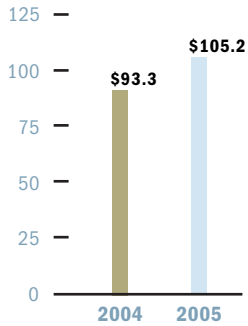


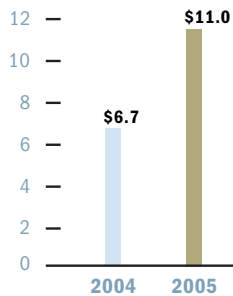


**TO OUR FELLOW SHAREHOLDERS:**

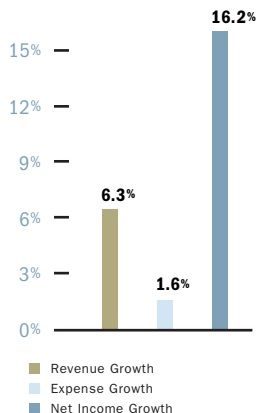
**Total Revenue**  
(IN MILLIONS)



**Operating Income**  
(IN MILLIONS)



**Same Store Comparison**  
2004-2005 (PERCENTAGE CHANGE)



**The significant** accomplishments of 2005 were a result of our experienced and dedicated team continuing to successfully execute on our long-term strategy. These accomplishments strengthened our capital structure, resulted in improved operating performance and provided us with greater financial flexibility. The operating and financial improvements we continue to achieve are converging with better industry fundamentals, lower capitalization rates and continued attractive interest rates to form a solid platform for future growth. These positive factors are contributing to an active acquisitions market, bringing opportunities which we believe will position the Company for sustainable improvements in cash flow and profitability.

There were three major initiatives that created the platform for our success in 2005 and that are moving us forward in 2006:

*Maximizing the Value of our Communities.*

At the end of 2005, we had achieved 92 percent occupancy in our stabilized communities, enabling us to begin capitalizing on our operating leverage. As a result, revenues at our communities under management increased 6.3 percent, and our net income grew 16.2 percent. Moving forward, we intend to further enhance the value of our property portfolio through increasing the assisted living capacity at several communities and through additional ancillary and supportive services.

*Sale/Leaseback Transactions.* In October 2005, we completed an approximate \$85 million sale/leaseback transaction with Ventas, Inc. of six communities owned by our joint venture with affiliates of Blackstone Real Estate Advisors. In early 2006, we announced a second sale/leaseback transaction with Ventas valued at approximately \$29 million and a nine-property sale/leaseback transaction with Healthcare Property Investors, Inc., valued at approximately \$97 million. Through these and similar transactions, we expect to reduce our overall borrowing and fix the remaining debt at attractive rates, resulting in reduced interest expense and interest rate risk, as well as generating gains for the Company.

*Debt Improvement Initiative.* We completed the refinancing of four of our communities with GMAC Commercial Mortgage in July 2005. This increased our available cash by approximately \$4.6 million,

reduced the interest rate on the new loan amount by approximately 40 basis points and fixed it for 10 years.

We plan to complete refinancing activities for 15 additional communities in 2006 at fixed interest rates that are about 200 basis points below current levels.

As we move into 2006, our business plan is focused on providing significant income and asset growth potential, maximizing our return on invested capital and continuing to strengthen our balance sheet. The keystones of this business plan are:

- pursue additional sale/leaseback transactions;
- continue to maximize the value of our communities;
- complete acquisitions through joint ventures as well as REIT acquisitions and leasebacks; and
- increase revenue through management and development fees from third parties.

We began 2006 with our January 13 announcement of an initial acquisition of four communities through a dynamic joint venture with GE Healthcare Financial Services. With this transaction, Capital Senior Living owns and/or operates 59 communities in 21 states with a total capacity of 9,230 residents. Approximately 82 percent of these residents live independently, approximately 16 percent require assistance with activities of daily living and we provide skilled nursing services for approximately 2 percent.

We believe 2006 holds great potential for Capital Senior Living through the realization of our long-term strategy supported by positive industry trends. We look forward to sharing the results with you and thank you for your ongoing support.

Sincerely,

*James B. Stroud*  
JAMES A. STROUD  
Chairman of the Board

*Lawrence A. Cohen*  
LAWRENCE A. COHEN  
Chief Executive Officer

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UNITED STATES SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

**Form 10-K**

(Mark One)

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

**For the Fiscal Year Ended December 31, 2005**

**Or**

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

**For the transition period from to**

**Commission file number: 1-13445**

**Capital Senior Living Corporation**

*(Exact name of registrant as specified in its charter)*

**Delaware**

*(State or other jurisdiction of  
incorporation or organization)*

**14160 Dallas Parkway, Suite 300  
Dallas, Texas**

*(Address of principal executive offices)*

**75-2678809**

*(I.R.S. Employer  
Identification No.)*

**75254**

*(Zip Code)*

**Registrant's telephone number, including area code:**

**(972) 770-5600**

**Securities registered pursuant to Section 12(b) of the Act:**

Title of Each Class

Name of Each Exchange on Which Registered

Common Stock, \$.01 par value

New York Stock Exchange

Indicate by a check mark if the registrant is a well-known seasoned issuer, as defined by Rule 405 of the Securities Act. Yes  No

Indicate by a check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes  No

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

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act (Check One).

Large accelerated filer  Accelerated filer  Non-accelerated filer

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

The aggregate market value of the 21,457,198 shares of the Registrant's Common Stock, par value \$0.01 per share ("Common Stock"), held by nonaffiliates on December 31, 2005, based upon the closing price of the Registrant's Common Stock as reported by the New York Stock Exchange on June 30, 2005, was approximately \$152,131,534. As of March 29, 2006, the Registrant had 26,313,883 shares of Common Stock outstanding.

**DOCUMENTS INCORPORATED BY REFERENCE**

The Registrant's definitive proxy statement pertaining to the 2005 Annual Meeting of Stockholders (the "Proxy Statement") and filed or to be filed not later than 120 days after the end of the fiscal year pursuant to Regulation 14A is incorporated herein by reference into Part III.

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**CAPITAL SENIOR LIVING CORPORATION**  
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## PART I

### ITEM 1. BUSINESS

#### Overview

Capital Senior Living Corporation, a Delaware corporation (together with its subsidiaries, the “Company”), is one of the largest operators of senior living communities in the United States in terms of resident capacity. The Company and its predecessors have provided senior living services since 1990. As of December 31, 2005, the Company operated 55 senior living communities in 20 states with an aggregate capacity of approximately 8,900 residents, including 33 senior living communities which the Company owned or in which the Company had an ownership interest, seven senior living communities that the Company leased and 15 senior living communities it managed for third parties. As of December 31, 2005, the Company also operated one home care agency. During 2005 approximately 95% of total revenues for the senior living communities owned and managed by the Company were derived from private pay sources. As of December 31, 2005, the stabilized communities (defined as communities not in lease-up) that the Company operated had an average occupancy rate of approximately 92%.

The Company’s operating strategy is to provide quality senior living communities and services to its residents, while achieving and sustaining a strong, competitive position within its chosen markets, as well as to continue to enhance the performance of its operations. The Company provides senior living services to the elderly, including independent living, assisted living, skilled nursing and home care services. Many of the Company’s communities offer a continuum of care to meet its residents’ needs as they change over time. This continuum of care, which integrates independent living and assisted living and is bridged by home care through independent home care agencies or the Company’s home care agency, sustains residents’ autonomy and independence based on their physical and mental abilities.

Three major initiatives formed the Company’s platform for success in fiscal 2005 and will continue into fiscal 2006. These three initiatives included maximizing the value of the Company’s communities, sale/leaseback transactions and debt improvement initiatives.

The Company’s stabilized communities achieved an overall occupancy of 92% at December 31, 2005, which has begun to allow the Company to capitalize on its operating leverage. In addition, during 2006 the Company intends to further enhance the value of its communities through increasing assisted living capacity at selected communities and through increasing ancillary and supportive services offered at its communities.

In October 2005, the Company completed an \$85 million sale/leaseback transaction with Ventas Healthcare Properties, Inc. (“Ventas”) of six communities previously owned by the Company’s joint venture with Blackstone Real Estate Advisors (“Blackstone”). In fiscal 2006, the Company has announced three sale/leaseback transactions: one transaction involving one community valued at \$29 million with Ventas, a second transaction involving three communities valued at \$54 million with Healthcare Property Investor, Inc. (“HCPI”) and a third transaction involving six communities valued at \$43 million with HCPI. Through these and similar transactions the Company expects to reduce its overall borrowing and to fix the interest rates on nearly all of its remaining debt.

During fiscal 2005, the Company completed the refinancing of four communities with GMAC Commercial Mortgage Corporation (“GMAC”) which increased available cash by \$4.6 million, reduced the interest rate on the new debt by approximately 40 basis points and fixed the interest rate for ten years. The Company plans to refinance 15 additional communities in fiscal 2006 at fixed interest rates that are expected to be 200 basis points below the current interest rate on the related debt.

As the Company enters fiscal 2006, its business plan includes pursuing of additional sale/leaseback transactions, continuing to maximize the value of its communities, pursuing additional acquisitions through joint venture partners and REITs and increasing revenues through management and development of communities for third parties.

In the first quarter of fiscal 2006, the Company through a joint venture agreement with GE Healthcare Financial Services (“GE Healthcare”) finalized the acquisition of four senior living communities and expects to close on a fifth community in the second quarter of fiscal 2006.

### **Website**

The Company’s internet website [www.capitalsenior.com](http://www.capitalsenior.com) contains an Investor Relations section, which provides links to the Company’s annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, proxy statements, Section 16 filings and amendments to those reports, which reports and filings are available through the Company’s internet website free of charge as soon as reasonably practicable after such material is electronically filed with or furnished to the Securities and Exchange Commission (“SEC”).

### **Industry Background**

The senior living industry encompasses a broad and diverse range of living accommodations and supportive services that are provided primarily to persons 75 years of age or older.

For the elderly who require limited services, independent living residences supplemented at times by home health care, offers a viable option. Most independent living communities typically offer community living packaged with basic services consisting of meals, housekeeping, laundry, 24-hour staffing, transportation, social and recreational activities and health care monitoring. Independent living residents typically are not reliant on assistance with activities of daily living (“ADL’s”) although some residents may contract out for those services.

As a senior’s need for assistance increases, care in an assisted living residence is often preferable and more cost-effective than home-based care or nursing home care. Typically, assisted living represents a combination of housing and support services designed to aid elderly residents with ADL’s such as ambulation, bathing, dressing, eating, grooming, personal hygiene, and monitoring or assistance with medications. Certain assisted living residences may also provide assistance to residents with low acuity medical needs, or may offer higher levels of personal assistance for incontinent residents or residents with Alzheimer’s disease or other cognitive or physical frailties. Generally, assisted living residents require higher levels of care than residents of independent living residences and retirement living centers, but require lower levels of care than patients in skilled nursing facilities. For seniors who need the constant attention of a skilled nurse or medical practitioner, a skilled nursing facility may be required.

According to the American Senior Housing Association Senior Housing Construction Report for 2005, 35% of senior housing properties in the U.S. are assisted living communities, 30% are independent living communities, 25% are senior apartments and 10% are continuing care retirement communities.

The senior living industry is highly fragmented and characterized by numerous small operators. Moreover, the scope of senior living services varies substantially from one operator to another. Many smaller senior living providers do not operate purpose-built residences, do not have extensive professional training for staff and provide only limited assistance with ADLs. The Company believes that many senior living operators do not provide the required comprehensive range of senior living services designed to permit residents to “age in place” within the community as residents develop further physical or cognitive frailties.

The Company believes that a number of demographic, regulatory, and other trends will contribute to the continued growth in the senior living market including the following:

#### ***Consumer Preference***

The Company believes that senior living communities are increasingly becoming the setting preferred by prospective residents and their families for the care of the elderly. Senior living offers residents greater independence and allows them to “age in place” in a residential setting, which the Company believes results in a higher quality of life than that experienced in more institutional or clinical settings.



The likelihood of living alone increases with age. Most of this increase is due to an aging population in which women outlive men. In 1993, eight out of 10 noninstitutionalized elderly who lived alone were women. According to the United States Bureau of Census, based on 1993 data, the likelihood of women living alone increases from 32% for 65 to 74-year-olds to 57% for those women aged 85 and older. Men show similar trends with 13% of the 65 to 74-year-olds living alone, rising to 29% of the men aged 85 and older living alone. Societal changes, such as high divorce rates and the growing numbers of persons choosing not to marry, have further increased the number of Americans living alone. This growth in the number of elderly living alone has resulted in an increased demand for services that historically have been provided by a spouse, other family members or live-in caregivers.

### ***Demographics***

The primary market for the Company's senior living services is comprised of persons aged 75 and older. This age group is one of the fastest growing segments of the United States population and is expected to grow from 17.9 million in 2005 to approximately 32.6 million in 2030. The population of seniors aged 85 and over has increased from approximately 3.1 million in 1990 to over 4.9 million in 2005. This age cohort is expected to grow to approximately 18% to 5.8 million by 2010 and by 82% to approximately 8.9 million by 2030. As the number of persons aged 75 and over continues to grow, the Company believes that there will be corresponding increases in the number of persons who need assistance with ADLs. According to industry analyses, approximately 19% of persons aged 75 to 79, approximately 24% of persons aged 80 to 84 and approximately 45% of persons aged 85 and older need assistance with ADLs.

### ***Senior Affluence***

The average net worth of senior citizens is higher than non-senior citizens, partially as a result of accumulated equity through home ownership. The Company believes that a substantial portion of the senior population thus has significant resources available for their retirement and long-term care needs. The Company's target population is comprised of moderate to upper income seniors who have, either directly or indirectly through familial support, the financial resources to pay for senior living communities, including an assisted living alternative to traditional long-term care.

### ***Reduced Reliance on Family Care***

Historically, the family has been the primary provider of care for seniors. The Company believes that the increase in the percentage of women in the work force, the reduction of average family size, and overall increased mobility in society is reducing the role of the family as the traditional caregiver for aging parents. The Company believes that these factors will make it necessary for many seniors to look outside the family for assistance as they age.

### ***Restricted Supply of Nursing Beds***

Several states in the United States have adopted Certificate of Need ("CON") or similar statutes generally requiring that, prior to the addition of new skilled nursing beds, the addition of new services, or the making of certain capital expenditures, a state agency must determine that a need exists for the new beds or the proposed activities. The Company believes that this CON process tends to restrict the supply and availability of licensed nursing facility beds. High construction costs, limitations on government reimbursement for the full costs of construction, and start-up expenses also act to constrain growth in the supply of such facilities. At the same time, nursing facility operators are continuing to focus on improving occupancy and expanding services to subacute patients generally of a younger age and requiring significantly higher levels of nursing care. As a result, the Company believes that there has been a decrease in the number of skilled nursing beds available to patients with lower acuity levels and that this trend should increase the demand for the Company's senior living communities, including, particularly, the Company's assisted living communities.



### ***Cost-Containment Pressures***

In response to rapidly rising health care costs, governmental and private pay sources have adopted cost containment measures that have reduced admissions and encouraged reduced lengths of stays in hospitals and other acute care settings. The federal government had previously acted to curtail increases in health care costs under Medicare by limiting acute care hospital reimbursement for specific services to pre-established fixed amounts. Private insurers have begun to limit reimbursement for medical services in general to predetermined charges, and managed care organizations (such as health maintenance organizations) are attempting to limit hospitalization costs by negotiating for discounted rates for hospital and acute care services and by monitoring and reducing hospital use. In response, hospitals are discharging patients earlier and referring elderly patients, who may be too sick or frail to manage their lives without assistance, to nursing homes and assisted living residences where the cost of providing care is typically lower than hospital care. In addition, third-party payors are increasingly becoming involved in determining the appropriate health care settings for their insureds or clients, based primarily on cost and quality of care. Based on industry data, the typical day-rate in an assisted living facility is two-thirds of the cost for comparable care in a nursing home.

### **Operating Strategy**

The Company's operating strategy is to provide quality, senior living services at an affordable price to its residents, while achieving and sustaining a strong, competitive position within its chosen markets, as well as continuing to enhance the performance of its operations. The Company is implementing its operating strategy principally through the following methods.

#### ***Provide a Broad Range of Quality Personalized Care***

Central to the Company's operating strategy is its focus on providing quality care and services that are personalized and tailored to meet the individual needs of each community resident. The Company's residences and services are designed to provide a broad range of care that permits residents to "age in place" as their needs change and as they develop further physical or cognitive frailties. By creating an environment that maximizes resident autonomy and provides individualized service programs, the Company seeks to attract seniors at an earlier stage, before they need the higher level of care provided in a skilled nursing facility. The Company also maintains a comprehensive quality assurance program designed to ensure the satisfaction of its residents and their family members. The Company conducts annual resident satisfaction surveys that allow residents at each community to express whether they are "very satisfied," "satisfied" or "dissatisfied" with all major areas of a community, including, housekeeping, maintenance, activities and transportation, food service, security and management. In 2005 and 2004, the Company achieved 94% and 95%, respectively, overall approval rating from the residents' satisfaction survey.

