

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

GENERAL

The Company is a leading provider of privatized correctional, treatment and educational services outsourced by federal, state and local government agencies. The Company provides a diversified portfolio of services for adults and juveniles through its three operating divisions (1) adult secure institutional services, (2) juvenile treatment, education and detention services and (3) pre-release correctional and treatment services. As of December 31, 2001, the Company had contracts to operate 69 facilities with a total service capacity of 15,444. The Company's facilities are located in 13 states and the District of Columbia.

The following table sets forth for the periods indicated total service capacity, the service capacity and contracted beds in operation at the end of the periods shown and the average occupancy percentages.

	Year Ended December 31,		
	2001	2000	1999
Total service capacity (1):			
Residential.....	11,267	11,318 (2)	11,796
Non-residential community-based.....	<u>4,177</u>	<u>3,046</u>	<u>3,049</u>
Total.....	15,444	14,364 (2)	14,845
Service capacity in operation (end of period).....	14,349	13,269	12,240
Contracted beds in operation (end of period) (3).....	9,503	10,061	9,029
Average occupancy based on contracted beds in operation (3) (4).....	95.9 %	94.3 %	95.8 %
Average occupancy excluding start-up operations (3).....	96.3 %	96.0 %	97.0 %

- (1) The Company's service capacity is comprised of the number of beds available for service upon completion of construction of residential facilities and the average program capacity of non-residential community-based programs.
- (2) The Utah DOC selected the Company's bid in June 1999 for the 490 bed Timpie Valley Correctional Facility subject to final contract negotiations. In 2000, the Utah DOC declined to pursue this project, therefore the Company's service capacity was reduced accordingly.
- (3) Occupancy percentages are based on contracted service capacity of residential facilities in operation. Since certain facilities have service capacities that exceed contracted capacities, occupancy percentages can exceed 100% of contracted capacity.
- (4) Occupancy percentages reflect less than normalized occupancy during the start-up phase of any applicable facility, resulting in a lower average occupancy in periods when the Company has substantial start-up activities.

From 1994 to 1999 the Company completed eight acquisitions. The acquisitions have generally targeted companies that assist the Company in penetrating new markets, diversifying its revenues and establishing a nationally recognized presence. To fulfill this strategy, the Company has acquired companies that have a reputation for high quality in the corrections and treatment industry.

The Company derives substantially all its revenues from providing corrections, treatment and educational services outsourced by federal, state and local government agencies in the United States. Revenues for the Company's services are generally recognized on a per diem rate based upon the number of occupant days or hours served for the period, on a guaranteed take-or-pay basis or on a cost-plus reimbursement basis.

Factors which the Company considers in determining the per diem rate to charge include (1) the programs specified by the contract and the related staffing levels; (2) wage levels customary in the respective geographic areas; (3) whether the proposed facility is to be leased or purchased and (4) the anticipated average occupancy levels which the Company believes could reasonably be maintained.

Although the Company has experienced higher operating margins in its adult secure institutional and pre-release divisions as compared to the juvenile division, the Company's operating margins generally vary from facility to facility based on whether the facility is owned or leased, the level of competition for the contract award, the proposed length of the contract, the occupancy levels for a facility, the level of capital commitment required with respect to a facility, the anticipated changes in operating costs over the term of the contract, and the Company's ability to increase contract revenues. The Company has and expects to experience interim period operating margin differences due to the number of calendar days in the period, higher payroll taxes in the first half of the year, and salary and wage increases that are incurred prior to certain contract revenue increases.

The Company is responsible for all facility operating expenses, except for certain debt service and lease payments with respect to facilities for which the Company has only a management contract (11 facilities in operation at December 31, 2001).

A majority of the Company's facility operating expenses consist of fixed costs. These fixed costs include lease and rental expense, insurance, utilities and depreciation. As a result, when the Company commences operation of new or expanded facilities, fixed operating expenses increase. The amount of the Company's variable operating expenses, including food, medical services, supplies and clothing, depend on occupancy levels at the facilities operated by the Company. The Company's largest single operating expense, facility payroll expense and related employment taxes and costs, has both a fixed and a variable component. The Company can adjust the staffing levels and payroll expense to a certain extent based on occupancy at a facility, but a minimum fixed number of employees is required to operate and maintain any facility regardless of occupancy levels. Personnel costs are subject to increase in tightening labor markets based on local economic and other conditions.

Following a contract award, the Company incurs pre-opening and start-up expenses including payroll, benefits, training and other operating costs prior to opening a new or expanded facility and during the period of operation while occupancy is ramping up. These costs vary by contract. Since pre-opening and start-up costs are factored into the revenue per diem rate that is charged to the contracting agency, the Company typically expects to recover these upfront costs over the life of the contract. Because occupancy rates during a facility's start-up phase typically result in capacity under-utilization for at least 90 to 180 days, the Company may incur additional post-opening start-up costs. The Company does not anticipate post-opening start-up costs at facilities operating under any future contracts with the FBOP because these contracts are currently take-or-pay, meaning that the FBOP will pay the Company at least 95% of the contractual monthly revenue once the facility opens regardless of actual occupancy.

Newly opened facilities are staffed according to contract requirements when the Company begins receiving offenders or clients. Offenders or clients are typically assigned to a newly opened facility on a phased-in basis over a one- to six-month period, although certain programs require a longer time period to reach break-even occupancy levels. The Company incurs start-up operating losses at new facilities until break-even occupancy levels are reached. Although the Company typically recovers these upfront costs over the life of the contract, quarterly results can be substantially affected by the timing of the commencement of operations as well as development and construction of new facilities.

Working capital requirements generally increase immediately prior to the Company's commencing management of a new or expanded facility as the Company incurs start-up costs and purchases necessary equipment and supplies before facility management revenue is realized.

In January 1999, the Company adopted Statement of Position 98-5, "Reporting on the Costs of Start-Up Activities," or SOP 98-5, and recorded a net-of-tax charge of approximately \$3.0 million for the cumulative effect of a change in accounting principle. As a result of the Company's adoption of SOP 98-5, the Company began to expense pre-opening and start-up costs as incurred.

General and administrative expenses consist primarily of costs for the Company's corporate and administrative personnel who provide senior management, finance, accounting, human resources, payroll, information systems and other services and costs of business development.

RECENT DEVELOPMENTS

On February 6, 2002, the Company announced that a Special Committee of the Audit Committee of the Board of Directors had been formed to review the accounting treatment for its August 2001 sale/leaseback transaction (the "2001 Sale and Leaseback Transaction"). The Company entered into a retainer agreement with an investment bank dated September 2001, which, as it had been amended, provides that (1) the Company pay the investment bank a non-refundable retainer fee of \$3.65 million to provide financial advisory services concerning separate future financing vehicles and the strategic development of the Company's business and (2) the retainer will be applied on a mutually agreed upon basis toward future contingent fees associated with investment banking services that may be provided to the Company. The review focused on whether the retainer agreement and the payment of the fee affected the previously reported accounting treatment for the 2001 Sale and Leaseback Transaction.

The Special Committee, which was composed solely of independent directors, retained independent counsel, who retained an accounting advisor, to assist the Special Committee in its review. The Special Committee was formed and conducted its review in response to correspondence from the Company's independent auditors to its Audit Committee regarding the 2001 Sale and Leaseback Transaction. In the course of its review and pursuant to a third letter from the Company's independent auditors addressed to the Company's Chairman dated February 21, 2002, the Special Committee also reviewed the accounting treatment for the Company's 2000 synthetic lease transaction. The review of the synthetic lease focused on whether a fee was paid pursuant to an engagement letter between the Company and two financial institutions participating in the transaction and the impact of the fee on the previously reported accounting treatment.

At the conclusion of its review, among other things, the Special Committee recommended to the Board of Directors that:

- based on various considerations, the Company's financial statements for 2000 and the first three quarters of 2001 should be restated to reflect the consolidation of the 2001 Sale and Leaseback Transaction and the 2000 synthetic lease transaction; and
- actions should be taken to strengthen further the Company's internal controls.

While the Company believes there are reasonable arguments supporting the previously reported accounting treatment of the 2001 Sale and Leaseback Transaction and the 2000 synthetic lease transaction, following discussions with its independent auditors and its advisors, and in view of anticipated changes in accounting rules and the market and regulatory environment currently existing and a desire to reach a final resolution of these matters as quickly as possible, the Company decided to consolidate both transactions for financial accounting purposes for past and future periods. As a result, the Company has restated its financial statements for 2000 and the first three quarters of 2001 to reflect the consolidation of the 2001 Sale and Leaseback Transaction and the 2000 synthetic lease transaction.

These restatements are reflected in the selected unaudited quarterly financial data set forth in Note 14 to the Consolidated Financial Statements. The restatements of the financial data for the year ended and as of December 31, 2000 are reflected in the audited financial statements included herewith.

On April 16, 2002, the Board of Directors amended the Company's Bylaws. Among other things, the amendments establish an executive chairman position, clarify specific levels of authority for members of senior management and identify appropriate limits on such authority. Pursuant to board action, Harry J. Phillips, Jr., the Company's Chairman, will serve as

the Executive Chairman of the Company, Steven W. Logan will serve as President, Thomas R. Jenkins shall continue to serve as the Chief Operating Officer of the Company, and John L. Hendrix shall continue to serve as the Chief Financial Officer of the Company. The Board of Directors is considering additional actions to strengthen further the Company's internal controls.

As a result of the Company's Special Committee review of certain Company transactions, the restatement of the Company's 2000 and 2001 financial statements and related matters, management expects to recognize a non-recurring pre-tax charge of approximately \$1.6 million for legal, accounting and other professional fees for the quarter ended March 31, 2002. See Notes 2 and 13 to the Consolidated Financial Statements.

Additionally, certain waivers and amendments to the Company's credit agreements were obtained by the Company in connection with the restatement of its financial statements during the first quarter of 2002. As a result of these waivers and amendments, the Company will recognize a pre-tax charge to interest expense of approximately \$800,000 for the quarter ended March 31, 2002 for lenders' fees and related professional fees.

RESULTS OF OPERATIONS

The Company's historical operating results reflect a significant expansion of the Company's business. Material fluctuations in the Company's results of operations are principally the result of the timing and effect of acquisitions, the level of new contract development activity conducted by the Company, and occupancy rates at Company-operated facilities and extraordinary and non-recurring charges. The Company's acquisitions have been accounted for using the purchase method of accounting, whereby the operating results of the acquired businesses have been reported in the Company's operating results since the date of acquisition.

The following table sets forth for the periods indicated the percentages of revenues represented by certain items in the Company's historical consolidated statements of operations:

	<u>Year Ended December 31,</u>		
	<u>2001</u>	<u>2000</u> (restated)	<u>1999</u>
Revenues ..	100.0%	100.0%	100.0%
Operating expenses ..	77.6	77.2	76.8
Pre-opening and start-up expenses ..	1.4	1.0	1.7
Depreciation and amortization ..	3.5	3.3	3.3
General and administrative expenses ..	<u>5.8</u>	<u>5.3</u>	<u>5.6</u>
Income from operations ..	11.7	13.2	12.6
Interest expense, net ..	7.9	7.3	4.8
Minority interest in losses of consolidated special purpose entities ..	<u>(.6)</u>	<u>(.1)</u>	<u>--</u>
Income before income taxes, extraordinary charges and cumulative effect of change in accounting principle ..	4.4	6.0	7.8
Provision for income taxes ..	<u>1.8</u>	<u>2.5</u>	<u>3.1</u>
Income before extraordinary charge and cumulative effect of change in accounting principle ..	<u><u>2.6%</u></u>	<u><u>3.5%</u></u>	<u><u>4.7%</u></u>

Year Ended December 31, 2001 Compared to Year Ended December 31, 2000 (Restated)

Revenues. Revenues increased 17.3% to \$265.3 million for the year ended December 31, 2001 from \$226.1 million for the year ended December 31, 2000.

Adult secure institutional division revenues increased 9.5% to \$99.8 million for the year ended December 31, 2001 from \$91.2 million for the year ended December 31, 2000 due principally to (1) the final 550 bed expansion at the D. Ray James Prison which began housing inmates late in the first quarter of 2000 and reached a full occupancy level late in the second quarter of 2000, (2) per diem rate increases realized in 2001, (3) the commencement of a management contract at the Valencia County Detention Center in the fourth quarter of 2000 and (4) increased occupancy at the Great Plains Correctional Facility as compared to the year ended December 31, 2000. The increase in revenue was offset, in part, by a reduction in occupancy at the Santa Fe County Detention Center. The Company's contract to manage the Santa Fe County Detention Center expired effective September 30, 2001. Revenues for the Santa Fe County Detention Center were \$5.1 million for the nine months ended September 30, 2001. There were no revenues attributable to start-up operations for the year ended December 31, 2001. Additionally, during the fourth quarter of 2000, the Company entered into a license agreement with its construction contractor that conveyed certain rights to the design of an adult secure institution. A non-recurring license agreement payment of \$950,000 was recognized as revenue by the Company. The Company has not licensed such designs in prior years and does not expect to generate significant revenues from such activity in future periods. Revenues attributable to start-up operations for the year ended December 31, 2000 were \$44,000 and related to the expansion of the D. Ray James Prison. Average occupancy, excluding start-up operations in 2000, was 97.0% for the year ended December 31, 2001 compared to 97.6% for the year ended December 31, 2000.

Juvenile division revenues increased 35.1% to \$116.3 million for the year ended December 31, 2001 from \$86.0 million for the year ended December 31, 2000 principally due to (1) the opening of the New Morgan Academy in the fourth quarter of 2000, (2) the commencement of a management contract at the Alexander Youth Center in the third quarter of 2001, (3) the opening of the William Penn Harrisburg Alternative School in the third quarter of 2001, (4) increased occupancy at the Cornell Abraxas Center for Adolescent Females, or ACAF, due to a facility expansion completed early in 2001, (5) increased occupancy at various facilities including the Griffin Juvenile facility and (6) the commencement of a management contract at the Schaffner Youth Center. Revenues attributable to start-up operations were \$2.8 million for the year ended December 31, 2001 and related to the operations of the New Morgan Academy and an expansion of ACAF. Revenues attributable to start-up operations were \$1.2 million for the year ended December 31, 2000 and related to the operations of the New Morgan Academy. Average occupancy, excluding start-up operations, was 91.2% for the year ended December 31, 2001 compared to 91.3% for the year ended December 31, 2000.

Pre-release division revenues increased to \$49.2 million for the year ended December 31, 2001 from \$48.9 million for the year ended December 31, 2000 due to increased average occupancy at various facilities offset by a reduction in revenue due to the terminations of the San Diego Center and Durham Treatment Center contracts as of January 31, 2001 and June 30, 2001, respectively. Average occupancy was 98.6% for the year ended December 31, 2001 compared to 94.2% for the year ended December 31, 2000.

Operating Expenses. Operating expenses increased 17.9% to \$205.8 million for the year ended December 31, 2001 from \$174.6 million for the year ended December 31, 2000.

Adult secure institutional division operating expenses increased 9.4% to \$74.6 million for the year ended December 31, 2001 from \$68.2 million for the year ended December 31, 2000 due principally to (1) the final 550 bed expansion of the D. Ray James Prison, which began housing inmates late in the first quarter of 2000 and reached a full occupancy level late in the second quarter of 2000, (2) increased personnel costs due to contractual wage increases at the Big Spring Complex associated with receiving an increase in per diem revenue, (3) the commencement of a management

contract at the Valencia County Detention Center in the fourth quarter of 2000 and (4) increased operating expenses at the Great Plains Correctional Facility due to increased occupancy as compared to the year ended December 31, 2000. The increase in operating expenses was offset, in part, by a reduction in occupancy at the Santa Fe County Detention Center. The Company's contract to manage the Santa Fe County Detention Center expired effective September 30, 2001. For the year ended December 31, 2000, secure division operating expenses included a provision for bad debts of approximately \$1.2 million related to the Santa Fe County Detention Center. As a percentage of adult secure institutional division revenues, excluding start-up operations and the \$950,000 license agreement revenue in 2000, adult secure institutional division operating expenses were 74.8% for the year ended December 31, 2001 compared to 75.0% for the year ended December 31, 2000.

