 2001 we paid a total of $5.7 million to certain of our bondholders in exchange for a total of $8.0 million principal amount of the subordinated notes. The transactions for the years ended December 31, 2000 and 2001, resulted in an extraordinary gains of $20.6 million and $2.1 million net of tax and costs.

The Company s various debt and lease agreements contain restrictive covenants requiring us to maintain certain financial ratios, including current ratio, working capital, minimum net worth, and debt service coverage, among others. At December 31, 2002, the Company was in compliance with all such covenants or had obtained waivers.

(4) Litigation Judgement

GeriCare was a former subsidiary of the Company that specialized in rehabilitative services, including speech, occupational and physical therapy. Although we terminated all GeriCare operations in 1998, revenue received or earned before termination that directly or indirectly was billed to the Medicare program is subject to statutory and regulatory changes, retroactive rate adjustments, administrative rulings, audits and funding restrictions. Medicare reimbursed GeriCare monthly for services provided on a cost basis, subject to certain adjustments. GeriCare submitted cost reports to the Healthcare Financing Administration (HCFA) on an annual basis and was subject to having amounts previously reimbursed adjusted retroactively.

On January 2, 2003, the Company and the United States of America, acting through the United States Department of Justice and on behalf of the Office of Inspector General of the United States Department of Health and Human Services (U.S.), entered into a Settlement Agreement. The parties entered into a settlement granting mutual releases of all outstanding Medicare claims relating to the Company s former GeriCare unit. The Settlement Agreement further required that in exchange for the releases, and without admitting any liability, for us to pay to the U.S. the sum of $1,625,000. This amount and related legal costs of $74,000 was accrued for at December 31, 2002 and included in other accrued liabilities in the accompanying consolidated balance sheet. This amount was paid subsequent to December 31, 2002.

(5) Employee Benefit Plans
Savings Plan

Effective January 1, 1997, we established a savings plan (the Savings Plan) that qualifies as a deferred salary arrangement under Section 401(k) of the Internal Revenue Code. Under the Savings Plan, participating employees who are at least 21 years of age may defer a portion of their pretax earnings, up to the Internal Revenue Service annual contribution limit. We match 25% of each employee s contributions up to a maximum of 6% of the employee s earnings. Employees are eligible to enroll at the first enrollment date following the start of their employment (July 1 or January 1). We match employees contributions beginning on the first enrollment date following one year of service or 1,000 hours of service. Our expense related to the Savings Plan was approximately $210,000, $171,000, and $175,000 for the years ended December 31, 2002, 2001 and 2000, respectively.

(6) Stock Options

The Company has three stock option plans that provide for the granting of stock options to officers, directors, consultants and key employees. The objectives of these plans include attracting and retaining the best personnel, providing for additional performance incentives, and promoting the success of the Company by providing employees the opportunity to acquire common stock. We have elected to follow APB Opinion No. 25, Accounting for Stock Issued to Employees (APB 25) and related interpretations in accounting for employee stock options.

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Under APB 25, because the exercise price of our employee stock options usually equals the market price of the underlying stock on the date of grant, no compensation expense is recorded.

The 1995 Stock Option and Incentive Plan of ARV Assisted Living, Inc. is two-tiered, one for the benefit of key employees and consultants and one for the benefit of non-employee directors. The maximum number of shares which may be issued under the Plan is 15% of the total outstanding shares at the end of the fiscal year. The number of shares which may be issued for Incentive Stock Options is limited to 1,155,666 shares.

The 1999 Stock Option Plan of ARV Assisted Living, Inc. is two-tiered and very similar to our 1995 Stock Option and Incentive plan. The maximum number of shares which may be granted under the 1999 and 1995 Plans are 2,400,000 plus 15% of any increase in total outstanding shares since June 30, 1999.

The 2002 Stock Option Plan of ARV Assisted Living, Inc. is again very similar to our 1995 Stock Option and Incentive plan. The maximum number of shares which may be granted under all the plans is 4,400,000 plus 15% of any increase in total outstanding shares since June 30, 1999. During the years ended December 31, 2002, 2001 and 2000 additional options granted were 770,000, 80,000 and 656,500, respectively. As of December 31, 2002 there are 2,181,138 Incentive Stock Options available for grant under all the Plans. Options granted under all stock option plans vest over periods ranging from one and one-half to five years from the date of grant.