#### ***Offer Services Across a Range of Pricing Options***

The Company's range of products and services is continually expanding to meet the evolving needs of its residents. The Company has developed a menu of products and service programs that may be further customized to serve both the moderate and upper income markets of a particular targeted geographic area. By offering a range of pricing options that are customized for each target market, the Company believes that it can develop synergies, economies of scale and operating efficiencies in its efforts to serve a larger percentage of the elderly population within a particular geographic market.

#### ***Improve Occupancy Rates***

The Company continually seeks to maintain and improve occupancy rates by: (i) retaining residents as they "age in place" by extending optional care and service programs; (ii) attracting new residents through the on-site marketing programs focused on residents and family members; (iii) selecting sites in underserved markets; (iv) aggressively seeking referrals from professional community outreach sources, including area religious organizations, senior social service programs, civic and business networks, as well as the medical community; and (v) continually refurbishing and renovating its communities.

### ***Improve Operating Efficiencies***

The Company seeks to improve operating efficiencies at its communities by actively monitoring and managing operating costs. By having an established national portfolio of communities with regional management in place, the Company believes it has established a platform to achieve operating efficiencies through economies of scale in the purchase of bulk items, such as food, and in the spreading of fixed costs, such as corporate overhead, over a larger revenue base, and to provide more effective management supervision and financial controls. The Company's growth strategy includes regional clustering of new communities to achieve further efficiencies.

### ***Emphasize Employee Training and Retention***

The Company devotes special attention to the hiring, screening, training, supervising and retention of its employees and caregivers to ensure that quality standards are achieved. In addition to normal on-site training, the Company conducts national management meetings and encourages sharing of expertise among managers. The Company's commitment to the total quality management concept is emphasized throughout its training program. This commitment to the total quality management concept means identification of the "best practices" in the senior living market and communication of those "best practices" to the Company's executive directors and their staff. The identification of best practices is realized by a number of means, including: emphasis on regional and executive directors keeping up with professional trade journals; interaction with other professionals and consultants in the senior living industry through seminars, conferences and consultations; visits to other properties; leadership and participation at national and local trade organization events; and information derived from marketing studies and resident satisfaction surveys. This information is continually processed by regional managers and the executive directors and communicated to the Company's employees as part of their training. The Company hires an executive director for each of its communities and provides them with autonomy, responsibility and accountability. The Company's staffing of each community with an executive director allows it to hire more professional employees at these positions, while the Company's developed career path helps it to retain the professionals it hires. The Company believes its commitment to and emphasis on employee training and retention differentiates the Company from many of its competitors.

### **Senior Living Services**

The Company provides senior living services to the elderly, including independent living, assisted living, skilled nursing and home care services. By offering a variety of services and encouraging the active participation of the resident and the resident's family and medical consultants, the Company is able to customize its service plan to meet the specific needs and desires of each resident. As a result, the Company believes that it is able to maximize customer satisfaction and avoid the high cost of delivering unnecessary services to residents.

The Company's operating philosophy is to provide affordable, quality living communities and services to senior citizens and deliver a continuum of care for its residents as their needs change over time. This continuum of care, which integrates independent living and assisted living and is bridged by home care, sustains residents' autonomy and independence based on their physical and mental abilities. As residents age, in many of the Company's communities, they are able to obtain the additional needed services within the same community, avoiding the disruptive and often traumatic move to a different facility.

### ***Independent Living Services***

The Company provides independent living services to seniors who typically do not yet need assistance or support with ADLs, but who prefer the physical and psychological comfort of a residential community that offers health care and other services. As of December 31, 2005, the Company had ownership interests in 32 communities, leased seven communities and managed 10 communities that provide independent living services, with an aggregate capacity for 7,560 residents.

Independent living services provided by the Company include daily meals, transportation, social and recreational activities, laundry, housekeeping, 24-hour staffing and health care monitoring. The Company also fosters the wellness of its residents by offering health screenings (such as blood pressure checks), periodic special services (such as influenza inoculations), dietary and similar programs, as well as ongoing exercise and fitness classes. Classes are given by health care professionals to keep residents informed about health and disease management. Subject to applicable government regulation, personal care and medical services are available to independent living residents through either the community staff or through the Company's agency or other independent home care agencies. The Company's independent living residents pay a fee ranging from \$975 to \$4,330 per month, in general, depending on the specific community, program of services, size of the unit and amenities offered. The Company's contracts with its independent living residents are generally for a term of one year and are typically terminable by the resident upon 30 days notice.

### *Assisted Living Services*

The Company offers a wide range of assisted living care and services, including personal care services, 24 hour staffing, support services, and supplemental services. As of December 31, 2005, the Company had ownership interests in 11 communities, leased three communities and managed six communities that provide assisted living services, which include communities that have independent living and other services, with an aggregate capacity for 1,185 residents. The residents of the Company's assisted living residences generally need help with some or all ADLs, but do not require the more acute medical care traditionally given in nursing homes. Upon admission to the Company's assisted living communities, and in consultation with the resident, the resident's family and medical consultants, each resident is assessed to determine his or her health status, including functional abilities and need for personal care services. The resident also completes a lifestyles assessment to determine the resident's preferences. From these assessments, a care plan is developed for each resident to ensure that all staff members who render care meet the specific needs and preferences of each resident where possible. Each resident's care plan is reviewed periodically to determine when a change in care is needed.

The Company has adopted a philosophy of assisted living care that allows a resident to maintain a dignified independent lifestyle. Residents and their families are encouraged to be partners in the residents' care and to take as much responsibility for their well being as possible. The basic types of assisted living services offered by the Company include the following:

*Personal Care Services.* These services include assistance with ADLs such as ambulation, bathing, dressing, eating, grooming, personal hygiene, and monitoring or assistance with medications.

*Support Services.* These services include meals, assistance with social and recreational activities, laundry services, general housekeeping, maintenance services and transportation services.

*Supplemental Services.* These services include extra transportation services, personal maintenance, extra laundry services, and special care services, such as services for residents with certain forms of dementia. Certain of these services require an extra charge in addition to the pricing levels described below.

In pricing its services, the Company has developed the following three levels or tiers of assisted living care:

- Level I typically provides for minimum levels of care and service, for which the Company generally charges a monthly fee per resident ranging from \$1,495 to \$5,390, depending upon unit size and the project design type. Typically, Level I residents need minimal assistance with ADLs.
- Level II provides for relatively higher levels and increased frequency of care, for which the Company generally charges a monthly fee per resident ranging from \$2,095 to \$5,690, depending upon the unit size and the project design type. Typically, Level II residents require moderate assistance with ADLs and may need additional personal care, support and supplemental services.

- Level III provides for the highest level of care and service, for which the Company generally charges a monthly fee per resident ranging from \$2,395 to \$6,390, depending upon the unit size and the project design type. Typically, Level III residents are either very frail or impaired and utilize many of the Company's services on a regular basis.

The Company maintains programs and special units at some of its assisted living communities for residents with certain forms of dementia, which provide the attention, care and services needed to help those residents maintain a higher quality of life. Specialized services include assistance with ADLs, behavior management and life skills based activities programs, the goal of which is to provide a normalized environment that supports residents' remaining functional abilities. Whenever possible, residents assist with meals, laundry and housekeeping. Special units for residents with certain forms of dementia are located in a separate area of the community and have their own dining facilities, resident lounge areas, and specially trained staff. The special care areas are designed to allow residents the freedom to ambulate as they wish, while keeping them safely contained within a secure area with a minimum of disruption to other residents. Special nutritional programs are used to help ensure caloric intake is maintained by residents. Resident fees for these special units are dependent on the size of the unit, the design type and the level of services provided.

### *Skilled Nursing Services*

In its skilled nursing facilities, the Company provides traditional long-term care through 24-hour-per-day skilled nursing care by registered nurses, licensed practical nurses and certified nursing assistants. The Company also offers a comprehensive range of restorative nursing and rehabilitation services in its communities including, but not limited to, physical, occupational, speech and medical social services. As of December 31, 2005, the Company had ownership interests in two facilities providing a continuum of care that includes nursing services with an aggregate capacity for 170 residents.

### *Home Care Services*

As of December 31, 2005, the Company provided home care services to clients at one senior living community through the Company's home care agency and made home care services available to clients at a majority of its senior living communities through third-party providers. The Company believes that the provision of private pay, home care services is an attractive adjunct to its independent living services because it allows the Company to provide more services to its residents as they age in place and increases the length of stay in the Company's communities. In addition, the Company makes available to residents certain customized physician, dentistry, podiatry and other health-related services that may be offered by third-party providers.

### **Operating Communities**

The table below sets forth certain information with respect to senior living communities owned and managed by the Company as of December 31, 2005.

<u>Community</u>	<u>Units</u>	<u>Resident Capacity(1)</u>				<u>Ownership(2)</u>	<u>Commencement of Operations(3)</u>	
		<u>IL</u>	<u>AL</u>	<u>SN</u>	<u>Total</u>			
<b>Owned:</b>								
Canton Regency . . .	Canton, OH	291	164	96	50	310	100%	03/91
Crosswood Oaks . . .	Sacramento, CA	121	127	—	—	127	100%	01/92
Gramercy Hill . . . .	Lincoln, NE	148	83	77	—	160	100%	10/98
Heatherwood . . . . .	Detroit, MI	158	188	—	—	188	100%	01/92
Independence Village . . . . .	East Lansing, MI	151	162	—	—	162	100%	08/00
Independence Village . . . . .	Peoria, IL	158	173	—	—	173	100%	08/00
Independence Village . . . . .	Raleigh, NC	165	177	—	—	177	100%	08/00

Community	Units	Resident Capacity(1)				Ownership(2)	Commencement of Operations(3)		
		IL	AL	SN	Total				
Independence Village . . . . .	Winston-Salem, NC	156	161	—	—	161	100%	08/00	
Sedgwick Plaza . . .	Wichita, KS	144	134	35	—	169	100%	08/00	
Tesson Heights . . . .	St. Louis, MO	184	140	58	—	198	100%	10/98	
Towne Centre . . . . .	Merrillville, IN	327	165	60	120	345	100%	03/91	
Veranda Club . . . . .	Boca Raton, FL	189	235	—	—	235	100%	01/92	
Waterford at Columbia . . . . .	Columbia, SC	120	136	—	—	136	100%	11/00	
Waterford at Deer Park . . . . .	Deer Park, TX	120	136	—	—	136	100%	11/00	
Waterford at Edison Lakes . . .	South Bend, IN	120	136	—	—	136	100%	12/00	
Waterford at Fairfield . . . . .	Fairfield, OH	120	136	—	—	136	100%	11/00	
Waterford at Fort Worth . . . . .	Fort Worth, TX	151	174	—	—	174	100%	06/00	
Waterford at Highland Colony	Jackson, MS	120	136	—	—	136	100%	11/00	
Waterford at Huebner . . . . .	San Antonio, TX	120	136	—	—	136	100%	04/99	
Waterford at Ironbridge . . . . .	Springfield, MO	119	136	—	—	136	100%	06/01	
Waterford at Mansfield . . . . .	Mansfield, OH	119	136	—	—	136	100%	10/00	
Waterford at Mesquite . . . . .	Mesquite, TX	154	174	—	—	174	100%	09/99	
Waterford at Pantego . . . . .	Pantego, TX	120	136	—	—	136	100%	12/00	
Waterford at Plano	Plano, TX	136	111	45	—	156	100%	12/00	
Waterford at Shreveport . . . . .	Shreveport, LA	117	136	—	—	136	100%	03/99	
Waterford at Thousand Oaks . .	San Antonio, TX	120	136	—	—	136	100%	05/00	
Wellington at Arapaho . . . . .	Richardson, TX	137	109	45	—	154	100%	05/02	
Wellington at North Richland Hills, TX . . . . .	North Richland Hills, TX	119	136	—	—	136	100%	01/02	
Wellington at Oklahoma City . .	Oklahoma City, OK	120	136	—	—	136	100%	11/00	
		4,324	4,245	416	170	4,831			
<b>Leased:</b>									
Amberleigh . . . . .	Buffalo, NY	267	394	—	—	394	N/A	01/92	
Cottonwood Village . . . . .	Cottonwood, AZ	163	135	47	—	182	N/A	03/91	
Crown Pointe . . .	Omaha, NE	132	163	—	—	163	N/A	08/00	
Georgetowne Place . . . . .	Fort Wayne, IN	162	247	—	—	247	N/A	10/05	
Harrison at Eagle Valley(4) . . . . .	Indianapolis, IN	124	138	—	—	138	N/A	03/91	

Community	Units	Resident Capacity(1)				Ownership(2)	Commencement of Operations(3)
		IL	AL	SN	Total		
Villa							
Santa Barbara Santa Barbara, CA	125	87	38	—	125	N/A	08/00
West Shores . . . . Hot Springs, AR	<u>137</u>	<u>135</u>	<u>32</u>	<u>—</u>	<u>167</u>	N/A	08/00
	1,110	1,299	117	—	1,416		
<b>Affiliates:</b>							
SHPII/CSL:							
Libertyville . . . . . Libertyville, IL	197	171	50	—	221	5%	03/01
Naperville . . . . . Naperville, IL	193	166	48	—	214	5%	01/01
Summit . . . . . Summit, NJ	88	—	98	—	98	5%	11/00
Trumbull . . . . . Trumbull, CT	<u>150</u>	<u>117</u>	<u>48</u>	<u>—</u>	<u>165</u>	5%	09/00
	628	454	244	—	698		
<b>Managed:</b>							
Atrium of Carmichael . . . Sacramento, CA	152	156	—	—	156	N/A	01/92
Covenant Place of Burleson . . . Burleson, TX	74	—	80	—	80	N/A	08/04
Covenant Place of Waxahachie Waxahachie, TX	50	—	55	—	55	N/A	08/04
Covenant Place of Abilene . . . Abilene, TX	50	—	55	—	55	N/A	08/04
Crescent Point . . Cedar Hill, TX	112	134	—	—	134	N/A	08/04
Good Place . . . . Hills, TX	72	—	80	—	80	N/A	08/04
Harding Place . . . Searcy, AR	115	148	—	—	148	N/A	08/04
Meadow Lakes . . Hills, TX	120	145	—	—	145	N/A	08/04
Meadow View . . . Arlington, TX	80	—	80	—	80	N/A	08/04
Mountain Creek Grand Prairie, TX	124	146	—	—	146	N/A	08/04
Saint Ann . . . . . Oklahoma City, OK	170	147	58	—	205	N/A	08/04
Southern Plaza . . Bethany, OK	115	145	—	—	145	N/A	08/04
Sunnybrook Estates . . . . . Madison, MS	108	133	—	—	133	N/A	08/04
Tealridge Manor Edmond, OK	169	208	—	—	208	N/A	08/04
The Arbrook . . . . Arlington, TX	<u>177</u>	<u>200</u>	<u>—</u>	<u>—</u>	<u>200</u>	N/A	08/04
	<u>1,688</u>	<u>1,562</u>	<u>408</u>	<u>—</u>	<u>1,970</u>		
	<u>7,750</u>	<u>7,560</u>	<u>1,185</u>	<u>170</u>	<u>8,915</u>		

- (1) Independent living (IL) residences, assisted living (AL) residences and skilled nursing (SN) beds.
- (2) Those communities shown as 5% owned consist of the Company's ownership of 5% of the member interests in the SHPII/CSL (as defined below).
- (3) Indicates the date on which the Company acquired or commenced operating the community. The Company operated certain of its communities pursuant to management agreements prior to acquiring interests in the communities.
- (4) The Company's home care agency is on-site at The Harrison at Eagle Valley community.



### *Third-Party Management Contracts*

Effective February 1, 2006, the Company entered into a series of property management agreements (the “Midwest Agreements”) to manage four communities acquired by Midwest Portfolio Holding, Inc. (“Midwest”), a joint venture owned approximately 89% by GE Healthcare and approximately 11% by the Company. The Midwest Agreements are for an initial term of five years and the agreements contain automatic one year renewals thereafter. The Midwest Agreements generally provide for a management fee of 5% of gross revenues.