Juvenile division operating expenses increased 27.8% to \$93.8 million for the year ended December 31, 2001 from \$73.4 million for the year ended December 31, 2000. The increase in operating expenses was due to (1) the opening of the New Morgan Academy in the fourth quarter of 2000, (2) the commencement of a management contract at the Alexander Youth Center in the third quarter of 2001, (3) the opening of the William Penn Harrisburg Alternative School in the third quarter of 2001, (4) increased operating expenses at ACAF due to a facility expansion, (5) the commencement of a management contract at the Schaffner Youth Center and (6) increased occupancy at various facilities including the Griffin Juvenile Facility. As a percentage of juvenile division revenues, excluding start-up operations, juvenile division operating expenses were 82.7% for the year ended December 31, 2001 compared to 84.4% for the year ended December 31, 2000. The decline in the 2001 operating margin was due principally to the operations of the Alexander Youth Center.

Pre-release division operating expenses increased 4.5% to \$37.4 million for the year ended December 31, 2001 from \$35.8 million for the year ended December 31, 2000 due principally to increased average occupancy at various facilities offset, in part, by a reduction to operating expenses due to the termination of the San Diego Center and Durham Treatment Center contracts as of January 31, 2001 and June 30, 2001, respectively. As a percentage of pre-release division revenues pre-release division operating expenses were 76.1% for the year ended December 31, 2001 compared to 73.1% for the year ended December 31, 2000. The decline in the 2001 operating margin was due principally to increased personnel and employee retention costs and utility costs due to the termination of the San Diego Center and Durham Treatment Center contracts as of January 31, 2001 and June 30, 2001, respectively.

Pre-opening and Start-up Expenses. Pre-opening and start-up expenses were \$3.9 million for the year ended December 31, 2001 and were attributable to the pre-opening and start-up activities of the New Morgan Academy, which opened in the fourth quarter of 2000, and an expansion of ACAF. Pre-opening and start-up expenses were \$2.3 million for the year ended December 31, 2000 and were attributable to the pre-opening and start-up activities of the New Morgan Academy, the final 550 bed expansion at the D. Ray James Prison in the first quarter of 2000 and the Moshannon Valley Correctional Center. Revenues associated with start-up operations were \$2.8 million and \$1.3 million for the years ended December 31, 2001 and 2000, respectively.

Depreciation and Amortization. Depreciation and amortization increased 24.3% to \$9.3 million for the year ended December 31, 2001 from \$7.5 million for the year ended December 31, 2000. The increase was due to (1) depreciation related to the New Morgan Academy which began operations in the fourth quarter of 2000, (2) the completion of a 150 bed expansion at the Big Spring Complex in the first quarter of 2001, (3) the purchase and renovation of a building for the expansion of ACAF, (4) depreciation of furniture and equipment purchased for the New Morgan Academy, (5) the write-off of leasehold improvements at the Durham Treatment Center due to its contract termination and (6) various facility improvements and furniture and equipment purchases.

General and Administrative Expenses. General and administrative expenses increased 27.2% to \$15.3 million for the year ended December 31, 2001 from \$12.0 million for the year ended December 31, 2000. Included in general and administrative expenses for the year ended December 31, 2001 were non-recurring charges of \$668,000 related to the write-off of deferred acquisition costs associated with the Fort Greeley, Alaska project and a \$200,000 charge for legal costs related to the class action lawsuits. The remaining increase in general and administrative expenses resulted primarily from retention and incentive bonus costs, costs for additional personnel providing public affairs and business development services, certain consulting and legal costs and other administrative infrastructure costs. Excluding the \$668,000 and \$200,000 charges in the 2001 period, general and administrative expenses were 5.4% and 5.5% of revenues for the year ended December 31, 2001 and 2000, respectively.

Interest. Interest expense, net of interest income, increased to \$20.9 million for the year ended December 31, 2001 from \$16.4 million for the year ended December 31, 2000. In August 2001, MCF issued \$197.4 million of 8.47% bonds due in August 2016 in connection with the 2001 Sale and Leaseback Transaction. Proceeds from the 2001 Sale and Leaseback Transaction were used by the Company, in part, to repay \$70.0 million outstanding under the Company's revolving line of credit and \$50.0 million of outstanding 7.74% Senior Secured Notes. Additionally, in December 2001, the Company repaid \$39.4 million of 12.875% notes under its Note and Equity Purchase Agreement ("Subordinated Notes") with proceeds from an offering and sale of its common stock. For the year ended December 31, 2001, interest expense increased due to (1) the increased borrowings of MCF, (2) increased borrowings under the Company's synthetic lease to finance the construction of the New Morgan Academy which began operations in the fourth quarter of 2000, and (3) a non-recurring charge of \$818,000 to write-off a portion of unamortized deferred debt issuance costs related to the Company's 2000 Credit Facility as a result of the repayment of all outstanding borrowings and an associated reduction in the credit commitment. For the year ended December 31, 2001 the Company capitalized interest of \$1.3 million related to the construction of the Moshannon Valley Correctional Center. Capitalized interest for the year ended December 31, 2000 was \$2.0 million and related to the construction of the New Morgan Academy and the Moshannon Valley Correctional Center.

Minority Interest in Losses of Consolidated Special Purpose Entities. Minority interest in consolidated special purpose entities represents third party equity contributed to the special purpose entities consolidated by the Company for financial reporting purposes. Minority interest is adjusted for income and losses of the special purpose entities. When the cumulative losses of MCF exceed the equity which is recorded as minority interest by the Company, the excess losses will be recorded in the Company's Consolidated Statement of Operations. Notwithstanding any additional third party equity contributions, management estimates that the cumulative losses of MCF will exceed the recorded minority interest of MCF during the first quarter of 2002. The cumulative losses of the Synthetic Lease Investor exceeded the recorded minority interest of the Synthetic Lease Investor during the third quarter of 2001.

Income Taxes. For the years ended December 31, 2001 and 2000, the Company recognized a provision for income taxes at an estimated effective rate of 42.0% and 41.0%, respectively. The increase in the effective rate was due to increased taxable income in certain states having higher rates.

Year Ended December 31, 2000 (Restated) Compared to Year Ended December 31, 1999

Revenues. Revenues increased 27.7% to \$226.1 million for the year ended December 31, 2000 from \$177.0 million for the year ended December 31, 1999.

Adult secure institutional division revenues increased 19.9% to \$91.2 million for the year ended December 31, 2000 from \$76.0 million for the year ended December 31, 1999 due principally to (1) the final 550 bed expansion of the D. Ray James Prison which began housing inmates late in the first quarter of 2000 and reached a full occupancy level late in the second quarter of 2000, (2) the opening of the additional 450 bed second phase of the D. Ray James Prison in the first quarter of 1999, (3) expansions at the Big Spring Complex completed in the fourth quarter of 1999 and the first quarter of 2000 and (4) the opening of the Valencia County Detention Center in the fourth quarter of 2000. These

revenue increases were offset, in part, by reductions in occupancy at certain facilities including a temporary reduction at the Great Plains Correctional Facility. As of December 31, 2000, occupancy at these facilities had returned to normal occupancy levels. Additionally, during the fourth quarter of 2000, the Company entered into a license agreement with its construction contractor that conveyed certain rights to the design of an adult secure institution. A non-recurring license agreement payment of \$950,000 was recognized as revenue by the Company. The Company has not licensed such designs in prior years and does not expect to generate significant revenues from such activity in future periods. Revenues attributable to start-up operations were approximately \$44,000 and \$866,000 for the years ended December 31, 2000 and 1999, respectively, and related primarily to the D. Ray James Prison expansions.

Juvenile division revenues increased 28.2% to \$86.0 million for the year ended December 31, 2000 from \$67.1 million for the year ended December 31, 1999 due to (1) the operations of the juvenile facilities and programs acquired from Interventions - Illinois in November 1999, (2) increased occupancy at the Cornell Abraxas I facility due to a facility expansion completed in the fourth quarter of 1999, (3) the opening of the Cornell Abraxas Youth Center late in the first quarter of 1999, (4) increased occupancy at certain facilities including the Santa Fe County Juvenile Detention Facility and the Griffin Juvenile Facility, (5) the opening of the New Morgan Academy in the fourth quarter of 2000, and (6) the addition of various new programs during 1999 including two new non-residential mental health programs and one new residential mental health program in Pennsylvania. Revenues attributable to start-up operations were \$1.2 million and \$432,000, for the years ended December 31, 2000 and 1999, respectively. For the year ended December 31, 2000, revenues attributable to start-up operations related primarily to the New Morgan Academy. For the year ended December 31, 1999 revenues attributable to start-up operations related to the opening of two new residential facilities and three new non-residential programs.

Pre-release division revenues increased 44.4% to \$48.9 million for the year ended December 31, 2000 from \$33.8 million for the year ended December 31, 1999 due principally to (1) the operations of the pre-release facilities and programs acquired from Interventions - Illinois in November 1999, (2) the opening of a new facility in Nome, Alaska late in the third quarter of 1999, and (3) increased occupancy at various facilities including the Leidel Comprehensive Sanctions Center, the Reid Community Correctional Center and the Dallas County Judicial Treatment Center. Revenues attributable to start-up operations were \$0 and \$122,000 for the years ended December 31, 2000 and 1999, respectively. Revenues attributable to start-up operations for the year ended December 31, 1999 related to the new facility in Nome, Alaska.

Operating Expenses. Operating expenses increased 28.5% to \$174.6 million for the year ended December 31, 2000 from \$135.9 million for the year ended December 31, 1999. For the years ended December 31, 2000 and 1999, operating expenses included approximately \$3.9 million and \$308,000, respectively, of rent expense resulting from the sale and leaseback of certain owned furniture and equipment during the fourth quarter of 1999. This operating rent expense was largely offset by a reduction of depreciation and interest expense.

Adult secure institutional division operating expenses increased 23.8% to \$68.2 million for the year ended December 31, 2000 from \$55.1 million for the year ended December 31, 1999 due principally to (1) the final 550 bed expansion of the D. Ray James Prison, which began housing inmates late in the first quarter of 2000 and reached a full occupancy level late in the second quarter of 2000, (2) the opening of the additional 450 bed second phase of the D. Ray James Prison in the first quarter of 1999, (3) increased occupancy at the Big Spring Complex due to expansions completed in the fourth quarter of 1999 and the first quarter of 2000, and (4) the opening of the Valencia County Detention Center in the fourth quarter of 2000. As a percentage of adult secure institutional division revenues, excluding start-up operations and the \$950,000 license agreement revenue, adult secure institutional division operating expenses were 75.0% for the year ended December 31, 2000 compared to 70.1% for the year ended December 31, 1999. The 2000 operating margin was impacted unfavorably due to (1) the sale and leaseback of certain owned furniture and equipment during the fourth quarter of 1999, (2) a reduction in occupancy at the Great Plains Correctional Facility offset, in part, by the expansion of the D. Ray James Prison, (3) a \$1.2 million bad debt provision related to a Santa Fe County Adult Detention Facility contract dispute and (4) a reduction to operating expenses during the year

ended December 31, 1999 of \$1.0 million at the Santa Fe County Adult Detention Facility resulting from a cost sharing agreement with the Company's construction contractor.

Juvenile division operating expenses increased 27.4% to \$73.4 million for the year ended December 31, 2000 from \$57.6 million for the year ended December 31, 1999. The increase in operating expenses was due to (1) the juvenile facilities and programs acquired from Interventions - Illinois in November 1999, (2) increased occupancy at the Cornell Abraxas I facility due to a facility expansion completed in the fourth quarter of 1999, (3) the opening of the Cornell Abraxas Youth Center late in the first quarter of 1999, (4) increased occupancy at certain facilities including the Santa Fe County Juvenile Detention Facility and the Griffin Juvenile Facility, (5) the opening of the New Morgan Academy in the fourth quarter of 2000, and (6) the addition of various programs including two new non-residential mental health programs and one residential mental health facility in Pennsylvania. As a percentage of juvenile division revenues, excluding start-up operations, juvenile division operating expenses were 84.4% for the year ended December 31, 2000 compared to 85.3% for the year ended December 31, 1999. The improved operating margin for the year ended December 31, 2000 compared to the year ended December 31, 1999 was due principally to the higher occupancy levels and revenue of certain facilities including Cornell Abraxas I, the Cornell Abraxas Youth Center, the Griffin Juvenile Facility and the Santa Fe County Juvenile Detention Facility. These operating margin improvements were offset, in part, by a margin reduction due to the sale and leaseback of certain owned furniture and equipment during the fourth quarter of 1999.

Pre-release division operating expenses increased 37.8% to \$35.7 million for the year ended December 31, 2000 from \$25.9 million for the year ended December 31, 1999 due principally to (1) the pre-release facilities and programs acquired from Interventions - Illinois in November 1999, (2) the opening of a new facility in Nome, Alaska late in the third quarter of 1999 and (3) increased occupancy at various facilities including the Leidel Comprehensive Sanctions Center, the Reid Community Correctional Center and the Dallas County Judicial Treatment Center. As a percentage of pre-release division revenues, excluding start-up operations, pre-release division operating expenses were 73.1% for the year ended December 31, 2000 compared to 75.4% for the year ended December 31, 1999. The improved operating margin for the year ended December 31, 2000 compared to the year ended December 31, 1999 was due principally to higher occupancy and revenues at certain facilities. These operating margin improvements were offset, in part, by margin reductions due to the sale and leaseback of certain owned furniture and equipment during the fourth quarter of 1999.

Pre-opening and Start-up Expenses. Pre-opening and start-up expenses were \$2.3 million for the year ended December 31, 2000 and were primarily attributable to the pre-opening and start-up activities of the New Morgan Academy which opened in the fourth quarter of 2000 and the final 550 bed expansion at the D. Ray James Prison in the first quarter of 2000. Pre-opening and start-up expenses were \$2.9 million for the year ended December 31, 1999 and were attributable to the pre-opening and start-up activities of an additional 450 beds in the D. Ray James Prison, the Cornell Abraxas Youth Center during the first quarter of 1999 and other new juvenile programs in Pennsylvania and a new pre-release facility in Alaska. Revenues associated with start-up operations were \$1.3 million and \$1.5 million for the years ended December 31, 2000 and 1999, respectively.

Depreciation and Amortization. Depreciation and amortization increased 24.2% to \$7.5 million for the year ended December 31, 2000 from \$6.0 million for the year ended December 31, 1999 due to (1) depreciation of buildings, furniture and equipment and amortization of non-compete agreements related to the acquisition of Interventions - Illinois in November 1999, (2) the completion of the expansions at the Big Spring Complex, (3) the completion of the additional 450 bed expansion in the first quarter of 1999 and the final 550 bed expansion in the first quarter of 2000 of the D. Ray James Prison, and (4) depreciation related to the New Morgan Academy and Taylor Street Center buildings financed through the Company's Synthetic Lease financing agreement. These increases were partially offset due to the sale and leaseback of certain owned furniture and equipment during the fourth quarter of 1999 and due to the Company's change in the estimated useful lives of certain adult secure institutions effective July 1, 1999.

General and Administrative Expenses. General and administrative expenses increased 21.1% to \$12.0 million for the year ended December 31, 2000 from \$9.9 million for the year ended December 31, 1999. The increase in general and administrative expenses resulted principally from the centralization of certain administrative functions and increases in public relations efforts and information technology infrastructure. Additionally, for the years ended December 31, 2000 and 1999, general and administrative expenses included approximately \$820,000 and \$93,000, respectively, of rent expense resulting from the sale and leaseback of certain owned furniture and equipment during the fourth quarter of 1999. This rent expense was largely offset by a reduction of depreciation and interest expense. Excluding the rent expense resulting from the 1999 sale and leaseback of certain furniture and equipment, general and administrative expenses for the year ended December 31, 2000 increased 13.9% compared to the year ended December 31, 1999.