The Black-Scholes option valuation model was developed for use in estimating the fair value of traded options which have no vesting restrictions and are fully transferable. Option valuation models require the input of highly subjective assumptions including the expected stock price volatility. Because our employee stock options have characteristics significantly different from those of traded options, and because changes in subjective input assumptions can materially affect the fair value estimate, actual fair values may differ from those estimates.

The following represents the estimated fair value of stock options granted and the assumptions used for calculation for the years ended December 31, 2002, 2001 and 2000:

	2002	2001	2000
Average estimated fair value per option at grant date	$ 1.25	$ 1.03	$ 5.10
Average exercise price per option granted	$ 1.77	$ 1.40	$ 5.10
Expected stock volatility	60%	60%	60%
Risk free interest rate	3.0%	5.0%	5.0%
Option term years	10	10	10
Stock dividend yield			

A summary of our stock option activity and related information for the years ended December 31, 2002, 2001 and 2000 is as follows:

	2002		2001		2000	
	Options	Weighted Average Exercise Price	Options	Weighted Average Exercise Price	Options	Weighted Average Exercise Price
Outstanding beginning of the Period	1,753,800	$ 2.15	2,339,552	$ 3.18	1,894,300	$ 6.46
Granted	770,000	$ 1.77	80,000	$ 1.40	656,500	$ 5.55
Exercised						$

Forfeited	(67,000)	$	5.74	(665,752)	$	5.66	(211,248)	$	10.41
Outstanding end of period	2,456,800	$	1.93	1,753,800	$	2.15	2,339,552	$	3.18
Exercisable at end of period	1,921,647	$	2.09	619,586	$	3.47	503,481	$	5.04
Weighted average fair value of options Granted during the period		$	1.25		$	1.03		$	5.10

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The following table summarizes information regarding options outstanding and options exercisable at December 31, 2002.

Range of Exercise Price	Outstanding at December 31, 2002	Weighted Average Remaining Contractual Life	Weighted Average Exercise Price	Shares Subject to Exercisable Options	Weighted Avg. Exercise Price per Share
$0.500-$0.560	571,500	7.97	$ 0.5297	381,003	$ 0.5297
$1.063 - $1.770	1,410,000	8.15	$ 1.6948	1,070,844	$ 1.6863
$3.000-$6.000	415,000	6.30	$ 3.1446	412,500	$ 3.1273
$8.060-$14.000	60,300	3.68	$ 12.5078	57,300	$ 12.4428

At December 31, 2002 options outstanding had a weighted average life of 7.68 years.

(7) Income Taxes

The provision for income tax expense (benefit) from continuing operations consists of the following for the years ended December 31, 2002, 2001 and 2000 (in thousands):

	For the Years Ended		
	2002	2001	2000
Current:			
Federal	$ (218)	$	$
State	186	151	160
Total current	(32)	151	160
Deferred:			
Federal			
State			
Total deferred			
	$ (32)	$ 151	$ 160

We have Federal net operating loss carryforwards of approximately $55,000,000, which expire in 2012 to 2022.

A reconciliation of income tax expense (benefit) related to income from continuing operations to the Federal statutory rate of 34% is as follows (in thousands):

	For the Years Ended		
	2002	2001	2000
Income tax benefit at statutory rate	(894)	$ (55)	$ (4,759)

State income tax expense, net of federal income taxes	186	151	160
Reduction of net operating losses due to carrybacks	1,604		
Reduction of net operating loss carryforwards due to extraordinary gain			7,076
Change in federal valuation allowance	(1,433)	21	(1,998)
Other	505	34	(319)
Total income tax expense (benefit)	$ (32)	$ 151	$ 160

Temporary differences giving rise to a significant amount of deferred tax assets and liabilities from continuing operations at December 31, 2002 and 2001 are as follows (in thousands):

	December 31, 2002	**December 31, 2001**
Deferred tax assets:		
Net operating loss carryforwards	$ 22,137	$ 22,031
Write down of properties	8,038	10,367
Merger costs and litigation judgement	1,141	
Other	573	824
Gross deferred tax asset	31,889	33,222
Less valuation allowance	(31,183)	(32,616)
Deferred tax liabilities other	(706)	(606)
Net long-term deferred tax asset	$	$

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A valuation allowance is provided against net deferred tax assets when it is more likely than not that some portion of the deferred tax asset will not be realized. We have established a valuation allowance for 100 percent of the deferred tax assets as, in our best estimate, it is not likely to be realized in the near term.