Effective August 18, 2004, the Company acquired from the Covenant Group of Texas (“Covenant”) all of the outstanding stock of Covenant’s wholly owned subsidiary, CGI Management, Inc. (“CGIM”). This acquisition resulted in the Company assuming the management contracts (the “CGIM Management Agreements”) on 14 senior living communities with a combined resident capacity of approximately 1,800 residents. The CGIM Management Agreements expire on various dates through August 2019. The CGIM Management Agreements generally provide for management fees of 5% to 5.5% of gross revenues, subject to certain base management fees. The Company earned \$1.4 million under the terms of the CGIM Management Agreements for the year ended December 31, 2005. In addition, the Company has the right to acquire seven of the properties owned by Covenant (which are part of the 14 communities managed by CGIM) based on sales prices specified in the stock purchase agreement. In the first quarter of fiscal 2006, the Company exercised its right to acquire the seven communities owned by Covenant and the Company plans to sell six of the communities to HCPI in a sale/leaseback transaction. The Company is marketing the seventh community and intends to complete a sale as soon as possible.

The Company is party to a property management agreement (the “SHPII Management Agreement”), effective September 30, 2003, with Senior Housing Partners II, LP (“SHPII”), a fund managed by Prudential Real Estate Investors (“Prudential”), to manage one senior living community. The SHPII Management Agreement extends until June 2008 and provides for management fees of 5% of gross revenue plus reimbursement for costs and expenses related to the communities. The Company earned \$0.2 million under the terms of the SHP Management Agreement for the year ended December 31, 2005.

The Company entered into a series of property management agreements (the “SHPII/CSL Management Agreements”), effective November 30, 2004, with four joint ventures (collectively “SHPII/CSL”) owned 95% by SHPII and 5% by the Company, which collectively own and operate four senior living communities (collectively the “Spring Meadows Communities”). The SHPII/CSL Management Agreements extend until various dates through November 2014. The SHPII/CSL Management Agreements provide for management fees of 5% of gross revenue plus reimbursement for costs and expenses related to the communities. The Company earned \$1.0 million under the terms of the SHPII/CSL Management Agreements for the year ended December 31, 2005.

Prior to SHPII/CSL’s acquisition of the Spring Meadows Communities on November 30, 2004, the Company was party to a series of property management agreements (the “Spring Meadows Agreements”) with affiliates of Lehman Brothers (“Lehman”) to operate the Spring Meadows Communities, which were owned by joint ventures in which Lehman and the Company were members. Three Spring Meadows Agreements provided for a base management fee of the greater of \$15,000 per month or 5% of gross revenues, plus an incentive fee equal to 25% of the excess cash flow over budgeted amounts. The remaining Spring Meadows Agreement provided for a base management fee of the greater of \$13,321 per month or 5% of gross revenues, plus an incentive fee equal to 25% of the excess cash flow over budgeted amounts. In addition, the Company received an asset management fee of 0.75% of annual revenues relating to each of the four communities.

The Company was party to a series of property management agreements (the “BRE/CSL Management Agreements”) with three joint ventures (collectively “BRE/CSL”) owned 90% by an affiliate of Blackstone Real Estate Advisors (“Blackstone”) and 10% by the Company, which collectively owned and operated six senior living communities. The BRE/CSL Management Agreements provided for management fees of 5% of gross revenue plus reimbursement for costs and expenses related to the communities. The Company earned



\$0.9 million under the terms of the BRE/CSL Management Agreements for the year ended December 31, 2005. These six communities were sold in September 2005 and leased back by the Company.

The Company was party to a series of property management agreements (the “Triad I Management Agreements”) pursuant to arrangements with Triad Senior Living I, LP (“Triad I”), a partnership affiliated with Lehman, which collectively owned and operated five senior living communities and two expansions. The Company had an approximate 1% limited partnership interest in Triad I. The Triad I Management Agreements provided for a base management fee of the greater of \$5,000 per month or 5% of gross revenue plus reimbursement for costs and expenses related to the communities. Under the provisions of FASB Interpretation No. 46, Triad I operations were consolidated with the Company’s operations from January 1, 2004 through November 30, 2004. Effective as of November 30, 2004, the Company acquired the partnership interests of Triad I that it did not already own and effective with these transactions the Company wholly owns Triad I.

During the first six months of fiscal 2003, the Company was party to a series of property management agreements (the “Triad Entities Agreements”) with four partnerships (Triad Senior Living II, L.P., Triad Senior Living III, L.P., Triad Senior Living IV, L.P. and Triad Senior Living V, L.P., collectively the “Triad Entities”) affiliated with Triad Senior Living, Inc., which collectively owned and operated 12 senior living communities. The Company had an approximate 1% limited partnership interest in each of the Triad Entities. The Triad Entities Management Agreements provided for a base management fee of the greater of \$5,000 per month or 5% of gross revenue plus reimbursement for costs and expenses related to the communities. Effective as of July 1, 2003, the Company acquired the partnership interests of the Triad Entities that it did not already own and effective with these transactions the Company wholly owns each of the Triad Entities.

The Company was party to a property management agreement (the “Buckner Agreement”) with Buckner Retirement Services, Inc. (“Buckner”), a not-for-profit corporation. The Company and Buckner entered into a Management Termination, Consulting, Licensing and Transfer Agreement (the “Calderwoods Termination Agreement”) effective September 30, 2001 whereby the Company and Buckner mutually agreed to terminate the Management Agreement then in place between the parties. Under the terms of the Calderwoods Termination Agreement, the Company continued to provide certain consulting services and earn a consulting/licensing fee of 3.5% of the facility’s gross revenues through December 31, 2001 and 3.0% of the facility’s gross revenues beginning on January 1, 2002 and continuing through May 31, 2005. In the first quarter of fiscal 2003, the Company and Buckner entered into an agreement whereby Buckner paid the Company \$0.3 million to terminate Buckner’s future consulting/licensing fee obligations under the Calderwoods Termination Agreement.

## **Growth Strategies**

The Company believes that the fragmented nature of the senior living industry and the limited capital resources available to many small, private operators provide an attractive opportunity for the Company to expand its existing base of senior living operations. The Company believes that its current operations throughout the United States serve as the foundation on which the Company can build senior living networks in targeted geographic markets and thereby provide a broad range of high quality care in a cost-efficient manner.

The following are the principal elements of the Company’s growth strategy:

### ***Organic Growth***

The Company intends to continue to focus on the lease-up of its non-stabilized communities and to improve its occupancy and operating margins of its stabilized communities. The Company continually seeks to maintain and improve occupancy rates by: (i) retaining residents as they “age in place” by extending optional care and service programs; (ii) attracting new residents through the on-site marketing programs focused on residents and family members; (iii) aggressively seeking referrals from professional community outreach sources, including area religious organizations, senior social service programs, civic and business networks, as well as the medical community; and (iv) continually refurbishing and renovating its communities.

### ***Pursue Strategic Acquisitions***

The Company intends to continue to pursue single or portfolio acquisitions of senior living communities. Through strategic acquisitions, joint venture investments, or facility leases, the Company seeks to enter new markets or acquire communities in existing markets as a means to increase market share, augment existing clusters, strengthen its ability to provide a broad range of care, and create operating efficiencies. As the industry continues to consolidate, the Company believes that opportunities will arise to acquire other senior living companies. The Company believes that the current fragmented nature of the senior living industry, combined with the Company's financial resources, national presence, and extensive contacts within the industry, can be expected to provide it with the opportunity to evaluate a number of potential acquisition opportunities in the future. In reviewing acquisition opportunities, the Company will consider, among other things, geographic location, competitive climate, reputation and quality of management and communities, and the need for renovation or improvement of the communities.

### ***Pursue Management Agreements***

The Company intends to pursue single or portfolio management opportunities for senior living communities. The Company believes that its management infrastructure and proven operating track record will allow the Company to take advantage of increased opportunities in the senior living market for new management contracts and other transactions.

### ***Pursue Development Agreements for New Senior Living Communities for Third Parties***

Since 1999 the Company has developed and opened 17 new senior living communities and expanded two communities for third parties. In addition, the Company has provided pre-opening marketing services for six communities owned by third parties. The Company intends to continue to pursue opportunities to provide third parties development and marketing services.

### ***Expand Referral Networks***

The Company intends to continue to develop relationships with local and regional hospital systems, managed care organizations and other referral sources to attract new residents to the Company's communities. In certain circumstances these relationships may involve strategic alliances or joint ventures. The Company believes that such arrangements or alliances, which could range from joint marketing arrangements to priority transfer agreements, will enable it to be strategically positioned within the Company's markets if, as the Company believes, senior living programs become an integral part of the evolving health care delivery system.

## **Operations**

### ***Centralized Management***

The Company centralizes its corporate and other administrative functions so that the community-based management and staff can focus their efforts on resident care. The Company maintains centralized accounting, finance, human resources, training and other operational functions at its national corporate office in Dallas, Texas. The Company also has a corporate office in New York, New York. The Company's corporate offices are generally responsible for: (i) establishing Company-wide policies and procedures relating to, among other things, resident care and operations; (ii) performing accounting functions; (iii) developing employee training programs and materials; (iv) coordinating human resources; (v) coordinating marketing functions; and (vi) providing strategic direction. In addition, financing, development, construction and acquisition activities, including feasibility and market studies, and community design, development, and construction management are conducted by the Company's corporate offices.

The Company seeks to control operational expenses for each of its communities through standardized management reporting and centralized controls of capital expenditures, asset replacement tracking, and purchasing for larger and more frequently used supplies. Community expenditures are monitored by regional

and district managers who are accountable for the resident satisfaction and financial performance of the communities in their region.

### ***Regional Management***

The Company provides oversight and support to each of its senior living communities through experienced regional and district managers. A district manager will oversee the marketing and operations of three to six communities clustered in a small geographic area. A regional manager will cover a larger geographic area consisting of seven to twelve communities. In most cases, the district and regional managers will office out of the Company's senior living communities. Currently there are regional managers based in the Northeast, Central Plains, Midwest, Southwest and West regions.

The executive director at each community reports to a regional or district manager. The regional and district managers report directly to the President and Chief Operating Officer of the Company. The district and regional managers make regular site visits to each of their communities. The site visits involve a physical plant inspection, quality assurance review, staff training, financial and systems audits, regulatory compliance, and team building.

### ***Community-Based Management***

An executive director manages the day-to-day operations at each senior living community, including oversight of the quality of care, delivery of resident services, and monitoring of financial performance. The executive director is also responsible for all personnel, including food service, maintenance, activities, security, assisted living, housekeeping, and, where applicable, nursing. In most cases, each community also has department managers who direct the environmental services, nursing or care services, business management functions, dining services, activities, transportation, housekeeping, and marketing functions.

The assisted living and skilled nursing components of the senior living communities are managed by licensed professionals, such as a nurse and/or a licensed administrator. These licensed professionals have many of the same operational responsibilities as the Company's executive directors, but their primary responsibility is to oversee resident care. Many of the Company's senior living communities and all of its skilled nursing facilities are part of a campus setting, which include independent living. This campus arrangement allows for cross-utilization of certain support personnel and services, including administrative functions that result in greater operational efficiencies and lower costs than freestanding facilities.

The Company actively recruits personnel to maintain adequate staffing levels at its existing communities and hires new staff for new or acquired communities prior to opening. The Company has adopted comprehensive recruiting and screening programs for management positions that utilize corporate office team interviews and thorough background and reference checks. The Company offers system-wide training and orientation for all of its employees at the community level through a combination of Company-sponsored seminars and conferences.

### ***Quality Assurance***

Quality assurance programs are coordinated and implemented by the Company's corporate and regional staff. The Company's quality assurance is targeted to achieve maximum resident and resident family member satisfaction with the care and services delivered by the Company. The Company's primary focus in quality control monitoring includes routine in-service training and performance evaluations of caregivers and other support employees. Additional quality assurance measures include:

*Resident and Resident's Family Input.* On a routine basis the Company provides residents and their family members the opportunity to provide valuable input regarding the day-to-day delivery of services. On-site management at each community has fostered and encouraged active resident councils and resident committees who meet independently. These resident bodies meet with on-site management on a monthly basis to offer input and suggestions as to the quality and delivery of services. Additionally, at each community the Company conducts annual resident satisfaction surveys to further monitor the satisfaction levels of both

residents and their family members. These surveys are sent directly to the corporate headquarters for tabulation and distribution to on-site staff and residents. For 2005 and 2004, the Company achieved a 94% and a 95%, respectively, approval rating from its residents. For any departmental area of service scoring below a 90%, a plan of correction is developed jointly by on-site, regional and corporate staff for immediate implementation.

*Regular Community Inspections.* Each community is inspected, on at least a quarterly basis, by regional and/or corporate staff. Included as part of this inspection is the monitoring of the overall appearance and maintenance of the community interiors and grounds. The inspection also includes monitoring staff professionalism and departmental reviews of maintenance, housekeeping, activities, transportation, marketing, administration and food and health care services, if applicable. The inspections also include observing of residents in their daily activities and the community's compliance with government regulations.

*Independent Service Evaluations.* The Company engages the services of outside professional independent consulting firms to evaluate various components of the community operations. These services include mystery shops, competing community analysis, pricing recommendations and product positioning. This provides management with valuable unbiased product and service information. A plan of action regarding any areas requiring improvement or change is implemented based on information received. At communities where health care is delivered, these consulting service reviews include the on-site handling of medications, record keeping and general compliance with all governmental regulations.

### **Marketing**

Each community is staffed by on-site sales directors and additional marketing/sales staff depending on the community size and occupancy status. The primary focus of the on-site marketing staff is to create awareness of the Company and its services among prospective residents and family members, professional referral sources and other key decision makers. These efforts incorporate an aggressive marketing plan to include monthly, quarterly and annual goals for leasing, new lead generation, prospect follow up, community outreach and resident and family referrals. Additionally, the marketing plan includes a calendar of promotional events and a comprehensive media program. On-site marketing departments perform a competing community assessment quarterly. Corporate and regional marketing directors monitor the on-site marketing departments' effectiveness and productivity on a monthly basis. Routine detailed marketing department audits are performed on an annual basis or more frequently if deemed necessary. Corporate and regional personnel assist in the development of marketing strategies for each community and produce creative media, assist in direct mail programs and necessary marketing collateral. Ongoing sales training of on-site marketing/sales staff is implemented by corporate and regional marketing directors.

In the case of new development, the corporate and regional staff develops a comprehensive community outreach program that is implemented at the start of construction. A marketing pre-lease program is developed and on-site marketing staff are hired and trained to begin the program implementation six to nine months prior to the community opening. Extensive use of media, including radio, television, print, direct mail and telemarketing, is implemented during this pre-lease phase.

After the community is opened and sustaining occupancy levels are attained, the on-site marketing staff is more heavily focused on resident and resident family referrals, as well as professional referrals. A maintenance program of print media and direct mail is then implemented.

### **Government Regulation**

Changes in existing laws and regulations, adoption of new laws and regulations and new interpretations of existing laws and regulations could have a material effect on the Company's operations. Failure by the Company to comply with applicable regulatory requirements could have a material adverse effect on the Company's business, financial condition, and results of operations. Accordingly, the Company monitors legal and regulatory developments on local and national levels.

The health care industry is subject to extensive regulation and frequent regulatory change. At this time, no federal laws or regulations specifically regulate assisted or independent living residences. While a number of states have not yet enacted specific assisted living regulations, certain of the Company's assisted living communities are subject to regulation, licensing, CON and permitting by state and local health care and social service agencies and other regulatory authorities. While such requirements vary from state to state, they typically relate to staffing, physical design, required services and resident characteristics. The Company believes that such regulation will increase in the future. In addition, health care providers are receiving increased scrutiny under anti-trust laws as integration and consolidation of health care delivery increases and affects competition. The Company's communities are also subject to various zoning restrictions, local building codes, and other ordinances, such as fire safety codes. Failure by the Company to comply with applicable regulatory requirements could have a material adverse effect on the Company's business, financial condition, and results of operations. Regulation of the assisted living industry is evolving. The Company is unable to predict the content of new regulations and their effect on its business. There can be no assurance that the Company's operations will not be adversely affected by regulatory developments.

The Company believes that its communities are in substantial compliance with applicable regulatory requirements. However, in the ordinary course of business, one or more of the Company's communities could be cited for deficiencies. In such cases, the appropriate corrective action would be taken. To the Company's knowledge, no material regulatory actions are currently pending with respect to any of the Company's communities.

Under the Americans with Disabilities Act of 1990, all places of public accommodation are required to meet certain federal requirements related to access and use by disabled persons. A number of additional federal, state and local laws exist that also may require modifications to existing and planned properties to permit access to the properties by disabled persons. While the Company believes that its communities are substantially in compliance with present requirements or are exempt therefrom, if required changes involve a greater expenditure than anticipated or must be made on a more accelerated basis than anticipated, additional costs would be incurred by the Company. Further legislation may impose additional burdens or restrictions with respect to access by disabled persons, the costs of compliance with which could be substantial.