Interest. Interest expense, net of interest income, increased to \$16.4 million for the year ended December 31, 2000 from \$8.4 million for the year ended December 31, 1999 due principally to (1) increased borrowings to fund the acquisition of Interventions - Illinois in November 1999, various facility expansions and the associated increases in working capital, (2) increased borrowings to fund the construction of the New Morgan Academy and the Moshannon Valley Correctional Center and (3) increases in base interest rates and the Company's interest rate margin on its 2000 Credit Facility (see Note 6 to the Consolidated Financial Statements). Capitalized interest for the year ended December 31, 2000 was \$2.0 million and related to the construction of the New Morgan Academy and the Moshannon Valley Correctional Center and expansions at the Big Spring Complex. During the year ended December 31, 1999, the Company capitalized interest totaling \$1.2 million related to the construction of the D. Ray James Prison.

Minority Interest in Losses of Consolidated Special Purpose Entities. Minority interest in consolidated special purpose entities represents third party equity contributed to the special purpose entity. Minority interest is adjusted for income and losses of the special purpose entity. When the cumulative losses of a special purpose entity exceed the equity which is recorded as minority interest by the Company, the excess losses are recorded in the Company's Consolidated Statements of Operations. The cumulative losses of the Synthetic Lease Investor exceeded the recorded minority interest of the Synthetic Lease Investor during the third quarter of 2001.

Income Taxes. For the year ended December 31, 2000 and 1999, the Company recognized a provision for income taxes at an estimated effective rate of 41% and 40%, respectively. The increase in the estimated effective tax rate for the year ended December 31, 2000 as compared to the year ended December 31, 1999 was due primarily to increased taxable income in certain higher taxing states.

LIQUIDITY AND CAPITAL RESOURCES

General. The Company's primary capital requirements are for (1) construction of new facilities, (2) expansions of existing facilities, (3) working capital, (4) pre-opening and start-up costs related to new operating contracts, (5) acquisitions, (6) information systems hardware and software, and (7) furniture, fixtures and equipment. Working capital requirements generally increase immediately prior to the Company commencing management of a new facility as the Company incurs start-up costs and purchases necessary equipment and supplies before facility management revenue is realized.

2001 Common Stock Offering. On November 30, 2001 the Company completed an offering of its common stock. Net proceeds to the Company from the sale of the 3,450,000 newly issued shares were approximately \$43.8 million. The Company used a portion of the proceeds to repay outstanding borrowings of \$39.4 million and retired the notes under its Note and Equity Purchase Agreement (the "Subordinated Notes") entered into in July 2000.

2001 Sale and Leaseback Transaction. On August 14, 2001, the Company completed an arms' length sale and leaseback transaction involving 11 of its real estate facilities (the "2001 Sale and Leaseback Transaction"). The Company sold the facilities to an unaffiliated company, Municipal Corrections Finance L.P. ("MCF"), and is leasing them back for an initial period of 20 years, with approximately 25 years of additional renewal period options.

MCF is an unaffiliated special purpose entity ("SPE"). Under current accounting rules, an SPE must maintain at least a 3% ownership interest throughout the life of the lease. In September 2001, the Company entered into a separate retainer agreement, thereafter amended, with affiliates of the equity investor in MCF ("MCF Equity Investor"), and in November 2001, paid the retainer fee of \$3.65 million for financial advisory services for separate potential future financing projects and the strategic development of the Company's business. The retainer will be applied on a mutually agreed upon basis toward future contingent fees associated with investment banking services that are expected to be provided to the Company. Under certain accounting interpretations, this retainer has been deemed to reduce the equity investment in MCF to below the required 3% level. Therefore, for financial reporting purposes only, the Company has consolidated the assets, liabilities, and results of operations of MCF in the Company's accompanying consolidated financial statements beginning August 14, 2001. As a result of consolidating the assets and liabilities of MCF, the Company's consolidated financial statements reflect the depreciation expense on the associated properties and interest expense on the bond debt of MCF used to finance MCF's acquisition of the 11 facilities in the 2001 Sale and Leaseback Transaction.

MCF issued \$197.4 million of 8.47% bonds due August 2016. The Company used \$120.0 million of the \$173 million of proceeds received by the Company from the sale of such facilities to repay the Company's long-term senior debt and invested the remaining proceeds of approximately \$53.0 million in short-term securities.

The Company's consolidated financial statements include the financial statements of MCF as of August 14, 2001 and thereafter. See Note 2 to the consolidated financial statements for discussion of the sale-leaseback transaction, the consolidation of MCF, and the restatement of the Company's financial statements for the quarter ended September 30, 2001.

Long-Term Credit Facilities. On August 14, 2001, the Company repaid \$70.0 million outstanding under its revolving line of credit with a portion of the proceeds from the 2001 Sale and Leaseback Transaction. In connection with the repayment, the Company amended its 2000 Credit Facility, which now provides for borrowings of up to \$45.0 million under a revolving line of credit. The commitment amount is reduced by \$1.6 million quarterly beginning July 2002. The amended 2000 Credit Facility matures in July 2005 and bears interest, at the election of the Company, at either the prime rate plus a margin of 2.0%, or a rate which is 3.0% above the applicable LIBOR rate. The amended 2000 Credit Facility is secured by substantially all of the Company's assets, including the stock of all of the Company's subsidiaries; does not permit the payment of cash dividends; and requires the Company to comply with certain leverage,

net worth and debt service coverage covenants. Due in part to the consolidation of MCF as of August 14, 2001, the Company was not in compliance with certain covenants required by the 2000 Credit Facility. On April 5, 2002, the 2000 Credit Facility was amended to waive such non-compliance and to revise the covenants to levels that accommodate the Company's consolidation of special purpose entities in its Consolidated Balance Sheet and Statements of Operations. As a result of this waiver and amendment, the Company paid fees and will recognize a pre-tax charge to interest expense of approximately \$800,000 during the first quarter of 2002. On April 11, 2002, the Company obtained a waiver from the lenders under the 2000 Credit Facility regarding the pending contractual default for the Moshannon Valley Correctional Center's construction delay.

As a result of the reduction of the revolving line of credit commitment in August 2001, the Company recognized a non-recurring charge of approximately \$818,000 to interest expense representing a portion of the unamortized deferred debt issuance costs related to the 2000 Credit Facility.

Additionally, the amended 2000 Credit Facility provides the Company with the ability to enter into lease financing arrangements for the acquisition or development of operating facilities. This lease financing arrangement provides for funding to the lessor under the leases of up to \$100.0 million, of which approximately \$49.9 million had been utilized as of December 31, 2001. The Company expects to utilize the remaining capacity under this lease financing arrangement to complete construction of the Moshannon Valley Correctional Center. The Company pays commitment fees at a rate of 0.5% annually for the unused portion of the lease financing capacity.

The Company's lease financing arrangement under its 2000 Credit Facility is a "synthetic lease". A synthetic lease is a form of lease financing that qualifies for operating lease accounting treatment and, when all criteria pursuant to generally accepted accounting principles (GAAP) are met, is kept "off-balance sheet". Under such a structure, the owner/lessor of the properties ("Synthetic Lease Investor") could be considered a virtual SPE when it obtains debt and equity capital to finance the project(s) and leases the projects to a company. This financial structure was used to finance the construction of the New Morgan Academy completed in the first quarter of 2001, the acquisition of the Taylor Street Center building in early 1999, and the construction-to-date of the Moshannon Valley Correctional Center which is still in process. The synthetic lease used to finance the above projects was originally entered into in December 1998 and was amended in July 2000 whereby the available financing was increased from \$40 million to \$100 million and the lease term extended to July 2005.

Under current accounting rules, the Synthetic Lease Investor in a virtual SPE must maintain at least a 3% equity ownership interest in the property throughout the life of the lease. The Company's synthetic lease documents, as amended in July 2000, provide for the equity investor to fund 3.5% of project costs. There are provisions in the lease and related credit documents for the lenders and Synthetic Lease Investor to fund and be paid interest, yield and fees. Under current GAAP rules, the payment of any yield and fees to the investors is required to be treated as a return of capital rather than a return on capital.

The Synthetic Lease Investor for the above projects received certain customary payments to assist as co-arranger in the structure of the initial \$40 million synthetic lease facility in 1998 and in July 2000 when the synthetic lease facility was increased to \$100 million. Although the Company does not believe the lessor is a special purpose entity, the lessor could be considered as a "virtual" special purpose entity under certain accounting interpretations. Therefore, these payments could be interpreted to reduce the Synthetic Lease Investor's equity ownership in the leased projects below the required 3% level as of the second quarter of 2000. If that were the case, these synthetic leases would no longer qualify for off-balance sheet treatment beginning in the second quarter of 2000. Accordingly, the assets and liabilities and results of operations of the synthetic lease owned by the Synthetic Lease Investor are consolidated in the Company's financial statements beginning in the second quarter of 2000. See "Recent Developments."

As a result of consolidating the synthetic lease assets and liabilities, the Company's accompanying consolidated financial statements reflect the depreciation expense on the associated properties and interest expense related to the Synthetic Lease Investor's debt, instead of rent expense.

The Synthetic Lease Investor's Note A and Note B have total credit commitments of \$81.4 million and \$15.1 million, respectively. The Synthetic Lease Investor's Notes A and B are cross collateralized with the Company's revolving line of credit and contain cross default provisions.

On August 14, 2001, the Company repaid the \$50.0 million of outstanding 7.74% Senior Secured Notes with a portion of the proceeds from the 2001 Sale and Leaseback Transaction.

Extraordinary Charges. In August 2001, the Company used a portion of the net proceeds from the 2001 Sale and Leaseback Transaction to retire \$50.0 million of outstanding 7.74% Senior Secured Notes which had a maturity date of July 15, 2010. As a result, the Company recognized an extraordinary charge of \$479,000 (net of related income taxes of \$333,000) in the third quarter of 2001 due to the write-off of unamortized deferred debt issuance costs related to the Senior Secured Notes.

In December 2001, the Company repaid the \$39.4 million outstanding on its Subordinated Notes which had a maturity date of July 21, 2007. As a result, the Company recognized an extraordinary charge of \$2.5 million (net of related income taxes of \$1.7 million) in the fourth quarter of 2001 comprised of the write-offs of unamortized deferred debt issuance costs and debt discount and assessed contractual prepayment fees.

New Facilities and Project Under Development. The New Morgan Academy was completed and became operational in two phases during the fourth quarter of 2000 and the first quarter of 2001.

In April 1999, the Company was awarded a contract to design, build and operate a 1,095 bed prison for the FBOP in Moshannon Valley, Pennsylvania (the "Moshannon Valley Correctional Center"). Construction and activation activities commenced immediately. In June 1999, the FBOP issued a Stop-Work Order pending a re-evaluation of their environmental documentation supporting the decision to award the contract. The environmental study was completed with a finding of no significant impact and the Stop-Work Order was lifted by the FBOP on August 9, 2001.

In September 1999, the Company received correspondence from the Office of the Attorney General of the Commonwealth of Pennsylvania indicating its belief that the operation of a private prison in Pennsylvania is unlawful. The Company and the FBOP have had, and continue to have, discussions with the Attorney General's staff regarding these and related issues. Management anticipates that these discussions will be resolved in the near-term. As of December 31, 2001, the Company had incurred approximately \$14.9 million for construction and land development costs and capitalized interest for the Moshannon Valley Correctional Center. According to the FBOP contract, as amended, the Company must complete the construction of the project by April 15, 2002. The Company will not be able to complete construction within that time frame. While the FBOP has not asserted any default or made any claim, if the Company is not able to negotiate a contract amendment with the FBOP, then the FBOP may have the right to assert that the Company has not completed construction of the project within the time frames provided in the FBOP contract, as amended. In the event that the FBOP desires to continue with the Moshannon Valley Correctional Center, management expects that the contract will be amended to address cost and construction timing matters resulting from the extended delay. In the event that the FBOP decides not to continue with the Moshannon project and terminates the contract, management believes that the Company has the right to recover its invested costs. In the event any portion of these costs are determined not to be reimbursed upon contract termination, such costs would be expensed.

At December 31, 2001, accounts receivable include costs totaling \$1.4 million for direct costs incurred by the Company since the issuance of the Stop-Work Order in June 1999 for payroll and other operating costs related to the Moshannon Valley Correctional Center. These costs were incurred with the understanding that such costs would be reimbursed. Although no formal written agreement exists, management believes that these costs will be reimbursed by the FBOP in the near term. In the event any portion of these costs are not reimbursed, such costs will be expensed if they are determined not to be reimbursable.

Development and construction costs for the New Morgan Academy and the Moshannon Valley Correctional Center have been financed with the Company's synthetic lease financing arrangement discussed under "Long-Term Credit Facilities".

Capital Expenditures. Capital expenditures for the year ended December 31, 2001 were \$14.2 million and related primarily to (1) a 150 bed expansion at the Big Spring Complex, (2) construction costs for the New Morgan Academy and the Moshannon Valley Correctional Center, (3) the purchase and renovation of a building and related furniture and equipment purchases for an expansion at ACAF, (4) purchases of furniture and equipment for the New Morgan Academy and (5) various facility improvements and furniture and equipment purchases.

Future Liquidity. Management believes that the Company's existing cash and cash equivalents and cash flows generated from operations, together with the revolving credit available under the 2000 Credit Facility and the lease financing capacity thereunder, will provide sufficient liquidity to meet the Company's committed capital and working capital requirements for currently awarded and certain potential future contracts. To the extent the Company's cash and current financing arrangements do not provide sufficient financing to fund construction costs related to future adult secure institutional contract awards or significant facility expansions, the Company anticipates obtaining additional sources of financing to fund such activities. However, there can be no assurance that such financing will be available, or will be available on terms favorable to the Company.

Contractual Obligations and Commercial Commitments. The Company has assumed various financial obligations and commitments in the ordinary course of conducting its business. The Company has contractual obligations requiring future cash payments under its existing contractual arrangements, such as management, consultative and non-competition agreements.

The Company maintains operating leases in the ordinary course of its business activities. These leases include those for operating facilities, office space and office and operating equipment, and the terms of the agreements vary from 2002 until 2075. As of December 31, 2001, the Company's total commitment under operating leases were approximately \$38.2 million.

The following table details the Company's known future cash payments (on an undiscounted basis) related to various contractual obligations as of December 31, 2001 (in thousands):

	<u>Payments Due by Period</u>				
	<u>Total</u>	<u>2002</u>	<u>2003 - 2004</u>	<u>2005 - 2006</u>	<u>Thereafter</u>
Contractual Obligations:					
Long-term debt	\$ 245,568	\$ 6,800	\$ 15,900	\$ 66,868	\$ 156,000
Capital lease obligations.....	85	85	--	--	--
Operating leases.....	38,183	8,745	8,528	2,601	18,309
Consultative and non-competition agreements.....	<u>1,876</u>	<u>455</u>	<u>796</u>	<u>625</u>	<u>--</u>
Total contractual cash obligations	<u>\$ 285,712</u>	<u>\$ 16,085</u>	<u>\$ 25,224</u>	<u>\$ 70,094</u>	<u>\$ 174,309</u>

The Company enters into letters of credit in the ordinary course of operating and financing activities. As of December 31, 2001, the Company had outstanding letters of credit of \$1.2 million related to insurance and other operating activities. The following table details the Company's letter of credit commitments as of December 31, 2001 (in thousands):

	<u>Total Amounts Committed</u>	<u>Amount of Commitment Expiration Per Period</u>			
		<u>Less than 1 Year</u>	<u>1-3 Years</u>	<u>4-5 Years</u>	<u>Over 5 Years</u>
Commercial Commitments:					
Standby letters of credit.....	\$ 1,228	\$ 58	\$ 1,170	\$ --	\$ --

CRITICAL ACCOUNTING POLICIES AND ESTIMATES

The discussion and analysis of financial condition and results of operations are based upon consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these financial statements require that management make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosure of contingent assets and liabilities. The Company evaluates its estimates on an on-going basis, based on historical experience and on various other assumptions that are believed to be reasonable under the circumstances. Actual results may differ from these estimates under different assumptions or conditions.