(8) Related Party Transactions

Fees and other amounts receivable from affiliates of $0, $7,000 and $718,000 at December 31, 2002, 2001 and 2000, respectively, consist of receivables related to management services we rendered and non-interest bearing expense advances to various partnerships. Amounts due from affiliates are generally expected to be repaid in subsequent years with cash from operations or from bank financing obtained by the affiliates. Related management fee revenue from affiliates totals $980,000, $1,002,000, and $629,000 during the year ended December 31, 2002, 2001 and 2000, respectively.

We are reimbursed for certain expenses such as payroll and retirement benefit, supplies and other expenses paid on behalf of Affiliated Partnerships. During the years ended December 31, 2002, 2001 and 2000, respectively, the expenses incurred on behalf of affiliates and the related reimbursements from these affiliates amounted to approximately $28.8 million, $25.0 million, and $22.3 million, respectively. We account for these reimbursements as a reduction of the related expenses.

On April 24, 2000, the Company entered into a Term Loan Agreement with LFSRI II Assisted Living LLC (LFSRI), an affiliate of Prometheus. Pursuant to the Term Loan Agreement, the Company could borrow up to $10,000,000 from LFSRI, subject to certain conditions, and the term of the loan could be extended by one year if no default occurred. On April 24, 2002, for a fee of $250,000, the parties amended the existing $10.0 million term loan to: (i) increase the principal amount by $1.5 million to $11.5 million, (ii) decrease the interest rate to LIBOR plus 9.54% payable monthly and (iii) extend the maturity date to July, 1 2004, with principal payments of $1.5 million due on each July 1 until maturity. The proceeds of $1.5 million were used to pay off the note payable to Prometheus of $1.5 million. In connection with the Term Loan Agreement, the Company issued to LFSRI a warrant to purchase up to 750,000 shares of the Company s Common Stock at a price of $3.00 per share, subject to various adjustments, which is exercisable until April 24, 2005. Also on April 24, 2000, the Company amended its Rights Agreement to prevent shares that Prometheus may be deemed to beneficially own by reason of LFSRI s rights under the warrant from causing Prometheus to become an Acquiring Person and thus causing a triggering event under the Rights Agreement.

On September 23, 2002, we received an unsolicited letter from Prometheus Assisted Living, LLC (Prometheus), an affiliate of Lazard Freres & Co. LLC, in which Prometheus stated that it had decided to propose a transaction to acquire for cash all of the outstanding shares of common stock of ARV not currently owned by Prometheus or its affiliates. Prometheus also stated that it was not interested in selling its shares in the Company. On January 3, 2003, ARV, Prometheus, and Jenny Merger Corp., a wholly-owned subsidiary of Prometheus, entered into an Agreement and Plan of Merger (the Merger Agreement). Pursuant to the Merger Agreement, Jenny Merger Corp. will merge with and into ARV and ARV will be the surviving corporation (the Merger). Upon consummation of the Merger, ARV will become a wholly owned subsidiary of Prometheus. According to the Merger Agreement, at the effective time of the Merger (the Effective Time), each share of ARV s common stock outstanding immediately prior to the Effective Time will be converted into the right to receive $3.90 in cash, without

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interest, and each holder of a stock option granted by the Company to purchase shares of the Company s common stock will receive in cash without interest, for each share of common stock subject to such option the excess, if any, of the Merger consideration of $3.90 per share over the exercise price of such option less any applicable withholding taxes.

The obligations of ARV and Prometheus to consummate the Merger are subject to certain closing conditions, including, among other things, that ARV obtains the affirmative vote of a majority of all the outstanding common stock of the Company. Prometheus currently owns approximately 43.5% of the Company s outstanding common stock and its affiliate holds a warrant, which if exercised, would result in Prometheus and its affiliates, together, owning approximately 45.8% of the Company s outstanding common stock. The Company has filed proxy materials with the Securities and Exchange Commission for a special meeting of the Company s stockholders to vote on the Merger. Prometheus has stated that following the completion of the transaction it intends to combine ARV with Atria, Inc. and Kapson Senior Quarters Corp. (also assisted living companies), subject to receipt of all necessary approvals and consents, but that its proposed acquisition of the remaining shares of the Company is not dependent on any subsequent transaction with Atria or Kapson.