The Health Insurance Portability and Accountability Act of 1996 ("HIPAA"), in conjunction with the federal regulations promulgated thereunder by the Department of Health and Human Services, has established, among other requirements, standards governing the privacy of certain protected and individually identifiable health information ("PHI") that is created, received or maintained by a range of covered entities. HIPAA has also established standards governing uniform health care transactions, the codes and identifiers to be used by the covered entities and standards governing the security of certain electronic transactions conducted by covered entities will go into effect. Penalties for violations can range from civil money penalties for errors and negligent acts to criminal fines and imprisonment for knowing and intentional misconduct. HIPAA is a complex set of regulations and many unanswered questions remain with respect to the manner in which HIPAA applies to businesses such as those operated by the Company.

In addition, the Company is subject to various federal, state and local environmental laws and regulations. Such laws and regulations often impose liability whether or not the owner or operator knew of, or was responsible for, the presence of hazardous or toxic substances. The costs of any required remediation or removal of these substances could be substantial and the liability of an owner or operator as to any property is generally not limited under such laws and regulations and could exceed the property's value and the aggregate assets of the owner or operator. The presence of these substances or failure to remediate such contamination properly may also adversely affect the owner's ability to sell or rent the property, or to borrow using the property as collateral. Under these laws and regulations, an owner, operator or an entity that arranges for the disposal of hazardous or toxic substances, such as asbestos-containing materials, at a disposal site may also be liable for the costs of any required remediation or removal of the hazardous or toxic substances at the disposal site. In connection with the ownership or operation of its properties, the Company could be liable for these costs, as well as certain other costs, including governmental fines and injuries to persons or properties. The Company has completed Phase I environmental audits of substantially all of the communities in which the



Company owns interests, typically at the time of acquisition, and such audits have not revealed any material environmental liabilities that exist with respect to these communities.

Under various federal, state and local environmental laws, ordinances and regulations, a current or previous owner or operator of real estate may be required to investigate and clean up hazardous or toxic substances or petroleum product releases at such property, and may be held liable to a governmental entity or to third parties for property damage and for investigation and clean up costs. The Company is not aware of any environmental liability with respect to any of its owned, leased or managed communities that the Company believes would have a material adverse effect on its business, financial condition, or results of operations. The Company believes that its communities are in compliance in all material respects with all federal, state and local laws, ordinances and regulations regarding hazardous or toxic substances or petroleum products. The Company has not been notified by any governmental authority, and is not otherwise aware of any material non-compliance, liability, or claim relating to hazardous or toxic substances or petroleum products in connection with any of the communities the Company currently operates.

The Company believes that the structure and composition of government and, specifically, health care regulations will continue to change and, as a result, regularly monitors developments in the law. The Company expects to modify its agreements and operations from time to time as the business and regulatory environments change. While the Company believes it will be able to structure all its agreements and operations in accordance with applicable law, there can be no assurance that its arrangements will not be successfully challenged.

## **Competition**

The senior living industry is highly competitive, and the Company expects that all segments of the industry will become increasingly competitive in the future. Although there are a number of substantial companies active in the senior living industry and in the markets in which the Company operates, the industry continues to be very fragmented and characterized by numerous small operators. The Company primarily competes with American Retirement Corporation, Brookdale Senior Living Inc., Emeritus Corporation, Five Star Quality Care, Inc., Holiday Retirement Corporation and Sunrise Senior Living, Inc. The Company believes that the primary competitive factors in the senior living industry are: (i) location; (ii) reputation for and commitment to a high quality of service; (iii) quality of support services offered (such as food services); (iv) price of services; and (v) physical appearance and amenities associated with the communities. The Company competes with other companies providing independent living, assisted living, skilled nursing, home health care, and other similar service and care alternatives, some of whom may have greater financial resources than the Company. Because seniors tend to choose senior living communities near their homes, the Company's principal competitors are other senior living and long-term care communities in the same geographic areas as the Company's communities. The Company also competes with other health care businesses with respect to attracting and retaining nurses, technicians, aides and other high quality professional and non-professional employees and managers.

## **Employees**

As of December 31, 2005, the Company employed 2,867 persons, of which 1,491 were full-time employees (52 of whom are located at the Company's corporate offices) and 1,376 were part-time employees. None of the Company's employees are currently represented by a labor union and the Company is not aware of any union organizing activity among its employees. The Company believes that its relationship with its employees is good.

## Executive Officers and Key Employees

The following table sets forth certain information concerning each of the Company's executive officers and key employees as of December 31, 2005:

<u>Name</u>	<u>Age</u>	<u>Position(s) with the Company</u>
Lawrence A. Cohen . . . . .	52	Chief Executive Officer and Vice Chairman of the Board
James A. Stroud . . . . .	55	Chairman and Secretary of the Company and Chairman of the Board
Keith N. Johannessen . . . . .	49	President and Chief Operating Officer
Ralph A. Beattie . . . . .	56	Executive Vice President and Chief Financial Officer
Rob L. Goodpaster . . . . .	52	Vice President — National Marketing
David W. Beathard, Sr. . . . .	58	Vice President — Operations
David R. Brickman . . . . .	47	Vice President and General Counsel
Glen H. Campbell . . . . .	61	Vice President — Development
Gloria Holland . . . . .	38	Vice President — Finance
Jerry D. Lee . . . . .	45	Corporate Controller
Robert F. Hollister . . . . .	50	Property Controller

*Lawrence A. Cohen* has served as a director and Vice Chairman of the Board since November 1996. He has served as Chief Executive Officer since May 1999 and was Chief Financial Officer from November 1996 to May 1999. From 1991 to 1996, Mr. Cohen served as President and Chief Executive Officer of Paine Webber Properties Incorporated, which controlled a real estate portfolio having a cost basis of approximately \$3.0 billion, including senior living facilities of approximately \$110.0 million. Mr. Cohen serves on the boards of various charitable organizations, and was a founding member and is on the executive committee of the Board of the American Seniors Housing Association. Mr. Cohen has earned a Masters in Law, is a licensed attorney and is also a Certified Public Accountant. Mr. Cohen has had positions with businesses involved in senior living for 21 years.

*James A. Stroud* has served as a director and officer of the Company and its predecessors since January 1986. He currently serves as Chairman and Secretary of the Company and Chairman of the Board. Mr. Stroud also serves on the boards of various educational and charitable organizations, and in varying capacities with several trade organizations, including as an Owner/Operator Advisory Group member to the National Investment Conference and as a Founding Sponsor of The Johns Hopkins University Senior Housing and Care Program. Mr. Stroud has served as a member of the Founder's Council and Leadership Council of the Assisted Living Federation of America. Mr. Stroud was the past President and Member of the board of directors of the National Association for Senior Living Industry Executives. He also was a founder of the Texas Assisted Living Association and served as a member of its board of directors. Mr. Stroud has earned a Masters in Law, is a licensed attorney and is also a Certified Public Accountant. Mr. Stroud has had positions with businesses involved in senior living for 21 years.

*Keith N. Johannessen* has served as President of the Company and its predecessors since March 1994, and previously served as Executive Vice President from May 1993 until February 1994. Mr. Johannessen has served as a director and Chief Operating Officer since May 1999. From 1992 to 1993, Mr. Johannessen served as Senior Manager in the health care practice of Ernst & Young. From 1987 to 1992, Mr. Johannessen was Executive Vice President of Oxford Retirement Services, Inc. Mr. Johannessen has served on the State of the Industry and Model Assisted Living Regulations Committees of the American Seniors Housing Association. Mr. Johannessen has been active in operational aspects of senior housing for 27 years.

*Ralph A. Beattie* joined the Company as Executive Vice President and Chief Financial Officer in May 1999. From 1997 to 1999, he served as Executive Vice President and the Chief Financial Officer of Universal Sports America, Inc., which was honored as the number one growth company in Dallas for 1998. For the eight



years prior to that he was Executive Vice President and Chief Financial Officer for Haggar Clothing Company, during which time Haggar successfully completed its initial public offering. Mr. Beattie has earned his Masters of Business Administration and is both a Certified Management Accountant and a Certified Financial Planner.

*Rob L. Goodpaster* has served as Vice President — National Marketing of the Company and its predecessors since December 1992. From 1990 to 1992, Mr. Goodpaster was National Director for Marketing for Autumn America, an owner and operator of senior housing facilities. Mr. Goodpaster has been active in professional industry associations and formerly served on the Board of Directors for the National Association for Senior Living Industries. Mr. Goodpaster has been active in the operational, development and marketing aspects of senior housing for 29 years.

*David W. Beathard, Sr.* has served as Vice President — Operations of the Company and its predecessors since August 1996. From 1992 to 1996, Mr. Beathard owned and operated a consulting firm, which provided operational, marketing, and feasibility consulting regarding senior housing facilities. Mr. Beathard has been active in the operational, sales and marketing, and construction oversight aspects of senior housing for 32 years.

*David R. Brickman* has served as Vice President and General Counsel of the Company and its predecessors since July 1992. From 1989 to 1992, Mr. Brickman served as in-house counsel with LifeCo Travel Management Company, a corporation that provided travel services to U.S. corporations. Mr. Brickman has also earned a Masters of Business Administration and a Masters in Health Administration. Mr. Brickman has either practiced law or performed in-house counsel functions for 19 years.

*Glen H. Campbell* has served as Vice President — Development of the Company since September 1997. From 1990 to 1997 Mr. Campbell served as Vice President of Development for Greenbrier Corporation, an assisted living development and management company. From 1985 to 1990 Mr. Campbell served as Director of Facility Management for Retirement Corporation of America. Mr. Campbell has been active in the design and development of retirement communities for 31 years.

*Gloria M. Holland* has served as Vice President — Finance since June 2004. From 2001 to 2004, Ms. Holland served as Assistant Treasurer and a corporate officer for Aurum Technology, Inc., a privately held company that provided technology and outsourcing to community banks. From 1996 to 2001, Ms. Holland held positions in Corporate Finance and Treasury at Brinker International, an owner and operator of casual dining restaurants. From 1989 to 1996, Ms. Holland was a Vice President in the Corporate Banking division of NationsBank and predecessor banks. Ms. Holland received a BBA in Finance from the University of Mississippi in 1989.

*Jerry D. Lee*, a Certified Public Accountant, has served as Corporate Controller since April 1999. Prior to joining the Company, Mr. Lee served as the Senior Vice President of Finance, from 1997 to 1999, for Universal Sports America, Inc., which produced sporting events and provided sports marketing services for collegiate conferences and universities. From 1984 to 1997, Mr. Lee held various accounting management positions with Haggar Clothing Company. Mr. Lee is a member of the Financial Executives International, the American Institute of Certified Public Accountants and is also a member of the Texas Society of Certified Public Accountants.

*Robert F. Hollister*, a Certified Public Accountant, has served as Property Controller for the Company and its predecessors since April 1992. From 1985 to 1992, Mr. Hollister was Chief Financial Officer and Controller of Kavanaugh Securities, Inc., a National Association of Securities Dealers broker dealer. Mr. Hollister is a member of the American Institute of Certified Public Accountants.

## **Subsidiaries**

Capital Senior Living Corporation is the parent company of several direct and indirect subsidiaries. Although Capital Senior Living Corporation and its subsidiaries are referred to for ease of reference in this Form 10-K as the Company, these subsidiaries are separately incorporated and maintain their legal existence separate and apart from the parent, Capital Senior Living Corporation.

## **New York Stock Exchange Certification**

In May 2005, as required in Section 303A.12(a) of the New York Stock Exchange Listed Company Manual, the Chief Executive Officer of the Company certified to the New York Stock Exchange that he was not aware of any violations by the Company of New York Stock Exchange corporate governance listing standards, except for the inadvertent omission in the Company's proxy statement last year of the procedure by which a presiding director is chosen for each regularly scheduled executive session of the Company's non-management directors, which the Company's corporate governance guidelines provide that the non-management directors shall choose at each executive session a director to preside. The certifications of the Chief Executive Officer and Chief Financial Officer required under Section 302 of the Sarbanes-Oxley Act have been filed as Exhibits 31.1 and 31.2 of this Form 10-K annual report.

## **ITEM 1A. RISK FACTORS**

The Company's business involves various risks. When evaluating the Company's business the following information should be carefully considered in conjunction with the other information contained in our periodic filings with the Securities and Exchange Commission. Additional risks and uncertainties not known to the Company currently or that currently the Company deems to be immaterial also may impair the Company's business operations. If the Company is unable to prevent events that have a negative effect from occurring, then the Company's business may suffer. Negative events are likely to decrease the Company's revenue, increase its costs, make its financial results poorer and/or decrease its financial strength, and may cause its stock price to decline.

***The Company has significant debt. The Company's failure to generate cash flow sufficient to cover required interest and principal payments could result in defaults of the related debt.***

As of December 31, 2005, the Company had mortgage and other indebtedness totaling approximately \$268.1 million. The Company cannot assure you that it will generate cash flow from operations or receive proceeds from refinancings, other financings or the sales of assets sufficient to cover required interest, principal and, if applicable, operating lease payments. Any payment or other default could cause the applicable lender to foreclose upon the communities securing the indebtedness or, if applicable, in the case of an operating lease, could terminate the lease, with a consequent loss of income and asset value to the Company. Further, because some of the Company's mortgages contain cross-default and cross-collateralization provisions, a payment or other default by the Company with respect to one community could affect a significant number of the Company's other communities.

***The Company's failure to comply with financial covenants contained in debt instruments could result in the acceleration of the related debt.***

There are various financial covenants and other restrictions in certain of the Company's debt instruments, including provisions which:

- require the Company to meet specified financial tests at the parent company level, which include, but are not limited to, liquidity requirements, earnings before interest, taxes and depreciation and amortization ("EBITDA") requirements, and tangible net worth requirements;
- require the Company to meet specified financial tests at the community level, which include, but are not limited to, occupancy requirements, debt service coverage tests, cash flow tests and net operating income requirements; and
- require consent for changes in control of the Company.

If the Company fails to comply with any of these requirements, then the related indebtedness could become due and payable prior to its stated maturity date. The Company cannot assure that it could pay this debt if it became due.

***The Company will require additional financing and/or refinancings in the future.***

The Company's ability to meet its long-term capital requirements, including the repayment of certain long-term debt obligations, will depend, in part, on its ability to obtain additional financing or refinancings on acceptable terms from available financing sources, including through the use of mortgage financing, joint venture arrangements, by accessing the debt and/or equity markets and possibly through operating leases or other types of financing, such as lines of credit. There can be no assurance that the financing or refinancings will be available or that, if available, it will be on terms acceptable to the Company. Moreover, raising additional funds through the issuance of equity securities could cause existing stockholders to experience dilution and could adversely affect the market price of the Company's common stock. The Company's inability to obtain additional financing or refinancings on terms acceptable to the Company could delay or eliminate some or all of the Company's growth plans, necessitate the sales of assets at unfavorable prices or both, and would have a material adverse effect on the Company's business, financial condition and results of operations.

***The Company's current floating rate debt, and any future floating rate debt, exposes it to rising interest rates.***

The Company currently has indebtedness with floating interest rates. Future indebtedness and, if applicable, lease obligations may be based on floating interest rates prevailing from time to time. Therefore, increases in prevailing interest rates would increase the Company's interest or lease payment obligations and could have a material adverse effect on the Company's business, financial condition and results of operations.

***The Company has significant operating lease obligations. The Company's failure to generate cash flows sufficient to cover these lease obligations could result in defaults under the lease agreements.***

As of December 31, 2005, the Company leases seven communities with lease obligations totaling approximately \$82.7 million over a 10 year period, with minimum lease obligations of \$8.9 million in fiscal 2006. The Company cannot assure you that it will generate cash flow from operations or receive proceeds from refinancings, other financings or the sales of assets sufficient to cover these required operating lease obligations. Any payment or other default under the Company's leases could result in the termination of the lease, with a consequent loss of income and asset value to the Company. Further, because all of the Company's leases contain cross-default provisions, a payment or other default by the Company with respect to one leased community could affect a significant number of the Company's other leased communities. Certain of the Company's leases contain various financial and other restrictive covenants, which could limit the Company's flexibility in operating its business. Failure to maintain compliance with the lease obligations as set forth in the Company's lease agreements could have a material adverse impact on the Company.

***The Company cannot assure that it will be able to effectively manage its growth.***

The Company intends to expand its operations, directly or indirectly, through the acquisition of new senior living communities, the expansion of some of its existing senior living communities and through the increase in the number of communities which it manages under management agreements. The success of the Company's growth strategy will depend, in large part, on its ability to implement these plans and to effectively operate these communities. If the Company is unable to manage its growth effectively, its business, results of operations and financial condition may be adversely affected.