The Company believes the following critical accounting policies affect its more significant adjustments and estimates used in the preparation of its consolidated financial statements.

The Company extends credit to the government agencies contracted with other parties in the normal course of business. Further, the Company regularly reviews outstanding receivables, and provides estimated losses through an allowance for doubtful accounts. In evaluating the level of established reserves, the Company makes judgments regarding its customers' ability to make required payments, economic events and other factors. As the financial condition of these parties change, circumstances develop or additional information becomes available, adjustments to the allowance for doubtful accounts may be required.

Deferred tax assets and liabilities are recognized for the difference between the book basis and tax basis of its net assets. In providing for deferred taxes, the Company considers current tax regulations, estimates of future taxable income and available tax planning strategies. If tax regulations, operating results or the ability to implement tax planning strategies vary, adjustments to the carrying value of deferred tax assets and liabilities may be required.

The Company maintains coverage for various aspects of our business and operations. The Company retains a portion of losses that occur through the use of deductibles and retention under self-insurance programs. The Company regularly reviews the estimates of reported and unreported claims and provides for losses through insurance reserves. As claims develop and additional information becomes available, adjustments to loss reserves may be required.

INFLATION

Other than personnel and offender medical costs at certain facilities during 2001, management believes that inflation has not had a material effect on the Company's results of operations during the past three years. Most of the Company's facility management contracts provide for payments to the Company of either fixed per diem fees or per diem fees that increase by only small amounts during the term of the contracts. Inflation could substantially increase the Company's personnel costs (the largest component of operating expenses) or other operating expenses at rates faster than any increases in contract revenues.

RISK FACTORS AND CAUTIONARY STATEMENT FOR PURPOSES OF THE "SAFE HARBOR" PROVISIONS OF THE PRIVATE SECURITIES LITIGATION REFORM ACT OF 1995

This report contains or incorporates by reference forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. These statements are based on current plans and expectations of management and involve risks and uncertainties that could cause actual future activities and results of operations to be materially different from those set forth in the forward-looking statements. Important factors that could cause actual results to differ include, among others, (1) risks associated with acquisitions and the integration thereof (including the ability to achieve administrative and operating cost savings and anticipated synergies), (2) the timing and costs of expansions of existing facilities, (3) changes in governmental policy to eliminate or discourage the privatization of correctional, detention and pre-release services in the United States, (4) availability of debt and equity financing on terms that are favorable to the Company, (5) fluctuations in operating results because of occupancy, competition (including competition from two competitors that are substantially larger than the Company), increases in cost of operations, fluctuations in interest rates and risks of operations and (6) significant charges to operating expense of deferred costs associated with financing and other projects in development if management determines that one or more of such projects is unlikely to be successfully concluded.

Where any forward-looking statement includes a statement of the assumptions or bases underlying the forward-looking statement, the Company cautions that, while it believes these assumptions or bases to be reasonable and in good faith, assumed facts or bases almost always vary from the actual results, and differences between assumed facts or bases and actual results can be material, depending upon the circumstances. Where, in any forward-looking statement, the Company or its management express an expectation or belief as to future results, that expectation or belief is expressed in good faith and is believed to have a reasonable basis. The Company cannot assure you, however, that the statement of expectation or belief will result or be achieved or accomplished. The words "believe," "expect," "estimate," "anticipate" and similar expressions will generally identify forward-looking statements. All of the Company's forward-looking statements, whether written or oral, are expressly qualified by these cautionary statements and any other cautionary statements that may accompany such forward-looking statements. In addition, the Company disclaims any obligation to update any forward-looking statements to reflect events or circumstances after the date of this report.

REPORT OF INDEPENDENT PUBLIC ACCOUNTANTS

*To the Board of Directors of
Cornell Companies, Inc.:*

We have audited the accompanying consolidated balance sheets of Cornell Companies, Inc. and subsidiaries as of December 31, 2001 and 2000 (as restated, see Notes 2 and 13), and the related consolidated statements of operations, stockholders' equity and cash flows for each of the three years in the period ended December 31, 2001. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

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

ARTHUR ANDERSEN LLP

A handwritten signature in black ink that reads "Arthur Andersen LLP". The signature is written in a cursive, flowing style.

Houston, Texas
April 16, 2002

CORNELL COMPANIES, INC.
CONSOLIDATED BALANCE SHEETS
(in thousands, except share data)

	<u>December 31,</u>	
	<u>2001</u>	<u>2000</u>
		(restated)
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	\$ 56,794	\$ 620
Accounts receivable (net of allowance for doubtful accounts of \$3,068 and \$2,578, respectively)	63,291	55,262
Restricted assets	12,376	2,011
Deferred tax assets	493	667
Prepays and other	<u>5,679</u>	<u>4,363</u>
Total current assets	138,633	62,923
PROPERTY AND EQUIPMENT, net	253,243	246,191
OTHER ASSETS:		
Debt service reserve fund	23,800	--
Intangible assets, net	15,456	16,861
Deferred costs and other	<u>13,675</u>	<u>10,875</u>
Total assets	<u>\$ 444,807</u>	<u>\$ 336,850</u>
LIABILITIES AND STOCKHOLDERS' EQUITY		
CURRENT LIABILITIES:		
Accounts payable and accrued liabilities	\$ 33,934	\$ 33,179
Current portion of long-term debt	<u>6,885</u>	<u>41</u>
Total current liabilities	40,819	33,220
LONG-TERM DEBT, net of current portion	238,768	191,722
DEFERRED TAX LIABILITIES	4,106	643
OTHER LONG-TERM LIABILITIES	7,970	6,330
MINORITY INTEREST IN CONSOLIDATED SPECIAL PURPOSE ENTITIES	40	615
COMMITMENTS AND CONTINGENCIES		
STOCKHOLDERS' EQUITY:		
Preferred stock, \$.001 par value, 10,000,000 shares authorized, none issued	--	--
Common stock, \$.001 par value, 30,000,000 shares authorized, 14,005,482 and 10,161,113 shares issued and outstanding, respectively	14	10
Additional paid-in capital	138,978	91,625
Retained earnings	23,886	19,227
Treasury stock (1,109,816 and 955,500 shares at cost, respectively)	(8,090)	(5,933)
Deferred compensation	(1,033)	--
Notes from shareholders	<u>(651)</u>	<u>(609)</u>
Total stockholders' equity	<u>153,104</u>	<u>104,320</u>
Total liabilities and stockholders' equity	<u>\$ 444,807</u>	<u>\$ 336,850</u>

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

CORNELL COMPANIES, INC.
CONSOLIDATED STATEMENTS OF OPERATIONS
(in thousands, except per share data)

	<u>Year Ended December 31,</u>		
	<u>2001</u>	<u>2000</u> (restated)	<u>1999</u>
Revenues	\$ 265,250	\$ 226,050	\$ 176,967
Operating Expenses.....	205,805	174,612	135,850
Pre-Opening and Start-Up Expenses.....	3,858	2,298	2,929
Depreciation and Amortization	9,278	7,463	6,007
General and Administrative Expenses.....	<u>15,291</u>	<u>12,024</u>	<u>9,932</u>
Income from Operations	31,018	29,653	22,249
Interest Expense	21,787	16,492	8,522
Interest Income	(888)	(100)	(117)
Minority Interest in Losses of Consolidated Special Purpose Entities	<u>(1,674)</u>	<u>(246)</u>	<u>--</u>
Income before Income Taxes, Extraordinary Charges and Cumulative Effect of Change in Accounting Principle.....	11,793	13,507	13,844
Provision for Income Taxes	<u>4,958</u>	<u>5,538</u>	<u>5,538</u>
Income before Extraordinary Charges and Cumulative Effect of Change in Accounting Principle	6,835	7,969	8,306
Extraordinary Charges for Early Retirement of Debt, Net of Related Income Tax Benefit of \$2.0 Million in 2001	(2,946)	--	--
Cumulative Effect of Change in Accounting Principle, Net of Related Income Tax Provision of \$535 in 2001 and Benefit of \$1,969 in 1999	<u>770</u>	<u>--</u>	<u>(2,954)</u>
Net Income	<u>\$ 4,659</u>	<u>\$ 7,969</u>	<u>\$ 5,352</u>
Earnings Per Share:			
Basic			
Income before extraordinary charges and cumulative effect of change in accounting principle.....	\$.71	\$.85	\$.88
Extraordinary charges	(.31)	--	--
Cumulative effect of change in accounting principle.....	<u>.08</u>	<u>--</u>	<u>(.31)</u>
Net income.....	<u>\$.48</u>	<u>\$.85</u>	<u>\$.57</u>
Diluted			
Income before extraordinary charges and cumulative effect of change in accounting principle.....	\$.68	\$.84	\$.86
Extraordinary charges	(.29)	--	--
Cumulative effect of change in accounting principle.....	<u>.07</u>	<u>--</u>	<u>(.31)</u>
Net income.....	<u>\$.46</u>	<u>\$.84</u>	<u>\$.55</u>
Number of Shares Used in Per Share Computation:			
Basic	9,616	9,383	9,432
Diluted	10,069	9,495	9,660

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

CORNELL COMPANIES, INC.
CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY
(in thousands, except share data)

	<u>Common Stock</u>		<u>Additional</u>	<u>Retained</u>	<u>Treasury</u>	<u>Deferred</u>	<u>Notes</u>
	<u>Shares</u>	<u>Par</u>	<u>Paid-In</u>	<u>Earnings</u>	<u>Stock</u>	<u>Compensation</u>	<u>from</u>
		<u>Value</u>	<u>Capital</u>				<u>Shareholders</u>
Balances at December 31, 1998.....	10,105,916	\$ 10	\$ 90,038	\$ 5,906	\$ (3,999)	\$ --	\$ (455)
Exercise of Stock Options.....	31,612	--	217	--	--	--	-
Income Tax Benefits from Stock							
Options Exercised	--	--	139	--	--	--	--
Net Income	<u>--</u>	<u>--</u>	<u>--</u>	<u>5,352</u>	<u>--</u>	<u>--</u>	<u>--</u>
Balances at December 31, 1999	10,137,528	10	90,394	11,258	(3,999)	--	(455)
Exercise of Stock Options.....	10,000	--	24	--	--	--	--
Income Tax Benefits from Stock							
Options Exercised	--	--	15	--	--	--	--
Purchase of Treasury Stock							
(258,400 Shares at Cost)	--	--	--	--	(1,934)	--	--
Issuance of Common Stock to							
Employee Stock Purchase Plan	13,585	--	97	--	--	--	--
Issuance of Stock Warrants	--	--	1,095	--	--	--	--
Accrued Interest on Notes from							
Shareholders	--	--	--	--	--	--	(154)
Net Income	<u>--</u>	<u>--</u>	<u>--</u>	<u>7,969</u>	<u>--</u>	<u>--</u>	<u>--</u>
Balances at December 31, 2000	10,161,113	10	91,625	19,227	(5,933)	--	(609)
Exercise of Stock Options.....	156,923	--	886	--	--	--	--
Income Tax Benefits from Stock							
Options Exercised	--	--	619	--	--	--	--
Deferred Compensation	--	--	1,088	--	--	(1,088)	--
Amortization of Deferred							
Compensation	--	--	--	--	--	55	--
Purchase of Treasury Stock							
(154,316 Shares at Cost)	--	--	--	--	(2,157)	--	--
Issuance of Common Stock							
In Public Offering	3,450,000	4	43,818	--	--	--	--
Issuance of Common Stock to							
Employee Stock Purchase Plan	46,767	--	214	--	--	--	--
Issuance of Common Stock Under							
2000 Director's Stock Plan.....	22,387	--	125	--	--	--	--
Exercise of Stock Warrants	168,292	--	603	--	--	--	--
Accrued Interest on Notes from							
Shareholders	--	--	--	--	--	--	(42)
Net Income	<u>--</u>	<u>--</u>	<u>--</u>	<u>4,659</u>	<u>--</u>	<u>--</u>	<u>--</u>
Balances at December 31, 2001	<u>14,005,482</u>	<u>\$ 14</u>	<u>\$138,978</u>	<u>\$23,886</u>	<u>\$ (8,090)</u>	<u>\$ (1,033)</u>	<u>\$ (651)</u>

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

CORNELL COMPANIES, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS
(in thousands)

	<u>Year Ended December 31,</u>		
	<u>2001</u>	<u>2000</u>	<u>1999</u>
		(restated)	
CASH FLOWS FROM OPERATING ACTIVITIES:			
Net income	\$ 4,659	\$ 7,969	\$ 5,352
Adjustments to reconcile net income to net cash provided by (used in) operating activities:			
Extraordinary charges	2,946	--	--
Cumulative effect of change in accounting principle	(770)	--	2,954
Depreciation	5,535	4,366	4,601
Amortization	3,743	3,097	1,406
Amortization of deferred compensation	55	--	--
Non-cash interest expense	2,012	1,332	511
Provision for bad debts	1,339	2,416	1,025
(Gain) loss on sale of property and equipment	39	13	(305)
Deferred income taxes	3,637	2,125	(1,741)
Change in assets and liabilities, net of effects from acquisitions:			
Accounts receivable	(9,368)	(9,740)	(21,553)
Restricted assets	(10,365)	328	(319)
Other assets	(4,407)	(5,442)	(1,340)
Accounts payable and accrued liabilities	770	5,023	10,006
Other liabilities	(2,360)	(1,561)	(1,478)
Net cash provided by (used in) operating activities	<u>(2,535)</u>	<u>9,926</u>	<u>(881)</u>
CASH FLOWS FROM INVESTING ACTIVITIES:			
Proceeds from sales of property and equipment	98	719	19,278
Capital expenditures	(14,168)	(56,792)	(29,067)
Acquisition of businesses, less cash acquired	--	--	(31,786)
Debt service reserve fund	(23,800)	--	--
Minority interest of consolidated special purpose entities	925	615	--
Net cash used in investing activities	<u>(36,945)</u>	<u>(55,458)</u>	<u>(41,575)</u>
CASH FLOWS FROM FINANCING ACTIVITIES:			
Proceeds from notes payable	--	--	69,335
Payments on note payable	--	(40,000)	(29,335)
Proceeds from long-term debt	273,774	199,796	53,194
Payments on long-term debt and capital lease obligations	(220,435)	(108,510)	(50,174)
Payments for debt issuance costs	(450)	(5,084)	(1,676)
Proceeds from issuances of common stock	43,822	97	--
Proceeds from exercise of stock options and warrants	1,100	24	356
Purchases of treasury stock	(2,157)	(1,934)	--
Net cash provided by financing activities	<u>95,654</u>	<u>44,389</u>	<u>41,700</u>
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	56,174	(1,143)	(756)
CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD	620	1,763	2,519
CASH AND CASH EQUIVALENTS AT END OF PERIOD	<u>\$ 56,794</u>	<u>\$ 620</u>	<u>\$ 1,763</u>
SUPPLEMENTAL CASH FLOW DISCLOSURE:			
Interest paid, net of amounts capitalized	<u>\$ 15,728</u>	<u>\$ 16,318</u>	<u>\$ 7,956</u>
Income taxes paid	<u>\$ 516</u>	<u>\$ 8,619</u>	<u>\$ 3,964</u>

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

CORNELL COMPANIES, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. DESCRIPTION OF THE BUSINESS

Cornell Companies, Inc. (collectively with its subsidiaries and consolidated special purpose entities, the "Company"), a Delaware corporation, provides to governmental agencies the integrated development, design, construction and management of facilities within three operating divisions: (1) adult secure institutional, correctional and detention services, (2) juvenile treatment, educational and detention services and (3) pre-release correctional and treatment services.