(9) Shareholders Rights Plan

In May 1998, we adopted a shareholders rights plan under which we have declared a dividend distribution of one Preferred Share Purchase Right on each outstanding share of our common stock. Subject to limited exceptions, the Rights will be exercisable if a person or group acquires 10% or, in the case of Lazard Freres Real Estate Investors, LLC (Lazard or LFREI), 50% or more of our stock or announces a tender offer for 10% or, in the case of LFREI, 50% or more of the common stock. When exercisable, each Right (except the Rights held by the acquiring person) will entitle its holder to purchase, at the Right s then-current exercise price, a number of our common shares having a market value at the time of twice the Right s exercisable price. If we are acquired in a merger or other business combination transaction which has not been approved by our Board of Directors, each Right will entitle its holder to purchase, at the Right s then-current exercise price, a number of the acquiring company s common shares having a market value at that time of twice the Right s exercise price.

On October 1, 2002, the Company and Continental Stock Transfer & Trust Company entered into a Third Amendment to Rights Agreement that provides: (i) Section 9 of the Rights Agreement was amended to allow the Company to temporarily suspend, for a period not to exceed 90 days, the exercisability of the Rights after the occurrence of a Trigger Event in order to prepare and file a registration statement in connection with the exercisability of the Rights; (ii) Section 23.1 of the Rights Agreement was amended to allow the Board of Directors of the Company, at its election, at any time prior to the Distribution Date, to redeem all but not less than all of the then outstanding Rights at a redemption price of $.01 per Right, and the Company may then, at its option, pay the Redemption Price in Common Shares, cash, or other consideration deemed appropriate by the Board; and (iii) Section 27.1 of the Rights Agreement was amended to allow the Board of Directors of the Company, at its option, at any time after the occurrence of a Trigger Event, to exchange Common shares for all or part of the then outstanding and exercisable Rights, by exchanging that number of Common Shares having an aggregate value equal to the Spread, i.e, the value of the Adjustment Shares issuable upon the exercise of a Right over the Purchase Price per Right, notwithstanding the fact that a Person has become the Beneficial Owner of 50% or more of the Common Shares of the Company then outstanding.

On January 7, 2003, the Company and Continental Stock Transfer & Trust company entered into a Fourth Amendment to Rights Agreement which provides that prior to the termination of the Merger Agreement, (I) neither Prometheus nor any of its affiliates will be deemed, by virtue of any equity or employment agreements involving such parties and relating to periods after the effective time of the Merger or approved by the Board of Directors of the Company, to beneficially own any securities of the Company beneficially owned by any officer, director or employee of the Company or any subsidiary and (ii) no officer, director or employee of the company shall be

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deemed, by virtue of any equity or employment agreements involving such parties and relating to periods after the effective time of the Merger or approved by the Board of Directors of the Company, to beneficially own any securities of the Company beneficially owned by any other officer, director or employee of the Company or any subsidiary or by Prometheus or any of its affiliates. In addition, the Board of Directors on January 3, 2003 approved the Agreement and Plan of Merger with Prometheus.

(10) Assisted Living Community Leases

We lease 33 ALCs. The original leases expired from 2006 to 2017, and contained two to three renewal options ranging from five to ten years. In January, 2001 we restructured 16 ALC leases into two lease pools of 8 ALCs each. In each restructured pool, the lease termination date was extended through fiscal 2021. As part of the restructure, we are allowed to finance the additional rent expense of up to $1.0 million during 2001, $1.0 million in 2002, $1.5 million in 2003, $1.0 million in 2004 and $0.5 million in 2005, converting into a note, at 7% interest. Interest only is payable monthly through 2005, and principal payments of $1.0 million per year beginning in 2006 with a due date of December 31, 2010. We had $2.0 million and $1.0 million outstanding on these notes payable at December 31, 2002 and December 31, 2001, respectively. We also incurred a restructuring fee of $4.5 million payable at $1.5 million for each of the first three years. The restructuring fee is accounted for on a straight-line basis. The restructured lease agreements provide for reimbursement to us from the landlord of capital improvement expenditures up to $3.0 million.

Generally, leases for Leased ALCs owned by a common landlord contain cross default provisions permitting the lessor to declare a default under all leases in the event of default on one lease. The lease agreements with each landlord are drafter so that we will not be entitled to exercise our right to renew one lease with a particular landlord without exercising our right to renew all other leases with that landlord. We anticipate that similar renewal and cross-default provisions will be included in leases with other landlords.