***The Company cannot assure that it will be able to acquire additional senior living communities or expand existing senior living communities.***

The acquisition of existing communities or other businesses involves a number of risks. Existing communities available for acquisition frequently serve or target different markets than those presently served by the Company. The Company may also determine that renovations of acquired communities and changes in staff and operating management personnel are necessary to successfully integrate those communities or businesses into its existing operations. The costs incurred to reposition or renovate newly acquired communi-

ties may not be recovered by the Company. In undertaking acquisitions, the Company also may be adversely impacted by unforeseen liabilities attributable to the prior operators of those communities or businesses, against whom it may have little or no recourse. The success of the Company's acquisition strategy will be determined by numerous factors, including its ability to identify suitable acquisition candidates; the competition for those acquisitions; the purchase price; the requirement to make operational or structural changes and improvements; the financial performance of the communities or businesses after acquisition; its ability to finance the acquisitions; and its ability to integrate effectively any acquired communities or businesses into its management, information, and operating systems. The Company cannot assure that its acquisition of senior living communities or other businesses will be completed at the rate currently expected, if at all, or if completed, that any acquired communities or businesses will be successfully integrated into its operations.

The Company's ability to successfully expand existing senior living communities will depend on a number of factors, including, but not limited to, its ability to acquire suitable sites for expansion at reasonable prices; its success in obtaining necessary zoning, licensing, and other required governmental permits and authorizations; and its ability to control construction costs and accurately project completion schedules. Additionally, the Company anticipates that the expansion of existing senior living communities may involve a substantial commitment of capital for a period of time of two years or more until the expansions are operating and producing revenue, the consequence of which could be an adverse impact on its liquidity. The Company cannot assure that its expansion of existing senior living communities will be completed at the rate currently expected, if at all, or if completed, that such expansions will be profitable.

***Termination of resident agreements and resident attrition could affect adversely the Company's revenues and earnings.***

State regulations governing assisted living facilities require written resident agreements with each resident. Most of these regulations also require that each resident have the right to terminate the resident agreement for any reason on reasonable notice. Consistent with these regulations, the resident agreements signed by the Company allow residents to terminate their agreement on 30 days' notice. Thus, the Company cannot contract with residents to stay for longer periods of time, unlike typical apartment leasing arrangements that involve lease agreements with specified leasing periods of up to a year or longer. If a large number of residents elected to terminate their resident agreements at or around the same time, then the Company's revenues and earnings could be adversely affected. In addition, the advanced age of the Company's average resident means that the resident turnover rate in the Company's senior living facilities may be difficult to predict.

***The Company largely relies on private pay residents. Circumstances that adversely effect the ability of the elderly to pay for the Company's services could have a material adverse effect on the Company.***

Approximately 95% of the Company's total revenues from communities that it owned and managed for each of the years ended December 31, 2005 and 2004 were attributable to private pay sources. For each of the same periods, approximately 5% of the Company's revenues from these communities were attributable to reimbursements from Medicare and Medicaid. The Company expects to continue to rely primarily on the ability of residents to pay for the Company's services from their own or familial financial resources. Inflation or other circumstances that adversely affect the ability of the elderly to pay for the Company's services could have a material adverse effect on the Company's business, financial condition and results of operations.

***The Company is subject to some particular risks related to third-party management agreements.***

The Company currently manages 15 senior living communities for third parties and eight senior living communities for joint ventures in which it has a minority interest pursuant to multi-year management agreements. The management agreements generally have initial terms of between five and fifteen years, subject to certain renewal rights. Under these agreements the Company provides management services to third party and joint venture owners to operate senior living communities and has provided, and may in the future provide, management and consulting services to third parties on market and site selection, pre-opening

sales and marketing, start-up training and management services for facilities under development and construction. In most cases, either party to the agreements may terminate them upon the occurrence of an event of default caused by the other party. In addition, subject to the Company's rights to cure deficiencies, community owners may terminate the Company as manager if any licenses or certificates necessary for operation are revoked, or if the Company has a change of control. Also, in some instances, a community owner may terminate the management agreement relating to a particular community if the Company is in default under other management agreements relating to other communities owned by the same community owner or its affiliates. In addition, in certain cases the community owner may terminate the agreement upon 30 days' notice to the Company in the event of a sale of the community. In those agreements, which are terminable in the event of a sale of the community, the Company has certain rights to offer to purchase the community. The termination of a significant portion of the Company's management agreements could have a material adverse effect on its business, financial condition and results of operations.

***Performance of the Company's obligations under its joint venture arrangements could have a material adverse effect on the Company.***

The Company holds minority interests ranging from approximately 5% to 11% in several joint ventures with affiliates of Prudential and GE Healthcare. The Company also manages the communities owned by these joint ventures. Under the terms of the joint venture agreements with Prudential covering four properties, the Company is obligated to meet certain cash flow targets and failure to meet these cash flow targets could result in termination of the management agreements. Under the terms of the joint venture agreements with GE Healthcare covering four properties, the Company is obligated to meet certain net operating income targets and failure to meet these net operating income targets could result in termination of the management agreements. All of the management agreements with the joint ventures contain termination and renewal provisions. The Company does not control joint venture decisions covering termination or renewal. Performance of the above obligations or termination or non-renewal of the management agreements could have a material adverse effect on the Company's business, financial condition and results of operations.

***The senior living services industry is very competitive and some competitors have substantially greater financial resources than the Company.***

The senior living services industry is highly competitive, and the Company expects that all segments of the industry will become increasingly competitive in the future. The Company competes with other companies providing independent living, assisted living, skilled nursing, home health care and other similar services and care alternatives. The Company also competes with other health care businesses with respect to attracting and retaining nurses, technicians, aides and other high quality professional and non-professional employees and managers. Although the Company believes there is a need for senior living communities in the markets where it operates residences, the Company expects that competition will increase from existing competitors and new market entrants, some of whom may have substantially greater financial resources than the Company. In addition, some of the Company's competitors operate on a not-for-profit basis or as charitable organizations and have the ability to finance capital expenditures on a tax-exempt basis or through the receipt of charitable contributions, neither of which are available to the Company. Furthermore, if the development of new senior living communities outpaces the demand for those communities in the markets in which the Company has senior living communities, those markets may become saturated. Regulation in the independent and assisted living industry, which represents a substantial portion of the Company's senior living services, is not substantial. Consequently, development of new senior living communities could outpace demand. An oversupply of those communities in the Company's markets could cause the Company to experience decreased occupancy, reduced operating margins and lower profitability.

***The Company relies on the services of key executive officers and the loss of these officers or their services could have a material adverse effect on the Company.***

The Company depends on the services of its executive officers for its management. The loss of some of the Company's executive officers and the inability to attract and retain qualified management personnel could



affect its ability to manage its business and could adversely effect its business, financial condition and results of operations.

***A significant increase in the Company's labor costs could have a material adverse effect on the Company.***

The Company competes with other providers of senior living services with respect to attracting and retaining qualified management personnel responsible for the day-to-day operations of each of its communities and skilled personnel responsible for providing resident care. A shortage of nurses or trained personnel may require the Company to enhance its wage and benefits package in order to compete in the hiring and retention of these personnel or to hire more expensive temporary personnel. The Company also will be dependent on the available labor pool of semi-skilled and unskilled employees in each of the markets in which it operates. No assurance can be given that the Company's labor costs will not increase, or that, if they do increase, they can be matched by corresponding increases in rates charged to residents. Any significant failure by the Company to control its labor costs or to pass on any increased labor costs to residents through rate increases could have a material adverse effect on its business, financial condition and results of operations.

***There is an inherent risk of liability in the provision of personal and health care services, not all of which may be covered by insurance.***

The provision of personal and health care services in the long-term care industry entails an inherent risk of liability. In recent years, participants in the long-term care industry have become subject to an increasing number of lawsuits alleging negligence or related legal theories, many of which involve large claims and result in the incurrence of significant defense costs. Moreover, senior living communities offer residents a greater degree of independence in their daily living. This increased level of independence may subject the resident and, therefore, the Company to risks that would be reduced in more institutionalized settings. The Company currently maintains insurance in amounts it believes are comparable to that maintained by other senior living companies based on the nature of the risks, the Company's historical experience and industry standards, and the Company believes that this insurance coverage is adequate. However, the Company may become subject to claims in excess of its insurance or claims not covered by its insurance, such as claims for punitive damages, terrorism and natural disasters. A claim against the Company not covered by, or in excess of, its insurance could have a material adverse effect upon the Company.

In addition, the Company's insurance policies must be renewed annually. Based upon poor loss experience, insurers for the long-term care industry have become increasingly wary of liability exposure. A number of insurance carriers have stopped writing coverage to this market, and those remaining have increased premiums and deductibles substantially. Therefore, the Company cannot assure that it will be able to obtain liability insurance in the future or that, if that insurance is available, it will be available on acceptable economic terms.

***The Company is subject to government regulations and compliance, some of which are burdensome and some of which may change to the Company's detriment in the future.***

Federal and state governments regulate various aspects of the Company's business. The development and operation of senior living communities and the provision of health care services are subject to federal, state and local licensure, certification and inspection laws that regulate, among other matters, the number of licensed beds, the provision of services, the distribution of pharmaceuticals, billing practices and policies, equipment, staffing (including professional licensing), operating policies and procedures, fire prevention measures, environmental matters and compliance with building and safety codes. Failure to comply with these laws and regulations could result in the denial of reimbursement, the imposition of fines, temporary suspension of admission of new residents, suspension or decertification from the Medicare program, restrictions on the ability to acquire new communities or expand existing communities and, in extreme cases, the revocation of a community's license or closure of a community. The Company believes that such regulation will increase in the future and the Company is unable to predict the content of new regulations or their effect on its business, any of which could materially adversely affect the Company.

Various states, including several of the states in which the Company currently operates, control the supply of licensed skilled nursing beds, assisted living communities and home health care agencies through (CON) or other programs. In those states, approval is required for the construction of new health care communities, the addition of licensed beds and some capital expenditures at those communities, as well as the opening of a home health care agency. To the extent that a CON or other similar approval is required for the acquisition or construction of new communities, the expansion of the number of licensed beds, services, or existing communities, or the opening of a home health care agency, the Company could be adversely affected by its failure or inability to obtain that approval, changes in the standards applicable for that approval, and possible delays and expenses associated with obtaining that approval. In addition, in most states, the reduction of the number of licensed beds or the closure of a community requires the approval of the appropriate state regulatory agency and, if the Company were to seek to reduce the number of licensed beds at, or to close, a community, the Company could be adversely affected by a failure to obtain or a delay in obtaining that approval.

Federal and state anti-remuneration laws, such as “anti-kickback” laws, govern some financial arrangements among health care providers and others who may be in a position to refer or recommend patients to those providers. These laws prohibit, among other things, some direct and indirect payments that are intended to induce the referral of patients to, the arranging for services by, or the recommending of, a particular provider of health care items or services. Federal anti-kickback laws have been broadly interpreted to apply to some contractual relationships between health care providers and sources of patient referral. Similar state laws vary, are sometimes vague, and seldom have been interpreted by courts or regulatory agencies. Violation of these laws can result in loss of licensure, civil and criminal penalties, and exclusion of health care providers or suppliers from participation in Medicare and Medicaid programs. There can be no assurance that those laws will be interpreted in a manner consistent with the Company’s practices.

Under the Americans with Disabilities Act of 1990, all places of public accommodation are required to meet federal requirements related to access and use by disabled persons. A number of additional federal, state and local laws exist that also may require modifications to existing and planned communities to create access to the properties by disabled persons. Although the Company believes that its communities are substantially in compliance with present requirements or are exempt therefrom, if required changes involve a greater expenditure than anticipated or must be made on a more accelerated basis than anticipated, additional costs would be incurred by the Company. Further legislation may impose additional burdens or restrictions with respect to access by disabled persons, the costs of compliance with which could be substantial.

The Health Insurance Portability and Accountability Act of 1996, in conjunction with the federal regulations promulgated thereunder by the Department of Health and Human Services, has established, among other requirements, standards governing the privacy of certain protected and individually identifiable health information that is created, received or maintained by a range of covered entities. HIPAA has also established standards governing uniform health care transactions, the codes and identifiers to be used by the covered entities and standards governing the security of certain electronic transactions conducted by covered entities. Penalties for violations can range from civil money penalties for errors and negligent acts to criminal fines and imprisonment for knowing and intentional misconduct. HIPAA is a complex set of regulations and many unanswered questions remain with respect to the manner in which HIPAA applies to businesses such as those operated by the Company.

***The Company may be subject to liability for environmental damages.***

Under various federal, state and local environmental laws, ordinances and regulations, a current or previous owner or operator of real estate may be required to investigate and clean up hazardous or toxic substances or petroleum product releases at the property, and may be held liable to a governmental entity or to third parties for property damage and for investigation and clean up costs incurred by those parties in connection with the contamination. These laws typically impose clean-up responsibility and liability without regard to whether the owner knew of or caused the presence of the contaminants, and liability under these laws has been interpreted to be joint and several unless the harm is divisible and there is a reasonable basis for allocation of responsibility. The costs of investigation, remediation or removal of the substances may be



substantial, and the presence of the substances, or the failure to properly remediate the property, may adversely affect the owner's ability to sell or lease the property or to borrow using the property as collateral. In addition, some environmental laws create a lien on the contaminated site in favor of the government for damages and costs it incurs in connection with the contamination. Persons who arrange for the disposal or treatment of hazardous or toxic substances also may be liable for the costs of removal or remediation of the substances at the disposal or treatment facility, whether or not the facility is owned or operated by the person. Finally, the owner of a site may be subject to common law claims by third parties based on damages and costs resulting from environmental contamination emanating from a site. If the Company becomes subject to any of these claims the costs involved could be significant and could have a material adverse effect on its business, financial condition and results of operations.

#### **ITEM 1B. UNRESOLVED STAFF COMMENTS**

Not applicable.

#### **ITEM 2. PROPERTIES**

The executive and administrative offices of the Company are located at 14160 Dallas Parkway, Suite 300, Dallas, Texas 75254, and consist of approximately 22,000 square feet. The lease on the premises extends through February 2008. The Company believes that its corporate office facilities are adequate to meet its requirements through at least fiscal 2006 and that suitable additional space will be available, as needed, to accommodate further physical expansion of corporate operations. The Company also leases executive office space in New York, New York pursuant to an annual lease agreement.

As of December 31, 2005, the Company owned, leased and/or managed the senior living communities referred to in Item 1 above under the caption "Operating Communities."

#### **ITEM 3. LEGAL PROCEEDINGS**

In the fourth quarter of 2002, the Company (and two of its management subsidiaries), Buckner and a related Buckner entity, and other unrelated entities were named as defendants in a lawsuit in district court in Fort Bend County, Texas brought by the heir of a former resident who obtained nursing home services at Parkway Place from September 1998 to March 2001. The Company managed Parkway Place for Buckner through December 31, 2001. The Company and its subsidiaries denied any wrongdoing. On March 16, 2004, the Court granted the Company's Motion to Dismiss.

In February 2004, the Company and certain subsidiaries, along with numerous other senior living companies in California, were named as defendants in a lawsuit in the superior court in Los Angeles, California. This lawsuit was brought by two public interest groups on behalf of seniors in California residing at the California facilities of the defendants. The plaintiffs alleged that pre-admission fees charged by the defendants' facilities were actually security deposits that must be refunded in accordance with California law. On November 30, 2004, the court approved a settlement involving the Company's independent living communities. Under the terms of the settlement, (a) all non-refundable fees collected at the independent living facilities since January 1, 2003 will be treated as a refundable security deposits and (b) the attorney for the plaintiffs received nominal attorney fees. There were no other settlement costs to the Company or its affiliates and the Company's assisted living community in California was not named.

In April 2005, the Company filed a claim before the American Arbitration Association in Dallas, Texas against a former brokerage consultant and her company (collectively, "Respondents") for (1) a declaratory judgment that it has fulfilled certain obligations to Respondents under contracts the parties had signed related to the Covenant transaction, (2) for damages resulting from alleged breach of a confidentiality provision, and (3) for damages for unpaid referral fees. Respondent has filed a counterclaim for causes of action including breach of contract, duress, and undue infliction of emotional distress. The counterclaim seeks damages of "up to \$1,291,500 (or more)". Respondent also seeks to recover unspecified amounts of additional damages if the Company acquires any of the Covenant owned properties on which she claims to be entitled to recover

brokerage fees. The proceeding is in the discovery phase. The Company's management believes strongly that its position has merit and intends to vigorously defend the counterclaim.