2. RESTATEMENT OF FINANCIAL STATEMENTS

The Company's lease financing arrangement under its 2000 Credit Facility is a "synthetic lease". A synthetic lease is a form of lease financing that qualifies for operating lease accounting treatment and, when all criteria pursuant to generally accepted accounting principles (GAAP) are met, is kept "off-balance sheet". Under such a structure, the owner/lessor of the properties ("Synthetic Lease Investor") could be considered as a virtual special purpose entity when it obtains debt and equity capital to finance the acquisition or construction of project(s) and leases the projects to a company. This financial structure was used to finance the construction of the New Morgan Academy completed in the first quarter of 2001, the acquisition of the Taylor Street Center building in early 1999, and the construction-to-date of the Moshannon Valley Correctional Center. The synthetic lease used to finance the above projects was executed in December 1998 and was amended in July 2000 whereby the available financing was increased from \$40 million to \$100 million and the lease term extended to July 2005.

Under current accounting rules, a Synthetic Lease Investor in a synthetic lease treated as a special purpose entity must maintain at least a 3% equity ownership interest in the property throughout the life of the lease. The Company's synthetic lease documents, as amended in July 2000, provide for the equity investor to fund 3.5% of project costs. There are provisions in the lease and related credit documents for the lenders and Synthetic Lease Investor to fund and be paid interest, yield and fees. Under current GAAP rules, the payment of any yield and fees to the investors is required to be treated as a return of capital rather than a return on capital.

The Synthetic Lease Investor for the above projects received certain customary payments to assist as co-arranger in the structure of the initial \$40 million synthetic lease facility in 1998 and in July 2000 when the synthetic lease facility was increased to \$100 million. Although the Company does not believe the lessor is a special purpose entity, the lessor is considered as a "virtual" special purpose entity under certain accounting interpretations. Therefore, these payments could be interpreted to reduce the Synthetic Lease Investor's equity ownership in the leased projects below the required 3% level as of the second quarter of 2000. If this were the case, these synthetic leases no longer qualified for off-balance sheet treatment beginning in the second quarter of 2000. Accordingly, the assets and liabilities and results of operations of the synthetic lease owned by the Synthetic Lease Investor are consolidated in the Company's financial statements. See Note 13.

As a result of consolidating the synthetic lease assets and liabilities, the Company's accompanying consolidated financial statements reflect, among other things, the depreciation expense on the associated properties and interest expense related to the Synthetic Lease Investor's debt, instead of rent expense.

associated properties and interest expense on the bond debt of MCF used to finance MCF's acquisition of the 11 facilities in the 2001 Sale and Leaseback Transaction. For income tax purposes, the Company recognizes rent expense pursuant to the terms of its lease with MCF and does not consolidate the assets, liabilities or results of operations of MCF.

All applicable amounts relating to the aforementioned restatements have been reflected in the consolidated financial statements and notes thereto. See Note 14 for a summary of the restated selected quarterly financial data.

3. SIGNIFICANT ACCOUNTING POLICIES

Consolidation

The accompanying consolidated financial statements include the accounts of the Company, its wholly-owned subsidiaries, and interests in partnerships which are special purpose entities or may be "virtual" special purpose entities for which the Company owns no partnership interest, but for financial reporting purposes only, has consolidated such special purpose entities as discussed in Note 2. All significant intercompany balances and transactions have been eliminated. Minority interest in consolidated special purpose entities represents third party equity contributed to the special purpose entities. Minority interest is adjusted for income and losses allocable to the owners of the special purpose entities. Should the cumulative losses of the special purpose entity exceed the equity which is recorded as minority interest by the Company, the excess losses are recorded in the Company's Statement of Operations.

Cash and Cash Equivalents

The Company considers all highly liquid unrestricted investments with original maturities of three months or less to be cash equivalents. The Company invests its available cash balances in short term money market accounts and commercial paper.

Accounts Receivable

The Company increased its allowance for doubtful accounts during the years ended December 31, 2001, 2000 and 1999 by \$1.3 million, \$2.4 million and \$1.0 million, respectively. Write-offs totaling \$0.9 million, \$2.8 million and \$1.2 million were charged against the allowance during the periods ended December 31, 2001, 2000 and 1999, respectively.

At December 31, 2001, accounts receivable include costs totaling \$1.4 million for direct costs incurred by the Company since the issuance of a Stop-Work Order by the Federal Bureau of Prisons ("FBOP") in June 1999 for payroll and other operating costs related to the Moshannon Valley Correctional Center. These costs were incurred at the direction of the FBOP with the understanding that such costs would be reimbursed. Although no formal written agreement exists, management believes that these costs will be reimbursed by the FBOP. In the event any portion of these costs are not reimbursed by the FBOP, such costs will be expensed if they are determined not to be reimbursable.

Restricted Assets

Included in restricted assets at December 31, 2001 was approximately \$10.2 million of MCF's restricted cash accounts. MCF's restricted accounts are comprised principally of a debt service fund used to segregate rental payment funds from the Company to MCF for MCF's semi-annual debt service. MCF's funds are invested in short term certificates of deposit, money market accounts and commercial paper.

For certain facilities, the Company maintains bank accounts for restricted cash belonging to offenders or residents, commissary operations, an equipment replacement fund used in state programs and a restoration fund for certain

facilities. These bank accounts and commissary inventories are collectively referred to as restricted assets and the corresponding obligations are included in accrued liabilities in the accompanying financial statements.

Change in Accounting for Supplies Inventory

In fiscal year 2001, management changed its method of accounting for supplies whereby the Company capitalizes durable operating supplies' purchases such as uniforms, linens and books and amortizes these costs to operating expense over an estimated period of benefit of 18 months. Management believes this new treatment more accurately matches expenses and revenue. Effective January 1, 2001, the Company capitalized a portion of previously expensed supplies and recognized a benefit in the consolidated statements of operations of approximately \$770,000 (net of related income taxes of \$535,000) for a cumulative effect of a change in accounting principle. For the year ended December 31, 2000, the pro forma impact of this change in accounting would have been immaterial.

Property and Equipment

Property and equipment are recorded at cost. Ordinary maintenance and repair costs are expensed, while renewal and betterment costs are capitalized. Prepaid facility use cost, which resulted from the July 1996 acquisition of the Big Spring Complex and the December 1999 transfer of ownership of the Great Plains Correctional Facility to a leasehold interest, is being amortized over 50 years using the straight-line method. Buildings and improvements are depreciated over their estimated useful lives of 30 to 50 years using the straight-line method. Furniture and equipment are depreciated over their estimated useful lives of 3 to 10 years using the straight-line method. Amortization of leasehold improvements is recorded using the straight-line method based upon the shorter of the life of the asset or the term of the respective lease.

Capitalized Interest

The Company capitalizes interest on facilities while under development and construction. Interest capitalized for the years ended December 31, 2001, 2000 and 1999 was \$1.3 million, \$2.0 million and \$1.2 million, respectively.

Debt Service Reserve Fund

The debt service reserve fund was established at the closing of MCF's bond issuance and is to be used solely for MCF's debt service to the extent that funds in MCF's debt services are insufficient. The debt service reserve fund is invested in short term commercial instruments and earns a guaranteed rate of return of 3.0%. See Note 11.

Intangible Assets

Goodwill represents the excess of the cost of acquired businesses over the fair value of the net tangible and identified intangible assets. Goodwill is amortized using the straight-line method over 20 years, which represents management's estimation of the related benefit to be derived from the acquired businesses. The carrying value of goodwill is reviewed periodically if events and circumstances suggest that it may be permanently impaired. If the review indicates that goodwill will not be recoverable, as determined by the undiscounted cash flow method, the asset will be reduced to its estimated recoverable value. Accumulated amortization of goodwill was \$3.6 million and \$2.9 million as of December 31, 2001 and 2000, respectively.

Non-compete agreements have been obtained primarily through acquisitions of businesses and are amortized over periods of 9 to 10 years using the straight-line method. Accumulated amortization of non-compete agreements was \$2.0 million and \$1.2 million at December 31, 2001 and 2000, respectively.

Intangible assets were as follows (in thousands):

	<u>December 31,</u>	
	<u>2001</u>	<u>2000</u>
Goodwill	\$ 12,913	\$ 12,913
Non-compete agreements	<u>8,180</u>	<u>8,060</u>
	21,093	20,973
Accumulated amortization	<u>(5,637)</u>	<u>(4,112)</u>
	<u>\$ 15,456</u>	<u>\$ 16,861</u>

In June 2001, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards ("SFAS") No. 141, "Business Combinations" and SFAS No. 142, "Goodwill and Other Intangible Assets", effective for fiscal years beginning after December 15, 2001. The new rules require that the purchase method of accounting be used for all business combinations initiated after June 30, 2001 and also specifies the criteria for the recognition of intangible assets separately from goodwill. Under the new rules, goodwill will no longer be amortized but will be subject to an impairment test at least annually. During the years ended December 31, 2001, 2000 and 1999, goodwill amortization was \$646,000, \$650,000 and \$566,000, respectively. Other intangible assets that meet the new criteria will continue to be amortized over their useful lives. The Company will apply the new rules on accounting for goodwill and other intangible assets on January 1, 2002. Other than goodwill no longer being amortized, management estimates the adoption of SFAS No. 141 will have no impact on the Company at transition.

Based upon preliminary calculations, management estimates that the adoption of SFAS No. 142 will result in a cumulative effect of change in accounting principle charge of up to approximately \$1.0 million (unaudited), net of tax, on January 1, 2002.

Deferred Costs

In April 1998, the American Institute of Certified Public Accountants issued SOP 98-5, "Reporting on the Costs of Start-Up Activities," which requires entities to expense start-up costs as incurred and to expense previously capitalized start-up costs as a cumulative effect of a change in accounting principle in the year adopted. In January 1999, the Company adopted SOP 98-5 and recorded a net of tax charge of \$3.0 million for the cumulative effect of a change in accounting principle.

Costs incurred related to obtaining debt financing are capitalized and amortized over the term of the related indebtedness. At December 31, 2001, the Company and its consolidated special purpose entities had net deferred debt issuance costs of approximately \$9.4 million.

Realization of Long-Lived Assets

SFAS No. 121, "Accounting for the Impairment of Long-Lived Assets and Long-Lived Assets to be Disposed Of," requires that long-lived assets be probable of future recovery in their respective carrying amounts as of each balance sheet date. Management of the Company believes its long-lived assets are realizable and that an impairment allowance is not necessary as of December 31, 2001 and 2000 pursuant to the provisions of SFAS No. 121.

In October 2001, the FASB issued SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets." SFAS No. 144 supersedes SFAS No. 121, "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of." For assets held and used in operations, SFAS No. 144 follows the framework

established in SFAS No. 121, which provides for the evaluation of impairment based on undiscounted cash flows. The Company's adoption of SFAS No. 144 on January 1, 2002 is not expected to have a material impact on the Company's financial position and results of operations.

Revenue Recognition

Substantially all revenues are derived from contracts with federal, state and local government agencies, which pay either per diem rates based upon the number of occupant days or hours served for the period, on a take-or-pay basis or cost-plus reimbursement. Revenues are recognized as services are provided.

In December 1999, the Securities and Exchange Commission ("SEC") issued Staff Accounting Bulletin No. 101, "Revenue Recognition" ("SAB No. 101"), which provides guidance on the recognition, presentation, and disclosure of revenue in financial statements filed with the SEC. SAB No. 101 outlines the basic criteria that must be met to recognize revenue and provides guidance for disclosure related to revenue recognition policies. Management believes its revenue recognition practices are in conformity with the guidelines prescribed in SAB No. 101.

Income Taxes

The Company utilizes the liability method of accounting for income taxes as required by SFAS No. 109, "Accounting for Income Taxes." Under this method, deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying values of existing assets and liabilities and their respective tax bases based on enacted tax rates.

Use of Estimates

The Company's financial statements are prepared in accordance with GAAP. Financial statements prepared in accordance with GAAP require the use of management estimates and assumptions that affect the reported amounts of assets and liabilities, and the disclosure of contingent assets and liabilities at the date of the financial statements. Additionally, management estimates affect the reported amounts of revenues and expenses in the reporting period. Actual results could differ from those estimates. The significant estimates made by management in the accompanying financial statements include the allowance for doubtful accounts and accruals for insurance and legal costs.

Business Concentration

Contracts with federal, state and local governmental agencies account for nearly all of the Company's revenues. The loss of, or a significant decrease in, business from one or more of these governmental agencies could have a material adverse effect on the Company's financial condition and results of operation. For the years ended December 31, 2001, 2000 and 1999, 21.0%, 18.5% and 19.8%, respectively, of the Company's consolidated revenues were derived from contracts with the FBOP.

Financial Instruments

The Company considers the fair value of all its financial instruments not to be materially different from their reported carrying values at the end of each year based on management's estimate of the Company's ability to borrow funds under terms and conditions similar to those of the Company's existing debt.

Accounting for Stock-Based Compensation

The Company accounts for its stock-based compensation plans under Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees." In accordance with SFAS No. 123, "Accounting for Stock-Based Compensation," certain pro forma disclosures are provided in Note 10 to the Consolidated Financial Statements. Accordingly, deferred compensation is recorded for stock-based compensation grants to employees based on the excess of the estimated fair value of the common stock on the measurement date over the exercise price. If the exercise price of the stock-based compensation grant is equal to the fair market value of the Company's stock on the date of grant, no compensation expense is recorded. The deferred compensation is amortized over the vesting period of each unit of stock-based compensation.

Earnings Per Share

Basic earnings per share ("EPS") is computed by dividing net income by the weighted average number of shares of common stock outstanding during the year. Diluted EPS reflects the potential dilution from the exercise or conversion of securities, such as stock options and warrants, into common stock.

Derivative Instruments

Derivative instruments are recognized in accordance with the provisions of SFAS Nos. 133 and 138, "Accounting for Derivative Instruments and Hedging Activities", as amended. The Company has only entered into derivative contracts that are classified as non-hedge derivatives. These non-hedge are recorded at their fair value with changes in fair value reported in current-period earnings.

4. ACQUISITIONS

In November 1999, the Company acquired certain of the adult and juvenile behavioral health and correctional assets of Interventions, a not-for-profit corporation headquartered in Chicago, Illinois, and BHS Consulting Corporation ("BHS"), a for-profit firm that provides management services to Interventions. The assets acquired included more than 30 programs provided throughout Illinois and the real properties of seven facilities. The aggregate purchase price for the transactions was approximately \$31.8 million including transaction costs. The Company financed the transaction with borrowings under a bridge loan. See Note 8 to the Consolidated Financial Statements.

The acquisition costs and the estimated fair market value of the aggregate assets acquired and liabilities assumed associated with the Interventions and BHS acquisitions were as follows (in thousands):

Cash paid	\$ 30,889
Transaction costs.....	<u>897</u>
Total purchase price.....	<u>\$ 31,786</u>
Net assets acquired:	
Prepays and other current assets	\$ 69
Property and equipment	23,883
Intangible assets	8,735
Accrued liabilities	<u>(901)</u>
	<u>\$ 31,786</u>

The Company's acquisitions have been accounted for as purchases; therefore, the accompanying statements of operations reflect the results of operations since the respective acquisition dates.

The unaudited consolidated results of operations on a pro forma basis as though the 1999 acquisitions had occurred as of the beginning of the Company's fiscal year 1999 were as follows (in thousands, except per share data):

Total revenues	\$ 195,945
Net income	3,237
Net earnings per share	
- Basic.....	\$.34
- Diluted.....	\$.34

5. PROPERTY AND EQUIPMENT

Property and equipment were as follows (in thousands):

	<u>December 31,</u>	
	<u>2001</u>	<u>2000</u> (restated)
Land.....	\$ 24,999	\$ 24,999
Prepaid facility use.....	68,237	68,237
Buildings and improvements.....	154,057	137,173
Furniture and equipment	12,945	7,129
Construction in progress	<u>15,681</u>	<u>23,576</u>
	275,919	261,114
Accumulated depreciation and amortization	<u>(22,676)</u>	<u>(14,923)</u>
	<u>\$ 253,243</u>	<u>\$ 246,191</u>

Construction in progress at December 31, 2001 and 2000, consisted primarily of construction costs attributable to the Moshannon Valley Correctional Center. Construction in progress at December 31, 2000 included a portion of costs for the New Morgan Academy that was partially completed.