Minimum lease payments required under assisted living community operating leases in effect at December 31, 2002 are as follows:

		(In Thousands)
Year Ended December 31:		
2003	$	33,704
2004		32,451
2005		32,929
2006		33,452
2007		34,511
Thereafter		337,071
	$	504,118

Certain of the leases require the payment of additional rent based on a percentage increase of gross revenues. Leases are subject to increase based upon changes in the consumer price index or gross revenues, subject to certain limits, as defined in the individual lease agreements. In the years ended December 31, 2002, 2001 and 2000 such additional rent amounted to $3.7 million, $3.1 million and $2.7 million respectively. Total rent expense was $31.9 million, $30.9 million and $31.6 million in the years ended December 31, 2002, 2001 and 2000, respectively.

(11) Liquidity

We believe that our existing liquidity, cash provided by operating activities, ability to sell assisted living communities and land sites which do not meet our financial objectives or geographic clustering strategy, and ability to refinance certain assisted living communities will provide adequate resources to meet our current operating and investing needs and support our current growth plans for the next 12 months. We will be required from time to time

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to incur additional indebtedness or issue additional debt or equity securities to finance our growth strategy, including the acquisition of assisted living communities as well as other capital expenditures and to provide additional funds to meet increased working capital requirements.

Although we executed a definitive Merger Agreement with Prometheus, it is subject to various closing conditions including approval by our stockholders and it is possible that the Merger may not be completed in the stated timeframe or at all. If the proposed merger is not completed we may be subject to the following risks:

(i) if the Merger Agreement is terminated under specified circumstances controlled by the Company, we will be required to pay Prometheus a termination fee of approximately $2.2 million plus Prometheus expenses up to $1.5 million; (ii)the price of our common stock may decline to the extent that the current market price reflects a market assumption that the proposed merger will be completed; (iii)costs related to the Merger such as legal, accounting and certain financial advisory fees, must be paid even if the Merger is not completed; (iv)if the proposed merger is terminated and our board of directors determines to seek another merger or business combination, we may not be able to find a partner willing to pay an equivalent or more attractive price than that which would be paid by Prometheus in the Merger and if the proposed merger is not completed by Prometheus then we will be reimbursed for our costs plus $4.5 million termination fee.

(12) Commitments and Contingent Liabilities
Commitments

At December 31, 2002, we have provided a limited guarantee of an indebtedness of $3.5 million for the benefit of an Affiliated Partnership for the term of the loan which ends May 2010. Under the terms of the guarantee, our payment obligation will be limited to 15% of the outstanding principal balance of the indebtedness at such time as (i) the outstanding principal balance does not exceed 75% of the appraised value of the security property, (ii) the security property has achieved a Debt Service Coverage ratio of not less than 1.0 to 1.0, and (iii) the security property achieves an occupancy level of 85% for the preceding 6 consecutive calendar months. In addition, at such time as the outstanding principal balance of the indebtedness does not exceed 75% of the appraised value of the security property and either (i) the security property achieves a Debt Service Coverage Ratio of not less than 1.25 to 1 for 6 consecutive months or (ii) the Affiliated Partnership prepays a portion of the indebtedness sufficient for the secured property to achieve a Debt Service Coverage ratio of not less than 1.25 to 1.0 for the preceding 6 months, our liability under the guarantee will be limited to liability based upon fraud, failure to remit insurance proceeds, failure to properly apply revenues of the secured property, commission of waste on the security property, or contamination of the secured property with hazardous waste. We also guarantee through January 2004, $1.0 million of debt on one of our consolidated partnerships in which we own 52.5%. In both cases the liability would be reduced by the sale proceeds of the underlying real estate asset secured by the loans. Another guarantee we have extended pertains to another partnership that we own more than 60.5%. The guaranteed amount is limited to a Curtailment Payment defined as the difference between the current debt service coverage ratio as defined by the lender, and 1.25 to 1.0 measured on a semi annual basis. At December 31, 2002 we had no liability for a Curtailment Payment. We are the general partner of certain limited partnerships that serve as the sole members of limited liability company borrowing entities which carried loan balances of $3.6 million at December 31, 2002. Although a member of a limited liability company is not personally liable for any contract or other obligation of that entity, we delivered limited guarantees in connection with the loans. Due to the limited guarantees, we assumed liability for repayment of the loan indebtedness as a result of fraudulent or intentional misconduct regarding the mortgaged properties, an unconsented transfer of a mortgaged property, a change of control by borrower, or violation of hazardous materials covenants

In our opinion, no claims may be currently asserted under any of the aforementioned guarantees based on the terms of the respective agreements other than those accrued.