On January 11, 2006, the Company received a demand letter from the Texas Property and Casualty Insurance Guaranty Association ("TPCIGA") for repayment of \$199,737.45 in worker's compensation payments allegedly made by TPCIGA on behalf of Company employees. The Company has also received other correspondence for repayment of \$45,357.82. TPCIGA's letter states that it has assumed responsibility for insureds of Reliance Insurance Company ("Reliance") which was declared insolvent and ordered into liquidation in October of 2001 by the Commonwealth Court of Pennsylvania. Reliance had been the Company's worker's compensation carrier. TPCIGA's demand letter states that under the Texas Insurance Code, TPCIGA is entitled to seek reimbursement from an insured for sums paid on its behalf if the insured's net worth exceeds \$50 million at the end of the year immediately proceeding the impaired insurer's insolvency. TPCIGA states that it pursues reimbursement of these payments from the Company pursuant to this "net worth" provision. The Company has requested additional information from TPCIGA to verify that the Company was indeed the employer of the individuals on whose behalf the TPCIGA has paid claims. The TPCIGA has not provided sufficient documentation at this time for the Company to be able to fully evaluate all of these claims.

The Company has other pending claims not mentioned above ("Other Claims") incurred in the course of its business. Most of these Other Claims are believed by management to be covered by insurance, subject to normal reservations of rights by the insurance companies and possibly subject to certain exclusions in the applicable insurance policies. Whether or not covered by insurance, these Other Claims, in the opinion of management, based on advice of legal counsel, should not have a material effect on the consolidated financial statements of the Company if determined adversely to the Company.

#### **ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS**

There were no matters submitted to a vote of the Company's security holders during the fourth quarter ended December 31, 2005.

### **PART II**

#### **ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY AND RELATED STOCKHOLDERS MATTERS**

##### **(a) Market for Common Stock; Dividends; Equity Compensation Plan Information.**

##### **Market for Common Stock**

The Company's shares of common stock are listed for trading on the New York Stock Exchange ("NYSE") under the symbol "CSU". The following table sets forth, for the periods indicated, the high and low sales prices for the Company's common stock, as reported on the NYSE. At March 10, 2006 there were approximately 114 stockholders of record of the Company's common stock.

<u>Year</u>	<u>High</u>	<u>Low</u>
2005		
First Quarter . . . . .	\$6.00	\$5.05
Second Quarter . . . . .	7.25	5.40
Third Quarter . . . . .	8.50	6.95
Fourth Quarter . . . . .	10.88	7.50
2004		
First Quarter . . . . .	\$7.28	\$5.78
Second Quarter . . . . .	6.65	4.55
Third Quarter . . . . .	5.03	3.65
Fourth Quarter . . . . .	5.75	4.75

## Dividends

It is the policy of the Company's Board of Directors to retain all future earnings to finance the operation and expansion of the Company's business. Accordingly, the Company has not and does not anticipate declaring or paying cash dividends on the Common Stock in the foreseeable future. The payment of cash dividends in the future will be at the sole discretion of the Company's Board of Directors and will depend on, among other things, the Company's earnings, operations, capital requirements, financial condition, restrictions in then existing financing agreements, and other factors deemed relevant by the Board of Directors.

## Equity Compensation Plan Information

The following table presents information relating to the Company's equity compensation plans as of December 31, 2005:

<u>Plan Category</u>	<u>Number of Securities to be Issued Upon Exercise of Outstanding Options, Warrants and Rights</u>	<u>Weighted-Average Exercise Price of the Outstanding Options, Warrants and Rights</u>	<u>Number of Securities Remaining Available for Future Issuance Under Equity Compensation Plans (Excluding Securities Reflected in First Column )</u>
Equity compensation plans approved by security holders .....	1,109,225	\$4.69	642,974
Equity compensation plans not approved by security holders .....	<u>—</u>	<u>—</u>	<u>—</u>
Total .....	<u>1,109,225</u>	<u>\$4.69</u>	<u>642,974</u>

(b) *Recent Sales of Unregistered Securities; Use of Proceeds from Registered Securities.* Not Applicable.

(c) *Issuer Purchases of Equity Securities.* Not Applicable.

## ITEM 6. SELECTED FINANCIAL DATA

The following table sets forth selected financial data of the Company. The selected financial data for the years ended December 31, 2005, 2004, 2003, 2002 and 2001 are derived from the audited consolidated financial statements of the Company except as noted in footnote 2 below.

	At and for the Year Ended December 31,				
	2005	2004	2003	2002	2001
	(In thousands, except per share data)				
Statements of Operations Data:					
Revenues:					
Resident and health care revenue . . . . .	\$101,770	\$ 90,544	\$ 62,564	\$ 57,574	\$ 62,807
Rental and lease income . . . . .	—	—	—	37	3,619
Unaffiliated management services revenue . . . . .	1,626	726	336	1,069	1,971
Affiliated management services revenue . .	1,834	1,992	3,236	2,062	1,743
Affiliated development fees . . . . .	—	—	189	740	403
Total revenues . . . . .	<u>105,230</u>	<u>93,262</u>	<u>66,325</u>	<u>61,482</u>	<u>70,543</u>
Expenses:					
Operating expenses (exclusive of depreciation and amortization shown below) (2) . . . . .	68,707	64,772	44,637	37,179	41,985
General and administrative expenses (2)	10,187	9,552	7,914	7,229	7,231
Provision for bad debts . . . . .	258	198	168	267	967
Facility lease expense . . . . .	2,070	—	—	—	—
Depreciation and amortization . . . . .	13,046	12,009	7,791	5,846	7,088
Total expenses . . . . .	<u>94,268</u>	<u>86,531</u>	<u>60,510</u>	<u>50,521</u>	<u>57,271</u>
Income from operations . . . . .	10,962	6,731	5,815	10,961	13,272
Other income (expense):					
Interest income . . . . .	133	572	4,278	5,968	5,914
Interest expense . . . . .	(18,595)	(15,769)	(12,481)	(10,749)	(14,888)
Gain (loss) on sale of properties . . . . .	104	(37)	6,751	1,876	2,550
Debt restructuring/derivative costs:					
Write-off of deferred loan cost . . . . .	(25)	(824)	—	—	—
Gain on interest rate swap agreement	—	1,435	—	—	—
Loss on interest rate lock agreement . .	(641)	(1,356)	—	—	—
Other income (expense) (1) . . . . .	416	182	3,616	69	(885)
(Loss) income before income taxes, and minority interest in consolidated partnership . . . . .	(7,646)	(9,066)	7,979	8,125	5,963
Benefit (provision) for income taxes . . . . .	2,273	2,270	(3,098)	(3,015)	(1,777)
(Loss) income before minority interest in consolidated partnership . . . . .	(5,373)	(6,796)	4,881	5,110	4,186
Minority interest in consolidated partnership	19	38	109	(428)	(1,430)
Net (loss) income . . . . .	<u>\$ (5,354)</u>	<u>\$ (6,758)</u>	<u>\$ 4,990</u>	<u>\$ 4,682</u>	<u>\$ 2,756</u>
Per share data:					
Basic (loss) earnings per share . . . . .	<u>\$ (0.21)</u>	<u>\$ (0.27)</u>	<u>\$ 0.25</u>	<u>\$ 0.24</u>	<u>\$ 0.14</u>
Diluted (loss) earnings per share . . . . .	<u>\$ (0.21)</u>	<u>\$ (0.27)</u>	<u>\$ 0.25</u>	<u>\$ 0.24</u>	<u>\$ 0.14</u>
Weighted average shares outstanding:					
Basic . . . . .	<u>25,827</u>	<u>25,213</u>	<u>19,784</u>	<u>19,726</u>	<u>19,717</u>
Diluted . . . . .	<u>25,827</u>	<u>25,213</u>	<u>19,975</u>	<u>19,917</u>	<u>19,734</u>

	At and for the Year Ended December 31,				
	2005	2004	2003	2002	2001
	(In thousands, except per share data)				
Balance Sheet Data:					
Cash and cash equivalents . . . . .	\$ 21,831	\$ 19,515	\$ 6,594	\$ 11,768	\$ 9,975
Working capital (deficit) . . . . .	10,860	(22,289)	(12,835)	4,349	(6,441)
Total assets . . . . .	434,051	431,175	421,333	278,251	308,082
Long-term debt, excluding current portion	252,733	219,526	255,549	140,385	156,755
Shareholders' equity . . . . .	145,415	149,547	124,367	118,281	113,544

- (1) Other income in fiscal 2003 includes the recognition of deferred income of \$3.4 million related to the liquidation of the HealthCare Properties, L.P. ("HCP") partnership. In fiscal 2001, the Company recognized a loss on foreclosure of \$0.4 million. The charge resulted from a loan foreclosure on HCP's McCurdy property.
- (2) Certain community level expenses were reclassified from general and administrative expense to operating expense in order to conform to industry practices. The amounts reclassified were \$6,971; \$4,429; \$4,328; \$4,771 for fiscal 2004, 2003, 2002 and 2001, respectively.

**ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

*Certain information contained in this report constitutes "Forward-Looking Statements" within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended, which can be identified by the use of forward-looking terminology such as "may," "will," "expect," "anticipate," "estimate" or "continue" or the negative thereof or other variations thereon or comparable terminology. The Company cautions readers that forward-looking statements, including, without limitation, those relating to the Company's future business prospects, revenues, working capital, liquidity, capital needs, interest costs, and income, are subject to certain risks and uncertainties that could cause actual results to differ materially from those indicated in the forward-looking statements, due to several important factors herein identified, among others, and other risks and factors identified from time to time in the Company's reports filed with the SEC.*

**Overview**

The following discussion and analysis addresses the Company's results of operations on a historical consolidated basis for the years ended December 31, 2005, 2004 and 2003. The following should be read in conjunction with the Company's historical consolidated financial statements and the selected financial data contained elsewhere in this report.

The Company is one of the largest operators of senior living communities in the United States in terms of resident capacity. The Company's operating strategy is to provide quality senior living services at an affordable price to its residents, while achieving and sustaining a strong, competitive position within its chosen markets, as well as to continue to enhance the performance of its operations. The Company provides senior living services to the elderly, including independent living, assisted living, skilled nursing and home care services.

As of December 31, 2005, the Company operated 55 senior living communities in 20 states with an aggregate capacity of approximately 8,900 residents, including 33 senior living communities which the Company owned or in which the Company had an ownership interest, seven senior living communities the Company leased and 15 senior living communities it managed for third parties. As of December 31, 2005, the Company also operated one home care agency.

The Company generates revenue from a variety of sources. For the year ended December 31, 2005, the Company's revenues were derived as follows: 96.7% from the operation of 36 owned and leased communities; 3.3% from management fees arising from management services provided for 10 affiliate-owned senior living

communities (six of which the Company now operates under lease arrangements with Ventas) and 15 third-party owned senior living communities.

### ***Management Agreements***

The Company managed and operated the 36 communities it wholly owned or leased, four communities owned by joint ventures in which the Company has a minority interest and 15 communities owned by third parties as of December 31, 2005. For communities owned by joint ventures and third parties the Company typically receives a management fee of 5% of gross revenues. In addition, certain of the contracts provide for supplemental incentive fees that vary by contract based upon the financial performance of the managed community.

The Company believes that the factors affecting the financial performance of communities managed under contracts with third parties do not vary substantially from the factors affecting the performance of owned and leased communities, although there are different business risks associated with these activities.

The Company's third-party management fees are primarily based on a percentage of gross revenues. As a result, the cash flow and profitability of such contracts to the Company are more dependent on the revenues generated by such communities and less dependent on net cash flow than for owned communities. Further, the Company is not responsible for capital investments in managed communities. The management contracts are generally terminable only for cause and upon the sale of a community, subject to the Company's rights to offer to purchase such community.

### ***Ventas Transactions***

Effective as of June 30, 2005, BRE/CSL entered into a Purchase and Sale Agreement (the "Ventas Purchase Agreement") with Ventas to sell the six communities owned by BRE/CSL to Ventas for \$84.6 million. In addition, Ventas and the Company entered into Master Lease Agreements (the "Ventas Lease Agreements") whereby the Company would lease the six communities from Ventas. Effective September 30, 2005, Ventas completed the purchase of the six BRE/CSL communities and the Company began consolidating the operations of the six communities in its consolidated statement of operations under the terms of the Ventas Lease Agreements. The Ventas Lease Agreements each have an initial term of ten years, with two five year renewal extensions available at the Company's option. The initial lease rate under the Ventas Lease Agreements is 8% and is subject to certain conditional escalation clauses. The Company incurred \$1.3 million in lease acquisition costs related to the Ventas Lease Agreements. These deferred lease acquisition costs are being amortized over the initial 10 year lease term and are included in facility lease expense in the Company's statement of operations. The Company has accounted for each of the Ventas Lease Agreements as operating leases. The sale of the six BRE/CSL communities to Ventas resulted in the Company recording a gain of approximately \$4.2 million, which has been deferred and is being recognized in the Company's statement of operations over the initial 10 year lease term.

On October 18, 2005, the Company entered into an agreement with Ventas to lease a senior living community ("Georgetown Place") which Ventas acquired for approximately \$19.5 million. Georgetown Place is located in Fort Wayne, Indiana and is a 162 unit senior living community with a capacity of 247 residents. The lease which the Company executed with Ventas has an initial term of ten years, with two five year renewal extensions available at the Company's option. The Company incurred \$0.2 million in lease acquisition costs related to the Georgetown Place lease. These deferred lease acquisition costs are being amortized over the initial 10 year lease term and are included in facility lease expense in the Company's statement of operations. The initial lease rate is 8% and is subject to conditional escalation provisions. The Company has accounted for the Georgetown Place lease as an operating lease.

### ***Triad Entities and Triad I Transactions***

Effective as of July 1, 2003, the Company acquired the partnership interest of the general partners and the other third party limited partners' interests in the Triad Entities for \$1.3 million in cash, \$0.4 million in notes payable and the assumption of all outstanding debt and liabilities. The total purchase price was



\$194.4 million and the acquisition was treated as a purchase of property. This acquisition resulted in the Company acquiring the 12 senior living communities owned by the Triad Entities with a combined resident capacity of approximately 1,670 residents. Subsequent to the end of the Company's third quarter of 2003, the Company repaid the \$0.4 million in notes payable related to this acquisition. Prior to this acquisition, the Company owned 1% of the limited partnership interests and managed the Triad Entities under a series of long-term management contracts.

Effective as of November 30, 2004, the Company acquired Lehman's approximate 81% limited partnership interest in Triad I for \$4.0 million in cash and the issuance of a note with a net present value of \$2.8 million. The Lehman note bears no interest and is deemed to be paid in full under any of the following three conditions: 1) the Company makes a payment of \$3.5 million before November 29, 2008; 2) the Company makes a payment of \$4.3 million before November 29, 2009; or 3) the Company makes a payment of \$5.0 million before November 29, 2010. The Company expects to repay the note on or before November 29, 2008 and therefore recorded the note at \$2.8 million (face amount \$3.5 million discounted at 5.7%). In addition, the Company acquired the general partner's interest in Triad I by assuming a \$3.6 million note payable from the general partner to a subsidiary of the Company. The acquisition was recorded as a purchase of property. The purchase price of \$10.4 million was recorded as a step-up in basis of \$9.3 million and in addition the Company recorded a deferred tax asset of \$1.1 million as Triad I had been previously consolidated under FASB Interpretation No. 46, revised December 2003, ("FIN 46"), as of December 31, 2003. These transactions resulted in the Company wholly owning Triad I. Triad I owned five Waterford senior living communities and two expansions. The two expansions were subsequently deeded to a subsidiary of the Company in order for the two expansions to be consolidated with their primary community. Prior to acquiring the remaining interests of the general partner and the other third party limited partner in Triad I, the Company had an approximate 1% limited partner's interest in Triad I and has accounted for these investments under the equity method of accounting based on the provisions of the Triad I partnership agreement until December 31, 2003.

In 2003, the Financial Accounting Standards Board ("FASB") issued FIN. 46, "Consolidation of Variable Interest Entities", an interpretation of ARB No. 51, effective immediately for variable interest entities created after January 31, 2003 and effective as of December 31, 2003, for variable interest entities that existed prior to February 1, 2003. The Company adopted the provisions of this interpretation, as of December 31, 2003, which resulted in the Company consolidating Triad I's financial position as of December 31, 2003 and consolidating Triad I's results of operations beginning January 1, 2004. The consolidation of Triad I under the provisions of FIN 46 as of December 31, 2003 resulted in an increase in property and equipment of \$62.5 million.