The Company utilizes an unrelated privately owned construction company ("Construction Contractor") as its preferred contractor for construction projects. The Construction Contractor has received contracts to construct facilities, which the Company owns and/or operates, totaling approximately \$0 million, \$3.5 million and \$68.5 million during the years ended December 31, 2001, 2000 and 1999, respectively. Management believes the Company is a substantial customer of the Construction Contractor. During the fourth quarter of 2000, the Company entered into a license agreement with this construction contractor that conveyed certain rights to the design of an adult secure institution. A non-recurring license agreement payment of \$950,000 was recognized as revenue by the Company. The Company has not licensed such designs in prior years and does not expect to generate significant revenues from such activity in future periods. During the year ended December 31, 1999, this Construction Contractor paid the Company \$1.0 million related to a cost-sharing agreement in connection with the operations of the Santa Fe County Adult Detention Facility because the operating margins had not reached certain levels until June 1999. These cost-sharing payments were reported by the Company as a reduction of operating expenses. The Construction Contractor has no obligation to make any further cost-sharing payments.

6. ACCOUNTS PAYABLE AND ACCRUED LIABILITIES

Accounts payable and accrued liabilities consisted of the following (in thousands):

	December 31,	
	<u>2001</u>	<u>2000</u> (restated)
Accounts payable	\$ 12,317	\$ 16,557
Accrued compensation expense	7,281	6,701
Accrued interest payable	6,366	2,484
Accrued insurance	2,532	2,036
Resident funds	2,370	1,525
Other	<u>3,068</u>	<u>3,876</u>
	<u>\$ 33,934</u>	<u>\$ 33,179</u>

7. INCOME TAXES

The following is an analysis of the Company's deferred tax assets and liabilities (in thousands):

	December 31,	
	<u>2001</u>	<u>2000</u> (restated)
Deferred tax assets:		
Depreciation and amortization	\$ --	\$ 531
Accrued expenses	2,256	1,667
Deferred compensation	325	325
Other	<u>552</u>	<u>515</u>
	<u>3,133</u>	<u>3,038</u>
Deferred tax liabilities:		
Depreciation and amortization	1,089	--
Amortization of intangible assets	2,383	18
Prepaid facility use amortization	1,581	1,332
Prepaid expenses	459	422
Other	<u>1,234</u>	<u>1,242</u>
	<u>6,746</u>	<u>3,014</u>
Net deferred tax asset (liability)	<u>\$ (3,613)</u>	<u>\$ 24</u>

The components of the Company's income tax provision were as follows (in thousands):

	Year Ended December 31,		
	<u>2001</u>	<u>2000</u> (restated)	<u>1999</u>
Current provision	\$ 1,321	\$ 3,413	\$ 7,279
Deferred provision (benefit)	<u>3,637</u>	<u>2,125</u>	<u>(1,741)</u>
Income tax provision	<u>\$ 4,958</u>	<u>\$ 5,538</u>	<u>\$ 5,538</u>

The following is a reconciliation of taxes at the statutory federal income tax rate of 35% to the income tax provision recorded by the Company (in thousands):

	<u>Year Ended December 31,</u>		
	<u>2001</u>	<u>2000</u> (restated)	<u>1999</u>
Computed taxes at statutory rate.....	\$ 4,128	\$ 4,728	\$ 4,846
Amortization of non-deductible intangibles	119	129	119
State income taxes, net of federal benefit.....	562	460	369
Other	<u>149</u>	<u>221</u>	<u>204</u>
	<u>\$ 4,958</u>	<u>\$ 5,538</u>	<u>\$ 5,538</u>

8. CREDIT FACILITIES

The Company's long-term debt consisted of the following (in thousands):

	<u>December 31,</u>	
	<u>2001</u>	<u>2000</u> (restated)
Debt of Cornell Companies, Inc.:		
Revolving Line of Credit due July 2005 with an interest rate of prime plus 1.0% to 2.0%, or LIBOR plus 2.0% to 3.0%	\$ --	\$ 58,000
Senior Secured Notes due July 2010 with an interest rate of 7.74%	--	50,000
Subordinated Notes, net of discount, due July 2007 with an interest rate of 12.875%	--	38,890
Capital lease obligations	<u>85</u>	<u>77</u>
Subtotal	<u>85</u>	<u>146,967</u>
Debt of Special Purpose Entities:		
Synthetic Lease Investor Note A due July 2005 with an interest rate of LIBOR plus 3.25%	40,197	37,374
Synthetic Lease Investor Note B due July 2005 with an interest rate of LIBOR plus 3.50%	7,971	7,422
8.47% Bonds due 2016	<u>197,400</u>	<u>--</u>
Subtotal.....	<u>245,568</u>	<u>44,796</u>
Consolidated total debt.....	245,653	191,763
Less: current maturities	<u>(6,885)</u>	<u>(41)</u>
Consolidated long-term debt	<u>\$238,768</u>	<u>\$ 191,722</u>

On August 14, 2001, the Company repaid \$70.0 million outstanding under its revolving line of credit with a portion of the proceeds from the 2001 Sale and Leaseback Transaction. In connection with the repayment, the Company amended its 2000 Credit Facility, which now provides for borrowings of up to \$45.0 million under a revolving line of credit. The commitment amount is reduced by \$1.6 million quarterly beginning in July 2002. The amended 2000 Credit Facility matures in July 2005 and bears interest, at the election of the Company, at either the prime rate plus a margin of 2.0%, or a rate which is 3.0% above the applicable LIBOR rate. The amended 2000 Credit Facility is

secured by substantially all of the Company's assets, including the stock of all of the Company's subsidiaries; does not permit the payment of cash dividends; and requires the Company to comply with certain leverage, net worth and debt service coverage covenants. Due to the consolidation for financial reporting purposes of MCF as of August 14, 2001, the Company was not in compliance with certain leverage ratio covenants. On April 5, 2002, the 2000 Credit Facility was amended to waive such non-compliance and to revise the covenants to levels that accommodate the Company's consolidation of special purpose entities in its consolidated balance sheet and statement of operations. As a result of this waiver and amendment, the Company will recognize a pre-tax charge to interest expense of approximately \$800,000 during the first quarter of 2002 for lender fees and other professional fees. On April 11, 2002, the Company obtained a waiver from the lenders under the 2000 Credit Facility regarding the pending contractual default for the Moshannon Valley Correctional Center's construction delay.

As a result of the reduction of the revolving line of credit commitment, the Company recognized a charge of \$818,000 to interest expense representing a portion of the unamortized deferred debt issuance costs related to the 2000 Credit Facility.

Additionally, the amended 2000 Credit Facility provides the Company with the ability to enter into synthetic lease agreements for the acquisition or development of operating facilities. This synthetic lease financing arrangement provides for funding to the lessor under the operating leases of up to \$100.0 million, of which approximately \$49.9 million had been utilized as of December 31, 2001. The Company expects to utilize the remaining capacity under this synthetic lease financing arrangement to complete construction of the Moshannon Valley Correctional Center. The Synthetic Lease Investor's Note A and Note B have total credit commitments of \$81.4 million and \$15.1 million, respectively. The Company pays commitment fees at a rate of 0.5% annually for the unused portion of the synthetic lease financing capacity. The Synthetic Lease Investor's Notes A and B are cross collateralized with the Company's revolving line of credit and contain cross default provisions.

On August 14, 2001, MCF issued \$197.4 million of 8.47% taxable revenue bonds due August 1, 2016. Interest on the bonds is payable by MCF semiannually on February 1 and August 1, commencing February 1, 2002, and principal is payable by MCF in annual installments commencing August 1, 2002.

On August 14, 2001, the Company repaid the \$50.0 million of outstanding 7.74% Senior Secured Notes with a portion of the proceeds from the 2001 Sale and Leaseback Transaction. See Note 2 to the consolidated financial statements.

On November 30, 2001 the Company completed an offering of its common stock. Net proceeds to the Company from the sale of 3,450,000 newly issued shares was approximately \$43.8 million. The Company used a portion of the proceeds to repay outstanding borrowings of \$39.4 million and retired the notes under the Company's Note and Equity Purchase Agreements (the "Subordinated Notes") entered into in July 2000.

As a result of the early retirement of the Subordinated Notes, the Company recognized extraordinary charges of \$2.9 million, net of income tax of \$2.0 million due to the write-off of related unamortized deferred debt issuance costs and debt discount and assessed contractual prepayment fees.

Scheduled maturities of long-term debt were as follows (in thousands):

	Cornell Companies, Inc.	Synthetic Lease Investor	MCF	Consolidated
For the year ending December 31,				
2002	\$ 85	\$ --	\$ 6,800	\$ 6,885
2003	--	--	7,600	7,600
2004	--	--	8,300	8,300
2005	--	48,168	9,000	57,168
2006	--	--	9,700	9,700
Thereafter	--	--	<u>156,000</u>	<u>156,000</u>
Total.....	<u>\$ 85</u>	<u>\$ 48,168</u>	<u>\$ 197,400</u>	<u>\$ 245,653</u>

9. COMMITMENTS AND CONTINGENCIES

Operating Leases

The Company leases office space, and certain facilities and furniture and equipment under long-term operating leases. Rent expense for all operating leases for the years ended December 31, 2001, 2000 and 1999, was approximately \$11.4 million, \$9.7 million and \$5.4 million, respectively. In November 1999, the Company entered into an agreement for the sale and leaseback of certain of its furniture and equipment. The Company has purchase and lease renewal options at projected future fair market values under the agreements. The leases are classified as operating leases. At the date of sale, furniture and equipment with carrying values totaling \$11.8 million were sold and the gains realized on the sale totaling \$7.3 million were deferred and are being amortized as a credit to rent expense over the lease term. The increase in 2000 rent expense compared to 1999 was due principally to rent expense resulting from this sale and leaseback transaction.

Under the 2000 Credit Facility, the Company entered into operating lease agreements with what could be considered a "virtual" special purpose entity for the acquisition or development of operating facilities. This synthetic lease financing arrangement provides for funding from the "virtual" special purpose entity under the operating leases of up to \$100.0 million, of which approximately \$49.9 million had been utilized at December 31, 2001. The remaining capacity under this synthetic lease financing arrangement is expected to be utilized to complete construction of the Moshannon Valley Correctional Center. At December 31, 2001, approximately \$15.0 million of this synthetic lease financing arrangement had been utilized for construction costs for the Moshannon Valley Correctional Center. The leases under this arrangement each have a term of the lesser of five years or July 2005, include purchase and renewal options, and provide for residual value guarantees for each lease which average 81.4% of the total cost and would be due by the Company upon termination of the leases. Upon termination of a lease, the Company could either exercise a purchase option, or the facilities could be sold to a third party. The Company expects the fair market value of the leased facilities to substantially reduce or eliminate the Company's potential obligation under the residual value guarantee. At December 31, 2001, there were two operating leases under this arrangement. Lease payments under the lease financing arrangements are variable and are adjusted for changes in interest rates.

Because the long-term debt of the "virtual" special purpose entity related to the lease agreements described above and of MCF is consolidated in the Company's Financial Statements as described in Note 2 and 8 to the Consolidated Financial Statements, the related rental commitments under these leases are not included in the following table.

As of December 31, 2001, the Company had the following rental commitments under noncancelable operating leases (in thousands):

For the year ending December 31,	
2002	\$ 8,176,801
2003	6,277,625
2004	1,975,537
2005	1,384,310
2006	753,516
Thereafter.....	<u>11,408,508</u>
Total.....	<u>\$ 29,976,297</u>

401(k) Plan

The Company has a defined contribution 401(k) plan. The Company's matching contribution currently represents 50% of a participant's contribution, up to the first 6% of the participant's salary. For the years ended December 31, 2001, 2000 and 1999, the Company recorded \$1.1 million, \$923,000 and \$754,000, respectively, of contribution expense.

Legal Proceedings

In March 2002, the Company, Steven W. Logan and John L. Hendrix, were named as defendants in two lawsuits styled *Graydon Williams, On Behalf of Himself and All Others Similarly Situated v. Cornell Companies, Inc, et al.*, No. H-02-0866, in the United States District Court for the Southern District of Texas, Houston Division, and *Richard Picard, On Behalf of Himself and All Others Similarly Situated v. Cornell Companies, Inc., et al.*, No. H-02-1075, in the United States District Court for the Southern District of Texas, Houston Division. The aforementioned lawsuits are putative class action lawsuits brought on behalf of all purchasers of the Company's common stock between March 6, 2001 and March 5, 2002. The lawsuits involve disclosures made concerning two prior transactions executed by the Company: the 2001 Sale and Leaseback Transaction and a 2000 synthetic lease transaction. The plaintiffs allege that the defendants violated Section 10(b) of the Securities Exchange Act of 1934 (the "Exchange Act"), Rule 10b-5 promulgated under Section 10(b) of the Exchange Act, and/or Section 20(a) of the Exchange Act. The Company believes that it has good defenses to each of the plaintiffs' claims and intends to vigorously defend against each of the claims.

Also in March 2002, the Company, its directors, and its independent auditor Arthur Andersen, were sued in a derivative action styled as *William Williams Derivatively and on Behalf of Nominal Defendant Cornell Companies, Inc. v. Anthony R. Chase, et al.*, No. 2002-15614, in the 127th Judicial District Court of Harris County, Texas. The lawsuit alleges breaches of fiduciary duty by all of the individual defendants and asserts breach of contract and professional negligence claims only against Arthur Andersen. The Company believes that it has good defenses to each of the plaintiff's claims and intends to vigorously defend against each of the claims.

While the plaintiffs in these cases have not quantified their claim of damages and the outcome of the matters discussed above cannot be predicted with certainty, based on information known to date, management believes that the ultimate resolution of these matters will not have a material adverse effect on the Company's financial position, operating results or cash flow.

The Company currently and from time to time is subject to claims and suits arising in the ordinary course of business, including claims for damages for personal injuries or for wrongful restriction of, or interference with, offender privileges and employment matters.

10. STOCKHOLDERS' EQUITY

Common Stock Offering

On November 30, 2001, the Company completed an offering of its Common Stock. Net proceeds to the Company from the sale of the 3,450,000 shares of newly issued Common Stock were approximately \$43.8 million. Proceeds from the offering were used to repay indebtedness of \$39.4 million and retired the notes under the Note and Equity Purchase Agreement dated July 21, 2000 with the remainder for general working capital purposes.

Stockholder Rights Plan

On May 1, 1998, the Company adopted a stockholder rights plan. Under the plan, each stockholder of record at the close of the business day on May 11, 1998, received one Preferred Stock Purchase Right ("Right") for each share of common stock held. The Rights expire on May 1, 2008. Each Right initially entitles the stockholder to purchase one one-thousandth of a Series A Junior Participating Preferred Share for \$120.00. Each Preferred Share has terms designed to make it economically equivalent to one thousand common shares. The Rights will become exercisable only in the event a person or group acquires 15% or more of the Company's common stock or commences a tender or exchange offer which, if consummated, would result in that person or group owning 15% or more of the Company's common stock. If a person or group acquires a 15% or more position in the Company, each Right (except those held by the acquiring party) will then entitle its holder to purchase, at the exercise price, common stock of the Company having a value of twice the exercise price. The effect will be to entitle the holder to buy the common stock at 50% of the market price. Also, if following an acquisition of 15% or more of the Company's common stock, the Company is acquired by that person or group in a merger or other business combination transaction, each Right would then entitle its holder to purchase common stock of the acquiring company having a value of twice the exercise price. The effect will be to entitle the Company's stockholders to buy stock in the acquiring company at 50% of the market price. The Company may redeem the Rights at \$0.01 per Right at any time prior to the acquisition of 15% or more of its common stock by a person or group.