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Contingencies

We have entered into four long-term leases of ALCs, the acquisition and construction of which have been or are being financed by tax exempt multi-unit housing revenue bonds. In order to meet the lease obligations and to allow the landlord to continue to qualify for favorable tax treatment of the interest payable on the bonds, the ALCs must comply with certain federal income tax requirements. These requirements principally pertain to the maximum income level of a specified portion of the residents. Should we elect to execute additional leases for ALCs to be constructed with bond financing, the same and possibly additional restrictions are anticipated to be imposed. Failure to satisfy these requirements will constitute an event of default under the leases, thereby permitting the landlord to accelerate their termination. Failure to obtain low-income residents in the sequence and time required could materially affect the lease-up schedule and, therefore, cash flow from such ALCs.

The Company, its directors and officers, and Prometheus were served with several complaints in relation to the September 23, 2002, announcement of Prometheus unsolicited offer to acquire for cash all of the outstanding shares of common stock of the Company not already owned by Prometheus or its affiliates. Four complaints were filed in the Court of Chancery of the State of Delaware between September 24 and 27, 2002, while a fifth complaint was filed on October 1, 2002, in the Orange County Superior Court for the State of California. The actions sought certification of a class of all ARV stockholders to enjoin the consummation of the proposed merger transaction, a declaration that the proposed acquisition was entered into in breach of defendants fiduciary duties, and recovery of damages, costs and attorneys fees. On January 3, 2003 the parties entered into Memoranda of Understanding, intended to resolve all shareholder claims that have or may be filed in connection with the Merger and related disclosures. Pursuant to the terms of the memoranda, the parties agree to use their best efforts to enter into a Stipulation of Settlement, which will include a release of all claims held by proposed stockholders against defendants. Defendants have also agreed to pay plaintiffs attorneys fees in each action in the amount of $275,000 (for a total of $550,000 for both actions). The settlement is contingent upon, among other things, consummation of the Merger at the $3.90 per share price and approval by the courts.

In January 2001, we disposed of our interests in five of the eight remaining partnerships in our apartment group (the Apartment Group). As part of the tax credit agreements relating to the Apartment Group, we remain responsible for guarantees for the period of time we acted as the general partner for the tax credit apartment partnerships if sufficient projected tax credits were not generated in order to meet agreed-upon levels of tax credit benefits. The Apartment Group required $2.9 million to fund permanent loan shortfalls in 2000, the balance of which was paid in January 2001from proceeds of the sale of partnership interests. Concurrently, we sold our interests in the related partnerships for a gain of $2.9 million.

Except as describe above, and other than the ordinary routine litigation that is incidental to, and arises in the normal course of, the business of the Company, there are no material legal proceedings pending against the Company. While we cannot predict the results with certainty, we do not believe that any liability from any such lawsuits or other matters will have a material effect on our financial position, results of operations, or liquidity.

General Liability Insurance

In order to protect itself against lawsuits and claims relating to general and professional liability, the Company currently maintains third party insurance policies in amounts and covering risks that are consistent with industry practice. Under the terms of such insurance policies, the Company s coverage is provided subject to varying deductible levels and liability amounts. As the result of these continuing increases in both deductible amounts and premiums, there can be no assurance that the Company will be able to obtain all desired insurance coverage in the future on commercially reasonable terms or at all. As a result of poor loss experience, a number of insurance carriers have stopped providing insurance coverage for the long-term care industry, and those remaining have increased premiums and deductibles substantially. Consistent with this trend, our general liability coverage is subject to $0.25

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million deductible per occurrence basis for the nine months ended December 31, 2001 and the three months ended March 31, 2002. For the nine months ended December 31, 2002, our general liability deductible per occurrence has again been materially increased to $1 million. Losses up to these deductible levels are accrued based upon our estimates of the aggregate liability for claims incurred based on our experience and a third party actuarial study. As a result of these continuing increases, in both deductible amounts and premiums, there can be no assurance that we will be able to obtain all desired insurance coverage in the future on commercially reasonable terms or at all.