### ***CGIM Transaction***

Effective August 18, 2004, the Company acquired from Covenant all of the outstanding stock of Covenant's wholly owned subsidiary, CGIM. The Company paid approximately \$2.3 million in cash (including closing costs of approximately \$0.1 million) and issued a non-interest bearing note with a fair value of approximately \$1.1 million (face amount \$1.4 million discounted at 5.7%), subject to various adjustments set forth in the purchase agreement, to acquire all of the outstanding stock of CGIM. The note is due in three installments of approximately \$0.3 million, \$0.4 million and \$0.7 million due on the first, third and fifth anniversaries of the closing, respectively, subject to reduction if the management fees earned from the third party owned communities with various terms are terminated and not replaced by substitute agreements during the period, and certain other adjustments. This acquisition resulted in the Company assuming the management contracts on 14 senior living communities with a combined resident capacity of approximately 1,800 residents. The acquisition was accounted for as a purchase and the entire purchase price of \$3.5 million was allocated to management contract rights. In addition, the Company recorded a deferred tax liability of \$2.1 million related to the acquisition of these management contract rights. The Company's first installment payment under the Covenant note was reduced by \$0.2 million under the terms of the stock purchase agreement and the \$0.2 million installment reduction was recorded as an adjustment to the purchase price. In addition, the Company has the right to acquire seven of the properties owned by Covenant (which are part of



the 14 communities managed by CGIM) based on sales prices specified in the stock purchase agreement. In the first quarter of fiscal 2006, the Company exercised its right to acquire the seven communities owned by Covenant and the Company plans to sell six of the communities to HCPI in a sale/leaseback transaction. The Company is marketing the seventh community and intends to complete a sale as soon as possible.

#### ***SHPII/CSL and SHPII Transactions***

Effective as of November 30, 2004, the Company acquired Lehman's approximate 81% interest in the Spring Meadows Communities and simultaneously sold the Spring Meadows Communities to SHPII/CSL, which is owned 95% by SHPII and 5% by the Company. As a result these transactions, the Company paid \$1.1 million for Lehman's interest in the joint ventures, received net current assets of \$0.9 million and wrote-off the remainder totaling \$0.2 million. In addition, the Company contributed \$1.3 million to SHPII/CSL for its 5% interest. The Company manages the communities for SHPII/CSL under long-term management contracts.

Prior to SHPII/CSL's acquisition of the Spring Meadows Communities, the Company, in December 2002, acquired from affiliates of LCOR Incorporated ("LCOR") its approximate 19% member interests in the four joint ventures, that owned the Spring Meadows Communities as well as loans made by LCOR to the joint ventures for \$0.9 million in addition to funding \$0.4 million to the venture for working capital and anticipated negative cash requirements of the communities. The Company's interests in the joint ventures that owned the Spring Meadows Communities included interests in certain loans to the ventures and an approximate 19% member interest in each venture. The Company recorded its initial advances of \$1.3 million to the ventures as notes receivable as the amount assigned for the 19% member interests was nominal. The Company accounted for its investment in the Spring Meadows Communities under the equity method of accounting based on the provisions of the partnership agreements. The Company managed the Spring Meadows Communities since the opening of each community in late 2000 and early 2001 and continued to manage the communities under long-term management contracts until November 2004 when the joint ventures were sold. In addition, the Company received an asset management fee relating to each of the four communities. The Company had the obligation to fund certain future operating deficits of the Spring Meadows Communities to the extent of its 19% member interest. No amounts were funded by the Company under this obligation.

In September 2003, the Company sold its Carmichael community to SHPII for \$11.7 million before closing costs of \$0.6 million. Carmichael is an independent living community located in Sacramento, California with a resident capacity of 156. As a result of the sale the Company retired \$7.4 million in debt and received \$3.6 million in cash and recognized a gain of \$3.1 million. The Company manages the Carmichael community for SHPII under a long-term management contract.

#### ***BRE/CSL Transactions***

The Company formed BRE/CSL with Blackstone in December 2001, and the joint ventures are owned 90% by Blackstone and 10% by the Company. Pursuant to the terms of the joint ventures, each of the Company and Blackstone must approve any acquisitions made by BRE/CSL. Each party must also contribute its pro rata portion of the costs of any acquisition.

In December 2001, BRE/CSL acquired Amberleigh, a 394 resident capacity independent living facility. In connection with the acquisition of Amberleigh by BRE/CSL, the Company contributed \$1.8 million to BRE/CSL. During the second quarter of 2002, BRE/CSL obtained permanent financing for the Amberleigh community and the Company recovered \$1.4 million of its contribution to BRE/CSL.

On June 13, 2002, the Company contributed to BRE/CSL four of its senior living communities with a capacity of approximately 600 residents. As a result of the contribution, the Company repaid \$29.1 million of long-term debt to GMAC, received \$7.3 million in cash from BRE/CSL, had a 10% equity interest in the venture of \$1.2 million and wrote-off \$0.5 million in deferred loan costs.

In addition, on June 30, 2003, the Company contributed to BRE/CSL one of its senior living communities with a capacity of 182 residents. As a result of the contribution the Company repaid \$7.4 million of long-term debt, received \$3.1 million in cash from BRE/CSL, and had a 10% equity interest in BRE/CSL of \$0.4 million resulting in the recognition of a gain of \$3.4 million.

The Company managed the six communities owned by BRE/CSL under long-term management contracts. The Company accounted for the BRE/CSL investment under the equity method of accounting. The Company deferred management services revenue as a result of its 10% interest in the BRE/CSL joint venture.

Effective September 30, 2005, the six BRE/CSL communities were sold to Ventas for approximately \$84.6 million and the Company subsequently leased the six communities from Ventas. The Company had guaranteed 25%, or \$1.9 million of the debt on one community owned by BRE/CSL. The Company made this guarantee to induce Bank One to allow the debt to be assumed by BRE/CSL. The Company estimated the carrying value of its obligation under this guarantee as nominal. The debt on this community was repaid upon the sale of the six BRE/CSL communities to Ventas and as a result the Company was released from this debt guarantee.

### *HCP Partnerships*

The Company owned 57% of the HCP partnership and the assets, liabilities, minority interest, and the results of operations of HCP have been consolidated in the Company's financial statements. During 2003, HCP sold its remaining community and subsequently has been dissolved with its remaining assets transferred to a liquidating trust. In connection therewith, the Company recognized deferred revenue of \$3.4 million in the fourth quarter of 2003 due to the liquidation.

### *Community Refinancing*

In July 2005, the Company refinanced the debt on four senior housing communities with GMAC. The total loan facility of \$39.2 million refinanced \$34.3 million of debt that was scheduled to mature in September 2005. The new loans include ten-year terms with the interest rates fixed at 5.46% and amortization of principal and interest payments over 25 years. The Company incurred \$0.7 million in deferred financing costs related to these loans, which is being amortized over ten years.

### *Recent Events*

On January 13, 2006, the Company announced the formation of a joint venture ("Midwest") with GE Healthcare to acquire five senior housing communities from a third party. Midwest agreed to pay approximately \$46.9 million for the five communities. The five communities comprise 293 assisted living units with a resident capacity of 389. Effective February 1, 2006, Midwest acquired four of the five communities and expects to close on the fifth community during the second quarter of fiscal 2006. The Company has an approximate 11% interest in Midwest and manages the four communities already acquired under long-term management agreements with Midwest.

On February 1, 2006, the Company announced that it had entered into an agreement to sell the Company's Towne Centre community to Ventas in a sale/leaseback transaction valued at approximately \$29.0 million. The lease agreement will have an initial term of ten years, with two five year renewal extensions available at the Company's option. The initial lease rate under the Towne Centre lease agreement will be 8% and will be subject to certain conditional escalation clauses. The Company expects to account for this lease as an operating lease. The sale of the Towne Centre community to Ventas is expected to result in the Company recording a gain of approximately \$14.5 million, which will be deferred and recognized in the Company's statement of operations over the initial 10 year lease term. The Towne Centre sale/leaseback transaction is expected to close in the Company's first quarter of fiscal 2006.

On March 8, 2006, the Company announced that it had entered into an agreement to sale three communities owned by the Company to HCPI in a sale/leaseback transaction valued at approximately

\$54.0 million. The lease agreements will have an initial term of ten years. The initial lease rate under the lease agreements will be 8% and will be subject to certain conditional escalation clauses. The Company expects to account for this lease as an operating lease. The sale of the three communities to HCPI is expected to result in the Company recording a gain of approximately \$13.0 million, which will be deferred and recognized in the Company's statement of operations over the initial 10 year lease term.

On March 13, 2006, The Company announced that it had exercised its option to acquire the seven communities owned by Covenant and upon completion of the acquisitions, will immediately sell six of the seven communities to HCPI in a sale/leaseback transaction valued at approximately \$43.0 million. The Company is currently marketing the seventh community and intends to complete a sale as soon as possible. The Company expects the transaction to result in the recognition of a gain between \$3.0 and \$4.0 million and the gain will be recognized over the initial 10 year lease term. The initial lease rate under the lease agreements will be 8% and will be subject to certain conditional escalation clauses. The Company expects to account for this lease as an operating lease.

### **Critical Accounting Policies**

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the amounts reported in the accompanying financial statements and related notes. Management bases its estimates and assumptions on historical experience, observance of industry trends and various other sources of information and factors, the results of which form the basis for making judgments about the carrying value of assets and liabilities that are not readily apparent from other sources. Actual results could differ from these estimates. Critical accounting policies are defined as those that are reflective of significant judgments and uncertainties, and potentially could result in materially different results under different assumptions and conditions. The Company believes the following critical accounting policies require management's most difficult, subjective and complex judgments.

#### ***Revenue Recognition***

Resident and health care revenue is recognized at estimated net realizable amounts, based on historical experiences, due from residents in the period to which the rental and other services are provided.

Revenues from the Medicare and Medicaid programs accounted for approximately 7%, 8% and 9% of the Company's net revenues in fiscal 2005, 2004 and 2003, respectively. Under the Medicare program, payments are determined based on established rates that differ from private pay rates. Revenue from the Medicare program is recorded at the reimbursement rates established by the federal government. Under the Medicaid program, communities are entitled to reimbursement at established rates that are lower than private pay rates. Patient service revenue for Medicaid patients is recorded at the reimbursement rates as the rates are set prospectively by the state upon the filing of an annual cost report.

Laws and regulations governing the Medicare and Medicaid programs are complex and subject to interpretation. The Company believes that it is in compliance with all applicable laws and regulations. Regulatory inquiries occur in the ordinary course of business and compliance with such laws and regulations can be subject to future government review and interpretation as well as significant regulatory action including fines, penalties, and exclusion from the Medicare and Medicaid programs.

Management services revenue and development fees are recognized when earned. Management services revenue relates to providing certain management and administrative support services under management contracts. The Company's management contracts include contingent management services revenue, usually based on exceeding certain gross revenue targets. These contingent revenues are recognized based on actual results according to the calculations specified in the various management agreements.

### *Investments in Partnerships and Amounts Due from Affiliates*

*SHPII/CSL:* The Company has formed SHPII/CSL with SHPII, in November 2004, and the joint ventures are owned 95% by SHPII and 5% by the Company. The Company accounts for its investment in SHPII/CSL under the equity method of accounting. The Company recorded its investment at cost and will adjust its investment for its share of earnings and losses of SHPII/CSL. The Company defers 5% of its management fee income earned from SHPII/CSL. Deferred management fee income is being amortized into income over the term of the Company's management contracts. As of December 31, 2005, the Company had deferred income of approximately \$48,000 relating to SHPII/CSL.

Prior to SHPII/CSL's acquisition of the Spring Meadows Communities, the Company, in December 2002, acquired LCOR's approximate 19% member interests in the four joint ventures that owned the Spring Meadows Communities from LCOR as well as loans made by LCOR to the joint ventures for \$0.9 million in addition to funding \$0.4 million to the venture for working capital and anticipated negative cash requirements of the communities. The Company's interests in the joint ventures that owned the Spring Meadows Communities included interests in certain loans to the ventures and an approximate 19% member interest in each venture. The Company recorded its initial advances of \$1.3 million to the ventures as notes receivable as the amount assigned for the 19% member interests was nominal. The Company accounted for its investment in the Spring Meadows Communities under the equity method of accounting based on the provisions of the partnership agreements. The Company managed the Spring Meadows Communities since the opening of each community in late 2000 and early 2001 and continued to manage the communities under long-term management contracts until November 2004 when the joint ventures were sold. In addition, the Company received an asset management fee relating to each of the four communities. The Company had the obligation to fund certain future operating deficits of the Spring Meadows Communities to the extent of its 19% member interest. No amounts were funded by the Company under this obligation.

*BRE/CSL:* The Company formed BRE/CSL with Blackstone, and the joint ventures are owned 90% by Blackstone and 10% by the Company. The Company accounted for its investment in BRE/CSL under the equity method of accounting. The Company recorded its investment at cost and adjusted its investment for its share of earnings and losses of BRE/CSL. The Company deferred 10% of its management fee income earned from BRE/CSL. Deferred management fee income was amortized into income over the term of the Company's management contract. Effective September 30, 2005, Ventas acquired the six communities owned by BRE/CSL and the Company entered into the Ventas Lease Agreements whereby the Company leases the six communities from Ventas.

*Triad Entities:* Effective as of July 1, 2003, the Company acquired the partnership interest of the general partners and the other third party limited partners' interests in the Triad Entities for \$1.3 million in cash, \$0.4 million in notes payable and the assumption of all outstanding debt and liabilities. The total purchase price was \$194.4 million and the acquisition was treated as a purchase of property. This acquisition resulted in the Company acquiring 12 senior living communities owned by the Triad Entities with a combined resident capacity of approximately 1,670 residents. Subsequent to the end of the Company's third quarter of 2003, the Company repaid the \$0.4 million in notes payable related to this acquisition. Prior to this acquisition, the Company owned 1% of the limited partnership interests and managed the Triad Entities under a series of long-term management contracts.

*Triad I:* Effective as of November 30, 2004, the Company acquired Lehman's approximate 81% limited partnership interest in Triad I for \$4.0 million in cash and the issuance of a note with a net present value of \$2.8 million. In addition, the Company acquired the general partner's interest in Triad I by assuming a \$3.6 million note payable from the general partner to a subsidiary of the Company. The acquisition was recorded as a purchase of property. The purchase price of \$10.4 million was recorded as a step-up in basis of \$9.3 million and in addition the Company recorded a deferred tax asset of \$1.1 million as Triad I had been previously consolidated under FIN 46 as of December 31, 2003. These transactions resulted in the Company wholly owning Triad I. Triad I owned five Waterford senior living communities and two expansions. The two expansions were subsequently deeded to a subsidiary of the Company in order for the two expansions to be consolidated with their primary community.

Prior to acquiring the remaining interests of the general partner and the other third party limited partner, the Company had an approximate 1% limited partner's interests in Triad I and had accounted for this investment under the equity method of accounting based on the provisions of the Triad I partnership agreement until December 31, 2003.

In 2003, the Financial Accounting Standards Board ("FASB") issued FASB Interpretation No. 46, revised December 2003, ("FIN 46") "Consolidation of Variable Interest Entities", an interpretation of ARB No. 51, effective immediately for variable interest entities created after January 31, 2003 and effective as of December 31, 2003, for variable interest entities that existed prior to February 1, 2003. The Company adopted the provisions of this interpretation, as of December 31, 2003, which resulted in the Company consolidating Triad I's financial position as of December 31, 2003 and consolidating Triad I's results of operations beginning January 1, 2004. The consolidation of Triad I under the provisions of FIN 46 as of December 31, 2003 resulted in an increase in property and equipment of \$62.5 million.

### *Assets Held for Sale*

The Company determines the fair value, net of costs of disposal, of an asset on the date the asset is categorized as held for sale, and the asset is recorded at the lower of its fair value, net of cost of disposal, or carrying value on that date. The Company periodically reevaluates assets held for sale to determine if the assets are still recorded at the lower of fair value, net of cost of disposal, or carrying value. The Company has four parcels of land held for sale at December 31, 2005. The fair value of these properties is generally determined based on market rates, industry trends and recent comparable sales transactions. The actual sales price of these assets could differ significantly from the Company's estimates.

### *Lease Accounting*

The Company determines whether to account for its leases as either operating, capital or financing leases depending on the underlying terms of the lease agreement. This determination of classification is complex and requires significant judgment relating to certain information including the estimated fair value and remaining economic life of the community, the Company's cost of funds, minimum lease payments and other lease terms. As of December 31, 2005, the Company leased seven communities and classified each of these leases as an operating lease. Facility lease expense in the Company's statement of operations includes the actual rent paid plus amortization expense relating to leasehold acquisition costs.

At December 31, 2005, the Company had \$1.5 million in deferred leasehold acquisition costs. These costs are being amortized on a straight-line basis over the initial term of the lease agreements. Accumulated amortization, at December 31, 2005, was \$37,000.