Preferred Stock

Preferred stock may be issued from time to time by the Board of Directors of the Company, which is responsible for determining the voting, dividend, redemption, conversion and liquidation features of any preferred stock.

Options

In December 2000, the Company adopted the 2000 Broad-Based Employee Plan ("2000 Plan"). Pursuant to the 2000 Plan, the Company may grant non-qualified stock options for up to the greater of 515,232 shares or 4% of the aggregate number of shares of common stock outstanding. The 2000 Plan options vest up to five years and expire ten years from the grant date. In May 1996, the Company adopted the 1996 Stock Option Plan and amended and restated the plan in April 1998 ("1996 Plan"). Pursuant to the 1996 Plan, the Company may grant non-qualified and incentive stock options for up to the greater of 1,932,119 shares or 15% of the aggregate number of shares of common stock outstanding. The 1996 Plan options vest up to seven years and expire seven to ten years from the grant date. The Compensation Committee of the Board of Directors, which is comprised of independent directors, is responsible for determining the exercise price and vesting terms for the granted options. The 1996 Plan and 2000 Plan option exercise prices can be no less than the market price of the Company's common stock on the date of grant.

In conjunction with the issuance of the Subordinated Notes in July 2000, the Company issued warrants to purchase 290,370 shares of the common stock at an exercise price of \$6.70. The Company recognized the fair value of these warrants of \$1.1 million as additional paid-in capital. The warrants may only be exercised by payment of the exercise price in cash to the Company, by cancellation of an amount of warrants equal to the fair market value of the exercise price, or by the cancellation of Company indebtedness owed to the warrant holder. During 2001, 168,292 shares of Common Stock were issued in conjunction with the exercise and cancellation of 217,778 warrants.

The following is a summary of the status of the Company's 2000 Plan, 1996 Plan and other options at December 31, 2001, 2000 and 1999, and changes during the years then ended:

	<u>2001</u>		<u>2000</u>		<u>1999</u>	
	<u>Shares</u>	<u>Weighted Average Exercise Price</u>	<u>Shares</u>	<u>Weighted Average Exercise Price</u>	<u>Shares</u>	<u>Weighted Average Exercise Price</u>
Outstanding at beginning of year	1,294,048	\$ 7.70	1,242,637	\$ 11.46	1,338,839	\$ 15.73
Granted.....	70,000	9.76	378,877	5.30	463,000	11.98
Exercised	(156,923)	5.64	(10,000)	2.50	(57,200)	10.60
Forfeited or canceled	<u>(28,501)</u>	12.26	<u>(317,466)</u>	19.74	<u>(502,002)</u>	23.40
Outstanding at end of year	<u>1,178,624</u>	7.98	<u>1,294,048</u>	7.70	<u>1,242,637</u>	11.46
Exercisable at end of year	602,839	7.61	619,673	6.79	523,712	7.17
Weighted average fair value of options granted.....	\$6.77		\$3.03		\$9.48	

The following table summarizes information about stock options outstanding at December 31, 2001:

<u>Range of Exercise Prices</u>	<u>Number Outstanding</u>	<u>Weighted Average Remaining Life (Years)</u>	<u>Weighted Average Exercise Price</u>	<u>Number Exercisable</u>	<u>Weighted Average Exercise Price</u>
\$ 2.00 to \$ 2.50	93,919	0.8	\$ 2.02	93,919	\$2.02
3.75 to 5.64	493,102	7.6	4.68	255,860	4.87
7.59 to 9.00	78,000	8.0	8.36	63,500	8.26
10.375 to 15.19	414,100	7.3	11.25	115,780	12.36
15.60 to 24.38	<u>99,503</u>	7.0	16.12	<u>73,780</u>	16.22
	<u>1,178,624</u>			<u>602,839</u>	

Had compensation cost for the stock option grants under the 2000 Plan, the 1996 Plan and other stock options been determined under SFAS No. 123, the Company's net income and diluted net earnings per share would have been the following (in thousands, except per share amounts):

		<u>Year Ended December 31,</u>		
		<u>2001</u>	<u>2000</u>	<u>1999</u>
Net income:	As reported	\$ 4,659	\$ 7,969	\$ 5,352
	Pro forma	3,023	6,093	3,662
Earnings per share (diluted):	As reported	.46	.84	.55
	Pro forma	.30	.64	.38

Under SFAS No. 123, the fair value of each option grant was estimated on the date of grant using the minimum value calculation prior to the Company's initial public offering ("IPO") and the Black-Scholes option pricing model subsequent to the IPO. The following weighted average assumptions were used for grants in 2001, 2000 and 1999, respectively: risk-free interest rates of 5.0%, 5.4% and 6.6%; dividend rates of \$0, \$0 and \$0; expected lives of 10.0, 6.6 and 10.0 years; expected volatility of 53.35%, 52.76% and 65.74%.

The Black-Scholes option pricing model and other existing models were developed for use in estimating the fair value of traded options that have no vesting restrictions and are fully transferrable. In addition, option valuation models require the input of, and are highly sensitive to, subjective assumptions including the expected stock price volatility. The Company's employee stock options have characteristics significantly different from those of traded options, and changes in the subjective input assumptions can materially affect the fair value estimate.

Notes from Shareholders

On July 8, 1996, the prior Chief Executive Officer and the current Chief Executive Officer of the Company exercised options to purchase an aggregate 137,110 and 82,750 shares of Class A Common Stock and Class B Common Stock at an aggregate price of \$274,220 and \$180,638, respectively. In connection with the exercise, each officer entered into a promissory note with the Company for the respective aggregate exercise amounts. The promissory notes, as amended in July 2000, bear interest at an annual rate of 6.63%, mature in June 2004, are full recourse and are collateralized by shares of the Company's common stock.

Treasury Stock

During the years ended December 31, 2001 and 2000, the Company repurchased 90,900 and 258,400 shares, respectively, of common stock for cash on the open market under a share repurchase program at an aggregate cost of \$1.1 million and \$1.9 million, respectively.

Employee Stock Purchase Plan

Effective as of January 1, 2000, the Company has an employee stock purchase plan whereby employees can make contributions to purchase the Company's common stock. Purchases of common stock are made annually at the lower of the beginning or end of year market value, less a 15% discount. For the years ended December 31, 2001 and 2000, contributions of approximately \$214,000 and \$97,000 were used to purchase 46,767 and 13,585 shares of the Company's common stock, respectively.

Deferred Bonus Plan

In the fourth quarter of 2001, the Company established a deferred bonus plan for certain employees. Pursuant to the plan, \$4,675,000 was deposited on behalf of individual participants into a rabbi trust account, which included \$3,587,500 in cash and \$1,087,500 in Company treasury stock. The treasury stock portion of the rabbi trust is to remain as treasury stock, while the participants may give investment directions to the trustee as to the cash portion, subject to certain limitations. The investments of the rabbi trust represent assets of the Company and are included in the accompanying consolidated balance sheet based on the nature of the assets held. Amounts held in the rabbi trust are generally distributable upon vesting.

The plan generally vests 100% upon the achievement of an aggregate amount of monthly credits (based on a fixed monthly earnings milestone) expected to occur at the end of five years beginning October 1, 2001. Vesting will accelerate to 60% at the end of three years if certain earnings targets are achieved. Based on the expected earnings period, compensation expense and the related compensation liability for the aggregate plan value are being recognized over five years. To the extent the vesting is extended or accelerated based on the achievement of the financial milestones, recognition of compensation expense will be adjusted on a prospective basis. Through December 31, 2001, the Company expensed approximately \$225,000 under the deferred bonus plan.

While periodic gains on the value of each participant's investments held in the rabbi trust are recorded currently in income, an equal amount of compensation expense and related compensation liability is recorded, since participants are fully vested in such gains. Periodic losses incurred by participants in their invested balances are recorded as incurred. Such losses in excess of a participant's recorded compensation expense are guaranteed by the participants with a full-recourse obligation to the Company. These guarantees function to offset the loss on investments to the extent the obligations are not reserved for collectibility by the Company.

Amounts held in treasury stock have been recorded at cost. An equal amount has been established as deferred compensation and additional paid-in capital in the accompanying statement of stockholders' equity. The balance in deferred compensation is amortized to compensation expense over the expected vesting period of five years.

11. DERIVATIVE FINANCIAL INSTRUMENTS

Debt Service Reserve Fund and Debt Service Fund

In August 2001, MCF completed a bond offering to finance the 2001 Sale and Leaseback Transaction. In connection with the bond offering, two reserve fund accounts were established by MCF pursuant to the terms of the indenture. MCF's Debt Service Reserve Fund, aggregating \$23.8 million, was established to make payments on MCF's outstanding bonds in the event the Company (as lessee) fails to make scheduled rental payments to MCF. MCF's Debt Service Fund, which aggregated \$9.5 million at December 31, 2001, is used to accumulate monthly lease payments MCF receives from the Company until such funds are used to pay MCF's semi-annual bond payments. Both reserve fund accounts are subject to agreements with the MCF Equity Investor whereby guaranteed rates of return of 3% and 5.08%, respectively, are provided for the balance in the Debt Service Reserve Fund and the Debt Service Fund. The guaranteed rates of return are characterized as non-hedge derivative instruments. The derivatives have an aggregate fair value of \$4.0 million, which has been recorded as a decrease to the equity investment in MCF made by the MCF Equity Investor (MCF Minority Interest) and as deferred income (a liability account) in the accompanying consolidated balance sheet. Changes in the derivative instruments will be recorded as an adjustment to deferred income.

Also in connection with MCF's bond offering, the MCF Equity Investor provided a guarantee of the Debt Service Reserve Fund if a bankruptcy of the Company were to occur and a trustee for the estate of the Company were to obtain jurisdiction of the Debt Service Reserve Fund for the Company's estate. This guarantee is characterized as a non-hedge derivative instrument. The derivative has an estimated fair value \$2.5 million, which has been recorded as an increase to MCF Minority Interest and as a deferred asset. Changes in the derivative instrument will be recorded as an adjustment to the deferred asset.

12. SEGMENT DISCLOSURE

The Company's three operating divisions are its reportable segments. The adult secure institutional segment consists of the operation of secure adult incarceration facilities. The juvenile segment consists of providing residential treatment and educational programs and non-residential community-based programs to juveniles between the ages of 10 and 17 who either have been adjudicated or suffer from behavioral problems. The pre-release segment consists of providing pre-release and halfway house programs for adult offenders who are either on probation or serving the last three to six months of their sentences on parole and preparing for re-entry into society at large. The accounting policies of the Company's segments are the same as those described in the summary of significant accounting policies in Note 3. Intangible assets are not included in each segment's reportable assets, and the amortization of intangible assets is not included in the determination of a segment's operating income or loss. The Company evaluates performance based on income or loss from operations before general and administrative expenses, incentive bonuses, amortization of intangibles, interest and income taxes. Corporate and other assets are comprised primarily of cash, accounts receivable, deposits, deferred costs and deferred taxes.

The only significant noncash item reported in the respective segments' income or loss from operations is depreciation and amortization (excluding intangibles).

	Year Ended December 31,		
	<u>2001</u>	<u>2000</u> (in thousands) (restated)	<u>1999</u>
Revenues			
Adult secure institutional	\$ 99,791	\$ 91,163	\$ 76,011
Juvenile	116,262	86,033	67,131
Pre-release	<u>49,197</u>	<u>48,854</u>	<u>33,825</u>
Total revenues	<u>\$ 265,250</u>	<u>\$ 226,050</u>	<u>\$ 176,967</u>
Depreciation and amortization			
Adult secure institutional	\$ 3,222	\$ 2,873	\$ 3,013
Juvenile	2,149	1,285	1,001
Pre-release	1,451	1,164	831
Amortization of intangibles	1,525	1,528	810
Corporate and other	<u>931</u>	<u>613</u>	<u>352</u>
Total depreciation and amortization	<u>\$ 9,278</u>	<u>\$ 7,463</u>	<u>\$ 6,007</u>
Income from operations			
Adult secure institutional	\$ 22,347	\$ 20,126	\$ 17,930
Juvenile	16,857	11,371	8,482
Pre-release	10,514	11,983	7,122
General and administrative expenses	(15,291)	(12,024)	(9,932)
Incentive bonuses	(1,000)	--	(50)
Amortization of intangibles	(1,525)	(1,528)	(810)
Corporate and other	<u>(884)</u>	<u>(275)</u>	<u>(493)</u>
Total income from operations	<u>\$ 31,018</u>	<u>\$ 29,653</u>	<u>\$ 22,249</u>
Assets			
Adult secure institutional	\$ 155,085	\$ 155,676	\$ 141,268
Juvenile	102,766	88,801	53,498
Pre-release	57,962	55,206	47,952
Intangible assets, net	15,456	16,861	17,911
Corporate and other	<u>113,538</u>	<u>20,306</u>	<u>13,362</u>
Total assets	<u>\$ 444,807</u>	<u>\$ 336,850</u>	<u>\$ 273,991</u>
Capital expenditures			
Adult secure institutional	\$ 4,083	\$ 17,105	\$ 13,536
Juvenile	7,117	33,219	4,203
Pre-release	675	4,254	5,184
Corporate and other	<u>2,293</u>	<u>2,214</u>	<u>6,144</u>
Total capital expenditures	<u>\$ 14,168</u>	<u>\$ 56,792</u>	<u>\$ 29,067</u>

13. SUBSEQUENT EVENTS

On February 6, 2002, the Company announced that a Special Committee of the Audit Committee of the Board of Directors had been formed to review the accounting treatment for its August 2001 sale/leaseback transaction (the "2001 Sale and Leaseback Transaction"). The Company entered into a retainer agreement with an investment bank dated September 2001, which, as it had been amended, provides that (1) the Company pay the investment bank a non-refundable retainer fee of \$3.65 million to provide financial advisory services concerning separate future financing vehicles and the strategic development of the Company's business and (2) the retainer will be applied on a mutually agreed upon basis toward future contingent fees associated with investment banking services that may be provided to the Company. The review focused on whether the retainer agreement and the payment of the fee affected the previously reported accounting treatment for the 2001 Sale and Leaseback Transaction.

The Special Committee, which was composed solely of independent directors, retained independent counsel, who retained an accounting advisor, to assist the Special Committee in its review. The Special Committee was formed and conducted its review in response to correspondence from the Company's independent auditors to its Audit Committee regarding the 2001 Sale and Leaseback Transaction. In the course of its review and pursuant to a third letter from the Company's independent auditors addressed to the Company's Chairman dated February 21, 2002, the Special Committee also reviewed the accounting treatment for the Company's 2000 synthetic lease transaction. The review of the synthetic lease focused on whether a fee was paid pursuant to an engagement letter between the Company and two financial institutions participating in the transaction and the impact of the fee on the previously reported accounting treatment.

At the conclusion of its review, among other things, the Special Committee recommended to the Board of Directors that:

- based on various considerations, the Company's financial statements for 2000 and the first three quarters of 2001 should be restated to reflect the consolidation of the 2001 Sale and Leaseback Transaction and the 2000 synthetic lease transaction; and
- actions should be taken to strengthen further the Company's internal controls.

Following discussions with its independent auditors and its advisors regarding the accounting treatment of the 2001 Sale and Leaseback Transaction and the 2000 synthetic lease transaction and in view of anticipated changes in accounting rules and the market and regulatory environment currently existing and a desire to reach a final resolution of these matters as quickly as possible, the Company decided to consolidate both transactions for financial accounting purposes for past and future periods. As a result, the Company has restated its financial statements for 2000 and the first three quarters of 2001 to reflect the consolidation of the 2001 Sale and Leaseback Transaction and the 2000 synthetic lease transaction.