(13) Disclosures About the Fair Value of Financial Instruments

The estimated fair values of our financial instruments have been determined using available market information and appropriate valuation methodologies. However, considerable judgment is necessarily required to interpret market data to develop the estimates of fair value. Accordingly, the estimates presented herein are not necessarily indicative of the amounts that could be realized in a current market exchange. The use of different market assumptions or estimation methodologies may have a material impact on the estimated fair value amounts.

The carrying amounts reported in the consolidated balance sheets for cash and cash equivalents, accounts receivable and amounts due from affiliates, net and, accounts payable, accrued payroll costs and other accrued liabilities and accrued interest payable, approximate fair value due to the short-term nature of these instruments. The notes payable bear interest at rates and other terms that approximate current market rates and terms. Therefore, we believe that the carrying value approximates fair value, except for convertible debt which was $5.1 million at December 31, 2001. The carrying value of convertible debt approximates fair value at December 31, 2002.

(14) Composition of Certain Financial Statement Captions

	December 31,	
	2002	2001
	(in thousands)	
Accrued liabilities		
Property taxes	$ 1,047	$ 1,097
Merger costs and litigation judgement	2,696	
Lease restructuring fee	1,500	
Various other accruals	5,592	5,562
	$ 10,835	$ 6,659

(15) Quarterly Financial Information (Unaudited)

	For the Quarter Ended			
	December 31	September 30	June 30	March 31
	(In Thousands, Except Per Share Data)			
2002				
Total revenue	$ 39,188	$ 39,669	$ 39,743	$ 39,778
Income from operations	1,815	2,759	2,726	2,796
Net income (loss)	(3,494)	206	170	(145)

Basic and diluted earnings (loss) per share	(0.20)	0.01	0.01	(0.01)
2001				
Total revenue	$ 37,415	$ 36,685	$ 35,852	$ 35,443
Income (loss) from operations	1,889	1,724	1,559	836
Net income (loss)	(751)	(739)	797	1,665
Basic and diluted earnings (loss) per share	(0.05)	(0.04)	0.05	0.10

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(16) Subsequent Events

The Company announced on January 10, 2003, that its Board of Directors had approved the definitive Merger Agreement between the Company, Prometheus, and Jenny Merger Corp (Merger Sub). Under the terms of the Merger Agreement, the Merger Sub will be merged with and into the Company and the Company, as the surviving entity, will become a wholly owned subsidiary of Prometheus. If the Merger is completed, each share of ARV common stock (except for shares held by Prometheus or its affiliates, ARV or any subsidiary, or holders who perfect their dissenters rights) will be converted into the right to receive $3.90 in cash and each holder of a stock option granted by the Company to purchase shares of the Company s common stock will receive in cash for each share of common stock subject to such option, the excess, if any, of $3.90 per share over the exercise price per share of such option, less any applicable withholding taxes.

The Merger costs include $0.5 million for a fairness opinion delivered by Cohen & Steers Capital Advisors LLC to our Special Committee of the Board of Directors on January 3, 2003. The remaining $0.6 million in merger costs represent legal and other professional fees related to assistance provided to the Company and the Special Committee in reviewing and negotiating the Merger Agreement.

The completion of the Merger is conditioned upon various conditions, including, but not limited to, the condition that the Company obtain the affirmative vote of a majority of the holders of the outstanding common stock of the Company. The Company filed proxy materials with the Securities and Exchange Commission for a special meeting of the Company s stockholders to vote on the Merger and those materials have been reviewed and approved. The Company expects to mail the required proxy materials to the stockholders for their approval within the next 30 days. In the event that the Merger is completed, the Company will be obligated to pay a Success Fee of $2.25 million to Cohen & Steers Capital Advisors LLC in consideration of the services they provided as financial advisors to the Company and the Special Committee of the Company s Board of Directors in connection with the Merger. The Company anticipates that the Merger should be completed during the second quarter of 2003.

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SCHEDULE II - VALUATION AND QUALIFYING ACCOUNTS
For the Years Ended December 31, 2002, 2001, and 2000
(In thousands)

Description	Balance At Beginning Of Year	Additions	Deductions	Balance At End of Year
Allowance for Other Assets:				
December 31, 2000	1,889	791	489	2,191
December 31, 2001	2,191			2,191
December 31, 2002	2,191			2,191

See accompanying independent auditors' report.