These restatements are reflected in the selected unaudited quarterly financial data set forth in Note 14 to the Consolidated Financial Statements. The restatements of the financial data for the year ended and as of December 31, 2000 are reflected in the audited financial statements included herewith.

On April 16, 2002, the Board of Directors amended the Bylaws. Among other things, the amendments establish an executive chairman position, clarify specific levels of authority for members of senior management and identify appropriate limits on such authority. Pursuant to board action, Harry J. Phillips, Jr., the Company's Chairman, will serve as the Executive Chairman of the Company, Steven W. Logan will serve as President, Thomas R. Jenkins shall continue to serve as the Chief Operating Officer of the Company, and John L. Hendrix shall continue to serve as the Chief Financial Officer of the Company. The Board of Directors is considering additional actions to strengthen further the Company's internal controls.

As a result of the Company's Special Committee review of certain Company transactions, the restatement of the Company's 2000 and 2001 financial statements and related matters, management expects to recognize a non-recurring pre-tax charge of approximately \$1.6 million for legal, accounting and other professional fees for the quarter ended March 31, 2002. See Note 2 to the Consolidated Financial Statements.

Additionally, certain waivers and amendments to the Company's credit agreements were obtained by the Company in connection with the restatement of its financial statements during the first quarter of 2002. As a result of these waivers and amendments, the Company will recognize a pre-tax charge to interest expense of approximately \$800,000 for the quarter ended March 31, 2002 for lenders' fees and related professional fees.

14. SELECTED QUARTERLY FINANCIAL DATA (UNAUDITED)

Reference is made to Notes 2 and 13 for a discussion of the Company's restated quarterly financial data.

	1 st Quarter		2 nd Quarter		3 rd Quarter		4 th Quarter		Year	
	As Reported	As Restated	As Reported	As Restated	As Reported	As Restated	As Reported	As Restated	As Reported	As Restated
2001:										
Revenues	\$ 60,628	\$ 60,628	\$ 65,745	\$ 65,745	\$ 68,733	\$ 68,733	\$ 70,144	\$ n/a	\$ n/a	\$ 265,250
Income from operations	4,080	4,570	7,551	8,121	6,426	8,493	9,834	n/a	n/a	31,018
Income before extraordinary charges and cumulative effect of change in accounting principle(1)(2).....	54	54	2,129	2,129	1,921	1,909	2,743	n/a	n/a	6,835
Net income.....	824	824	2,129	2,129	1,442	1,431	275	n/a	n/a	4,659
Earnings per share before extraordinary charges and cumulative effect of change in accounting principle:										
- Basic	\$.01	\$.01	\$.23	\$.23	\$.21	\$.21	\$.26	\$ n/a	\$ n/a	\$.71
- Diluted	\$.01	\$.01	\$.22	\$.22	\$.20	\$.19	\$.24	\$ n/a	\$ n/a	\$.68
Earnings per share:										
- Basic	\$.09	\$.09	\$.23	\$.23	\$.16	\$.15	\$.03	\$ n/a	\$ n/a	\$.48
- Diluted.....	\$.09	\$.09	\$.22	\$.22	\$.15	\$.14	\$.02	\$ n/a	\$ n/a	\$.46
2000:										
Revenues	\$ 53,468	\$ n/a	\$ 55,408	\$ 55,408	\$ 56,746	\$ 56,746	\$ 60,428	\$ 60,428	\$ 226,050	\$ 226,050
Income from operations	6,901	n/a	7,466	7,524	7,516	7,573	7,178	7,655	29,061	29,653
Net income.....	1,971	n/a	2,193	2,193	1,932	1,932	1,873	1,873	7,969	7,969
Earnings per share:										
- Basic	\$.21	\$ n/a	\$.23	\$.23	\$.21	\$.21	\$.20	\$.20	\$.85	\$.85
- Diluted.....	\$.21	\$ n/a	\$.23	\$.23	\$.20	\$.20	\$.20	\$.20	\$.84	\$.84
1999:										
Revenues	\$ 38,356	\$ n/a	\$ 43,609	\$ n/a	\$ 45,321	\$ n/a	\$ 49,681	\$ n/a	\$ 176,967	\$ n/a
Income from operations	3,987	n/a	4,815	n/a	5,945	n/a	7,502	n/a	22,249	n/a
Income before cumulative effect of change in accounting principle.....	1,440	n/a	1,783	n/a	2,287	n/a	2,796	n/a	8,306	n/a
Net income (loss) (3)	(1,514)	n/a	1,783	n/a	2,287	n/a	2,796	n/a	5,352	n/a
Earnings per share before cumulative effect of change in accounting principle:										
- Basic	\$.15	\$ n/a	\$.19	\$ n/a	\$.24	\$ n/a	\$.30	\$ n/a	\$.88	\$ n/a
- Diluted.....	\$.15	\$ n/a	\$.18	\$ n/a	\$.24	\$ n/a	\$.29	\$ n/a	\$.86	\$ n/a
Earnings per share:										
- Basic	\$ (.16)	\$ n/a	\$.19	\$ n/a	\$.24	\$ n/a	\$.30	\$ n/a	\$.57	\$ n/a
- Diluted.....	\$ (.16)	\$ n/a	\$.18	\$ n/a	\$.24	\$ n/a	\$.29	\$ n/a	\$.55	\$ n/a
2001 Balance Sheet Data:										
Working capital	\$ 35,526	\$ 35,526	\$ 41,294	\$ 41,294	\$ 96,885	\$ 88,584	\$ 97,814	\$ n/a	\$ n/a	\$ 97,814
Total assets.....	294,000	341,682	298,593	346,013	185,693	434,012	444,807	n/a	n/a	444,807
Long-term debt, net of current portion	153,957	201,155	159,488	206,686	38,424	276,718	238,768	n/a	n/a	238,768
Stockholders' equity	105,478	105,478	106,771	106,771	109,221	109,209	153,104	n/a	n/a	153,104
2000 Balance Sheet Data:										
Working capital (deficit).....	\$(11,628)	\$ n/a	\$ 32,739	\$ 32,739	\$ 35,633	\$ 35,633	\$ 29,703	\$ 29,703	\$ 29,703	\$ 29,703
Total assets.....	274,164	n/a	276,551	313,453	284,120	325,884	291,439	336,850	291,439	336,850
Long-term debt, net of current portion	101,250	n/a	145,000	180,943	150,848	191,942	146,926	191,722	146,926	191,722
Stockholders' equity	99,301	n/a	101,494	101,494	103,094	103,094	104,320	104,320	104,320	104,320

(1) The Company early retired \$50.0 million and \$39.4 million outstanding of its Senior Secured Notes and Subordinated Notes in the third quarter and fourth quarter of 2001, respectively, and recorded net-of-tax charges of \$479,000 in the third quarter and \$2.5 million in the fourth quarter due to the write-off of unamortized deferred debt issuance costs related to the credit facilities. See Note 8 to the Consolidated Financial Statements.

(2) The Company changed its method of accounting for supplies effective January 1, 2002 and recorded a net-of-tax charge of approximately \$770,000 for the cumulative effect of a change in accounting principle. See Note 3 to the Consolidated Financial Statements.

(3) The Company adopted SOP 98-5 in January 1999 and recorded a net-of-tax charge of approximately \$3.0 million for the cumulative effect of a change in accounting principle.

SELECTED CONSOLIDATED FINANCIAL DATA

The selected consolidated financial data should be read in conjunction with the Company's Consolidated Financial Statements and Notes thereto and "Management's Discussion and Analysis of Financial Condition and Results of Operations" included elsewhere in this report.

	<u>Year Ended December 31,</u>				
	<u>2001(1)</u>	<u>2000(1)</u>	<u>1999(2)</u>	<u>1998(3)</u>	<u>1997(4)</u>
(dollars in thousands, except per share data)					
Statement of Operations Data:					
Revenues.....	\$ 265,250	\$ 226,050	\$ 176,967	\$ 123,119	\$ 70,302
Income from operations.....	31,018	29,653	22,249	12,589	5,630
Income before income taxes, extraordinary charges and cumulative effect of change in accounting principle.....	11,793	13,507	13,844	10,104	5,553
Income before extraordinary charges and cumulative effect of change in accounting principle.....	6,835	7,969	8,306	6,062	3,554
Extraordinary charges for early retirement of debt, net of income tax.....	(2,946)	--	--	--	--
Cumulative effect of change in accounting principle, net of income tax.....	770	--	(2,954)	--	--
Net income.....	\$ 4,659	\$ 7,969	\$ 5,352	\$ 6,062	\$ 3,554
Earnings per share:					
- Basic					
Income before extraordinary charges and cumulative effect of change in accounting principle.....	\$.71	\$.85	\$.88	\$.64	\$.48
Net income	\$.48	\$.85	\$.57	\$.64	\$.48
- Diluted					
Income before extraordinary charges and cumulative effect of change in accounting principle.....	\$.68	\$.84	\$.86	\$.62	\$.46
Net income	\$.46	\$.84	\$.55	\$.62	\$.46
Number of shares used to compute EPS (in thousands):					
- Basic	9,616	9,383	9,432	9,442	7,350
- Diluted	10,069	9,495	9,660	9,772	7,740
Operating Data:					
Total service capacity (5):					
Residential.....	11,267	11,318 (6)	11,796	9,135	6,172
Non-residential community-based.....	4,177	3,046	3,049	1,390	900
Total.....	15,444	14,364 (6)	14,845	10,525	7,072
Service capacity in operation					
(end of period).....	14,349	13,269	12,240	8,700	5,061
Contracted beds in operation					
(end of period) (7).....	9,503	10,061	9,029	7,310	4,161
Average occupancy based on contracted beds in operation (7) (8)					
	95.9%	94.3%	95.8%	93.8%	97.6%
Average occupancy excluding start-up operations (7).....					
	96.3%	96.0%	97.0%	98.3%	97.6%

	<u>2001(1)</u>	<u>2000(1)</u>	<u>December 31,</u> <u>1999(2)</u> (in thousands)	<u>1998(3)</u>	<u>1997(4)</u>
Balance Sheet Data:					
Working capital (deficit).....	\$ 97,814	\$ 29,703	\$ (12,636)	\$ 16,828	\$ 26,220
Total assets	444,807	336,850	273,991	212,695	104,109
Long-term debt, net of current portion.....	238,768	191,722	101,500	98,407	138
Stockholders' equity	153,104	104,320	97,208	91,500	86,730

Notes to Selected Consolidated Financial Data

- (1) The Company restated its financial statements for the year ended December 31, 2000 and for the nine months ended September 30, 2001. See Notes 2 and 13 to the Consolidated Financial Statements for additional information.
- (2) Includes the operations of Interventions-Illinois acquired in November 1999.
- (3) Includes the operations of the Great Plains Correctional Facility acquired in January 1998 and the Alaska facilities purchased from Allvest in August 1998.
- (4) Includes the operations of Interventions-Texas and Abraxas acquired in January 1997 and September 1997, respectively.
- (5) The Company's service capacity is comprised of the number of beds available for service upon completion of construction of residential facilities and the average program capacity of non-residential community-based programs.
- (6) The Utah Department of Corrections ("Utah DOC") selected the Company's bid in June 1999 for the 490 bed Timpie Valley Correctional Facility subject to final contract negotiations. In 2000, the Utah DOC declined to pursue this project, therefore the Company's service capacity was reduced accordingly.
- (7) Occupancy percentages are based on contracted service capacity of residential facilities in operation. Since certain facilities have service capacities that exceed contracted capacities, occupancy percentages can exceed 100% of contracted capacity.
- (8) Occupancy percentages reflect less than normalized occupancy during the start-up phase of any applicable facility, resulting in a lower average occupancy in periods when the Company has substantial start-up activities.

MARKET FOR CORNELL COMPANIES, INC. COMMON STOCK AND RELATED STOCKHOLDER MATTERS

The common stock of the Company is currently listed on the New York Stock Exchange (“NYSE”) under the symbol “CRN.” As of March 31, 2002, there were approximately 34 record holders of common stock. The quarterly high and low closing sales prices for the common stock from January 1, 2000 through March 31, 2002 are shown below:

	<u>High</u>	<u>Low</u>
2000:		
First Quarter.....	\$ 11.00	\$ 7.56
Second Quarter	11.00	6.56
Third Quarter	9.00	6.13
Fourth Quarter	8.19	3.50
2001:		
First Quarter.....	\$ 8.25	\$ 5.69
Second Quarter	15.00	7.90
Third Quarter	18.11	13.40
Fourth Quarter	17.90	14.10
2002:		
First Quarter.....	\$ 18.21	\$ 9.96

The Company has never declared or paid cash dividends on its capital stock. The Company currently intends to retain excess cash flow, if any, for use in the operation and expansion of its business and does not anticipate paying cash dividends on the common stock in the foreseeable future. The payment of dividends is within the discretion of the Board of Directors and is dependent upon, among other factors, the Company’s results of operations, financial condition, capital requirements, restrictions, if any, imposed by financing commitments and legal requirements. The Company’s Amended and Restated Credit Agreement, dated as of July 21, 2000 (“2000 Credit Facility”), currently prohibits the payment of dividends. See “Management’s Discussion and Analysis of Financial Condition and Results of Operations -- Liquidity and Capital Resources”.

THIS PAGE INTENTIONALLY LEFT BLANK

CORPORATE DIRECTORY

DIRECTORS

Anthony R. Chase^{1,2 & 3} (47)

Chairman and Chief Executive Officer, ChaseCom, LP

James H.S. Cooper² (47)

Founder and Chairman, Brentwood Capital Advisors, LLC

David M. Cornell (66)

Retired Chairman of the Board

Peter A. Leidel³ (45)

Partner, Ticonderoga Capital

Managing Director, Yorktown Partners, LLC

Arlene R. Lissner (71)

Managing Director, National Marketing

Steven W. Logan (40)

President

Harry J. Phillips, Jr. (52)

Executive Chairman and

Chairman of the Board

Tucker Taylor^{1 & 2} (63)

President, CBCA, Inc.

Marcus A. Watts³ (44)

Senior Partner, Locke, Liddell & Sapp LLP

1 Compensation Committee

2 Audit Committee

3 Nominating Committee

CORPORATE INFORMATION

Annual Meeting of Shareholders

Date: June 13, 2002

Time: 10:00 a.m.

Location: Houston Marriott West Loop by the Galleria

1750 West Loop South

Houston, Texas 77027

713-960-0111

INDEPENDENT ACCOUNTANTS

Arthur Andersen LLP

711 Louisiana, Suite 1300

Houston, Texas 77002

STOCK LISTING

New York Stock Exchange

Ticker Symbol: **CRN**

STOCK TRANSFER AGENT AND REGISTRAR

Computershare Trust Company

12039 West Alameda Parkway, Z-2

Lakewood, Colorado 80228

303-986-5400

CORPORATE HEADQUARTERS

Cornell Companies, Inc.

1700 West Loop South, Suite 1500

Houston, Texas 77027

713-623-0790

EXECUTIVE OFFICERS AND KEY PERSONNEL

Harry J. Phillips, Jr. (52)

Executive Chairman and

Chairman of the Board

Steven W. Logan (40)

President

John L. Hendrix (53)

Chief Financial Officer and Senior Vice President

Thomas R. Jenkins, Jr. (54)

Chief Operating Officer and Senior Vice President

Arlene R. Lissner (71)

Managing Director, National Marketing

Leslie A. Balonick (50)

Vice President, Midwest Region

Luis A. Collazo (35)

Chief Accounting Officer and Corporate Controller

John C. Godlesky (55)

Vice President, Eastern Region

Gary L. Henman, Ph.D. (62)

Vice President, Adult Secure Institutions

Kevin B. Kelly (39)

Treasurer and Corporate Secretary

Patrick N. Perrin (41)

Chief Administrative Officer and Vice President

Laura J. Shol (47)

Vice President, Western Region

Kevin T. Smyley (51)

Vice President, Business Development

Marvin H. Wiebe, Jr. (54)

Senior Vice President