### *Long-Lived Assets*

Property and equipment are stated at cost and depreciated on a straight-line basis over the estimated useful lives of the assets. The estimated useful lives are 10 to 40 years for buildings and building improvements, 3 to 10 years for leasehold improvements, 5 to 20 years for land improvements and 5 to 10 years for furniture, equipment and automobiles.

At each balance sheet date, the Company reviews the carrying value of its property and equipment to determine if facts and circumstances suggest that they may be impaired or that the depreciation period may need to be changed. The Company considers external factors relating to each asset, including contract changes, local market developments, and other publicly available information. The carrying value of a long-lived asset is considered impaired when the anticipated undiscounted cash flows from such asset is separately identifiable and is less than its carrying value. In that event, a loss is recognized based on the amount the carrying value exceeds the fair market value, generally based on discounted cash flows, of the long-lived asset. The Company analyzed certain long-lived assets with operating losses, under the undiscounted cash flow method, for impairment. The Company does not believe there are any indicators that would require and the cash flow analysis did not require an adjustment to the carrying value of the property and equipment or their remaining useful lives as of December 31, 2005 and 2004.



## New Accounting Standards

On December 16, 2004, the Financial Accounting Standards Board issued FASB Statement No. 123, revised 2004 (“Statement 123(R)”), Share-Based Payment, which is a revision of FASB Statement 123, Accounting for Stock-Based Compensation. Statement 123(R) supersedes APB Opinion No. 25 Accounting for Stock Issued to Employees, and amends FASB Statement No. 95, Statement of Cash Flows. Generally the approach in Statement 123(R) is similar to the approach described in Statement 123. However, Statement 123(R) requires all share based payments to employees, including grants of employee stock options, to be recognized in the income statement based on their fair values. Pro forma disclosure is no longer an alternative. Statement 123(R) is effective for public entities in the first annual reporting period beginning after June 15, 2005.

Statement 123(R) permits public companies to adopt its requirements using one of two methods:

1. A “modified prospective” method in which compensation cost is recognized beginning with the effective date (a) based on the requirements of Statement 123(R) for all share-based payments granted after the effective date and (b) based on the requirements of Statement 123 for all awards granted to employees prior to the effective date of Statement 123(R) that remain unvested on the effective date.

2. A “modified retrospective” method which includes the requirements of the modified prospective method described above, but also permits entities to restate based on the amounts previously recognized under Statement 123 for purposes of pro forma disclosures either (a) all prior periods presented or (b) prior interim periods of the year of adoption.

Effective July 1, 2005, the Company early adopted Statement 123(R). The Company adopted Statement 123(R) using the modified prospective method. Under the modified prospective method the Company recognized compensation expense for new share-based awards and recognized compensation expense for the remaining vesting period of awards that had been included in pro-forma disclosures in prior periods. The Company has not adjusted prior period financial statements under the modified prospective method. The impact of expensing stock awards resulted in stock compensation expense of \$0.2 million (\$0.2 million after tax) in fiscal 2005.

Under APB No. 25, pro forma expense for stock awards with pro-rata vesting was calculated on a straight line basis over the awards vesting period which typically ranges from one to five years. Upon the adoption of Statement 123(R), the Company records stock compensation expense on a straight line basis over the awards vesting period, which ranges from one to five years.

In March 2005, the FASB issued FASB Interpretation No. 47 (“FIN 47”), Accounting for Conditional Asset Retirement Obligations, to clarify the requirement to record liabilities stemming from a legal obligation to perform an asset retirement activity in which the timing or method of settlement is conditional on a future event. The Company adopted FIN 47 on December 31, 2005. No conditional retirement obligations were recognized and, accordingly, the adoption of FIN 47 had no effect on the Company’s financial statements.



## Results of Operations

The following tables set forth, for the periods indicated, selected historical consolidated statements of income data in thousands of dollars and expressed as a percentage of total revenues.

	Year Ended December 31,					
	2005		2004		2003	
	\$	%	\$	%	\$	%
Revenues:						
Resident and healthcare revenue ..	\$ 101,770	96.7%	\$ 90,544	97.1%	\$ 62,564	94.3%
Unaffiliated management services revenue .....	1,626	1.6%	726	0.8%	336	0.5%
Affiliated management services revenue .....	1,834	1.7%	1,992	2.1%	3,236	4.9%
Affiliated development fees .....	—	—%	—	—%	189	0.3%
Total revenues .....	<u>105,230</u>	<u>100.0%</u>	<u>93,262</u>	<u>100.0%</u>	<u>66,325</u>	<u>100.0%</u>
Expenses:						
Operating expenses (exclusive of depreciation and amortization shown below) .....	68,707	65.3%	64,772	69.5%	44,637	67.3%
General and administrative expenses .....	10,187	9.7%	9,552	10.2%	7,914	11.9%
Provision for bad debts .....	258	0.2%	198	0.2%	168	0.3%
Facility lease expense .....	2,070	2.0%	—	—%	—	—%
Depreciation and amortization .....	<u>13,046</u>	<u>12.4%</u>	<u>12,009</u>	<u>12.9%</u>	<u>7,791</u>	<u>11.7%</u>
Total expenses .....	<u>94,268</u>	<u>89.6%</u>	<u>86,531</u>	<u>92.8%</u>	<u>60,510</u>	<u>91.2%</u>
Income from operations .....	10,962	10.4%	6,731	7.2%	5,815	8.8%
Other income (expense):						
Interest income .....	133	0.1%	572	0.6%	4,278	6.5%
Interest expense .....	(18,595)	(17.6)%	(15,769)	(16.9)%	(12,481)	(18.8)%
Gain (loss) on sale of properties ..	104	0.1%	(37)	(0.0)%	6,751	10.2%
Debt restructuring/derivative costs:						
Write-off of deferred loan cost ..	(25)	(0.0)%	(824)	(0.9)%	—	—%
Gain on interest rate swap agreement .....	—	—%	1,435	1.5%	—	—%
Loss on interest rate lock agreement .....	(641)	(0.6)%	(1,356)	(1.5)%	—	—%
Other income (expense) .....	<u>416</u>	<u>0.4%</u>	<u>182</u>	<u>0.2%</u>	<u>3,616</u>	<u>5.5%</u>
(Loss) income before income taxes and minority interest in consolidated partnership .....	(7,646)	(7.3)%	(9,066)	(9.7)%	7,979	12.0%
Benefit (provision) for income taxes .....	<u>2,273</u>	<u>2.2%</u>	<u>2,270</u>	<u>2.4%</u>	<u>(3,098)</u>	<u>(4.7)%</u>
(Loss) Income before minority interest in consolidated partnership .....	(5,373)	(5.1)%	(6,796)	(7.3)%	4,881	7.4%
Minority interest in consolidated partnership .....	<u>19</u>	<u>0.0%</u>	<u>38</u>	<u>0.0%</u>	<u>109</u>	<u>0.2%</u>
Net (loss) income .....	<u>\$ (5,354)</u>	<u>(5.1)%</u>	<u>\$ (6,758)</u>	<u>(7.2)%</u>	<u>\$ 4,990</u>	<u>7.5%</u>

### *Year Ended December 31, 2005 Compared to the Year Ended December 31, 2004*

*Revenues.* Total revenues increased \$12.0 million or 12.8% to \$105.2 million in 2005 compared to \$93.3 million in 2004. Resident and health care revenue increased \$11.2 million or 12.4% to \$101.8 million in 2005 compared to \$90.5 million in the prior year. The increase in resident and healthcare revenue reflects an increase of \$5.4 million from the consolidation of the six communities, previously owned by BRE/CSL, that were sold to Ventas and leased back by the Company on September 30, 2005, \$0.8 million from the consolidation of Georgetowne Place which the Company leased from Ventas on October 19, 2005 and an increase resident and healthcare revenue at the Company's other communities of \$5.0 million as a result of higher occupancy and rental rates in the current fiscal year. Unaffiliated management services revenue increased \$0.9 million in fiscal 2005 primarily due to a full year of management fees earned on 15 third party senior living communities compared to management fees earned on the same 15 senior living communities in fiscal 2004, 14 of which were assumed on August 18, 2004 as a result of the Company's acquisition of CGIM. Affiliated management services revenue in both fiscal 2005 and 2004 results from the management of 10 affiliate owned communities, six of which were sold to Ventas and leased back by the Company on September 30, 2005.

*Expenses.* Total expenses increased \$7.7 million or 8.9% to \$94.3 million in 2005 compared to \$86.5 million in 2004. This increase in expense primarily results from a \$3.9 million increase in operating expenses, a \$0.6 million increase in general and administrative expenses, a \$2.1 million increase in facility lease expenses, a \$0.1 million increase in bad debt expenses and a \$1.0 million increase in depreciation and amortization expense. Operating expenses increased to \$68.7 million compared to \$64.8 million in the prior year. This 6.1% increase in operating expenses primarily results from \$3.4 million in operating expenses related to the six communities leased from Ventas on September 30, 2005, \$0.6 million in operating expenses from the operations of Georgetowne Place community which was leased from Ventas on October 19, 2005, \$0.3 million in costs associated with hurricane damage at two of the Company's communities offset by an overall decrease in operating expenses at the Company's other communities of \$0.4 million. General and administrative expenses increased to \$10.2 million in 2005 compared to \$9.6 million in the prior year. This 6.6% increase in general and administrative expenses primarily results from a \$0.6 million increase in employee compensation and benefit costs, \$0.2 million in stock compensation expense, and an increase of \$0.2 million in insurance costs offset by a decrease in professional fees of \$0.3 million and a decrease in other corporate overhead costs of \$0.1 million. Bad debt expense increase to \$0.3 million in fiscal 2005 compared to \$0.2 million in fiscal 2004. Facility lease expense represents actual rent paid plus amortization expense relating to lease acquisition cost on the seven communities leased from Ventas. Depreciation and amortization expense increased to \$13.0 million in 2005 compared to \$12.0 million in 2004, primarily from the amortization of the CGIM management contracts and additional depreciation expense resulting from the Company's acquisition of Triad I.

*Other income and expenses.* Interest income decreased \$0.5 million to \$0.1 million in fiscal 2005 compared to \$0.6 million in fiscal 2004. This 76.7% decrease in interest income primarily results from the consolidation of Triad I. Prior to consolidating Triad I the Company recognized interest income on certain notes receivable from Triad I. Interest expense increased \$2.8 million to \$18.6 million in 2005 compared to \$15.8 million in 2004. This 17.9% increase in interest expense is primarily the result higher interest rates on the Company's variable rate notes in the current fiscal year. Gain on sale of assets in fiscal 2005 represents the recognition of deferred gains associated with the sale/leaseback of the six BRE/CSL communities. As a result of this sale/leaseback transaction, the Company deferred \$4.2 million in gains that are being recognized into income over the initial 10 year lease term. In fiscal 2004, the Company sold one parcel of land, which resulted in the recognition of a gain of \$0.2 million and net proceeds of \$0.5 million. In addition, in 2004 the Company acquired the four joint ventures that owned the Spring Meadows Communities and simultaneously sold the Spring Meadows Communities to SHPII/CSL resulting in a net loss of \$0.2 million and net proceeds to the Company of \$0.8 million. The Company recognized a loss of \$0.6 million during fiscal 2005 relating to the interest rate lock agreements. The loss represents the change in the fair value of the interest rate lock agreements. As a result of refinancing certain debt related to the Company's interest rate lock agreements with Key Bank and settling the Company's swap agreements with Key Bank, during fiscal 2004, the Company

recognized a loss on the interest rate interest rate lock agreements of \$1.4 million and a gain on the interest rate swap agreements of \$1.4 million. Subsequent to the end of fiscal 2005, the Company settled its interest rate lock liability with Key Bank by paying \$1.8 million in cash and converting the remaining balance of \$5.7 million to a five-year note. The note bears interest at LIBOR plus 250 basis points with principal amortized on a straight-line basis over a seven year term. Due to refinancing certain debt during fiscal 2005 and 2004, the Company wrote-off unamortized deferred loan cost of \$25,000 and \$0.8 million, respectively. Other income in fiscal 2005 relates to the Company's equity in the earnings of affiliates, which represents the Company's share of the earnings on its investments in BRE/CSL and SHPII/CSL. Equity in the earnings of affiliates in fiscal 2004 represents the Company's share of the earnings and losses on its investments in BRE/CSL, SHPII/CSL and the Spring Meadows Communities.

*Provision for income taxes.* Benefit for income taxes in 2005 was \$2.3 million or 29.8% effective tax rate compared to a provision for income taxes in 2004 of \$2.3 million or 25.1% effective tax rate. The effective tax rates for 2005 and 2004 differ from the statutory tax rates because of state income taxes and permanent tax differences. The permanent tax differences in the fiscal 2004 include \$2.7 million in net losses incurred by Triad I, which was consolidated under the provisions of FIN 46 for the first eleven months of fiscal 2004 prior to the Company's acquisition of Triad I on November 30, 2004.

*Minority interest.* Minority interest for both 2005 and 2004 represents the minority holders' share of the losses incurred by HCP.

*Net income.* As a result of the foregoing factors, net loss decreased \$1.4 million to a net loss of \$5.4 million for 2005, as compared to a net loss of \$6.8 million for 2004.

#### ***Year Ended December 31, 2004 Compared to the Year Ended December 31, 2003***

*Revenues.* Total revenues increased \$27.0 million or 40.6% to \$93.3 million in 2004 compared to \$66.3 million in 2003. Resident and health care revenue increased \$27.9 million or 44.7% to \$90.5 million in 2004 compared to \$62.6 million in the prior year. The increase in resident and healthcare revenue reflects an increase of \$14.8 million from the acquisition of the Triad Entities (12 communities), an increase of \$15.0 million from the consolidation of Triad I (five communities and two expansions), and an increase at the Company's other communities of \$2.3 million offset by a decrease in resident and healthcare revenue of \$4.2 million relating to two communities that were sold at the end of the second and third quarters of fiscal 2003. Unaffiliated management services revenue in fiscal 2004 was derived from the management of 15 third party communities, 14 of which were assumed during the third quarter of 2004 as a result of the Company's acquisition of CGIM. Unaffiliated management services revenue in fiscal 2003 resulted primarily from the management of one third-party community in the fourth quarter of 2003 and the settlement of a management contract with Buckner. Affiliated management services revenue decreased \$1.2 million primarily as a result of the Company's acquisition/consolidation of the Triad Entities and Triad I. Affiliated development fees in fiscal 2003 represent the recognition of deferred development fees related to the Triad Entities and Triad I.

*Expenses.* Total expenses increased \$26.0 million or 43.0% to \$86.5 million in 2004 compared to \$60.5 million in 2003. This increase in expense primarily results from a \$20.1 million increase in operating expenses, a \$1.6 million increase in general and administrative expenses and a \$4.2 million increase in depreciation and amortization expense. Operating expenses increased to \$64.8 million compared to \$44.6 million in the prior year. This 45.3% increase in operating expenses primarily results from \$10.4 million related to the Company's acquisition of the Triad Entities and \$12.5 million due to the acquisition/consolidation of Triad I, offset by a \$0.5 million decrease in operating expenses at the Company's other communities and a decrease of \$2.9 million relating to the two communities that were sold during fiscal 2003. General and administrative expenses increased to \$9.6 million in 2004 compared to \$7.9 million in the prior year. This 21.5% increase in general and administrative expenses primarily results from an increase in salary and benefits of \$0.7 million, an increase in professional fees of \$0.6 million, primarily related to compliance with the Sarbanes-Oxley Act, an increase in insurance expense of \$0.1 million and an increase of \$0.3 million in other corporate overhead. Bad debt expense in both fiscal 2004 and 2003 was \$0.2 million. Depreciation and amortization expense increased to \$12.0 million in 2004 compared to \$7.8 million in 2003. This 54.1% increase

primarily results from \$2.5 million related to the Company's acquisition of the Triad Entities, \$2.0 million due to the acquisition/consolidation of Triad I offset by a decrease of \$0.3 million relating to the two communities that were sold during 2003.

*Other income and expenses.* Interest income decreased \$3.7 million to \$0.6 million in fiscal 2004 compared to \$4.3 million in fiscal 2003. This 86.6% decrease in interest income primarily results from the acquisition/consolidation of the Triad Entities and Triad I. Interest expense increased \$3.3 million to \$15.8 million in 2004 compared to \$12.5 million in 2003. This 26.3% increase in interest expense is primarily the result of higher debt outstanding in 2004 compared to the same period of fiscal 2003 due to the assumption of \$109.6 million of debt related to the acquisition of the Triad Entities in July 2003 and due to \$47.6 million of debt consolidated in December 2003 related to Triad I offset by \$14.9 million of debt repaid related to the two communities sold during 2003 and \$19.0 million of debt retired during the fiscal 2004. Gain (loss) on sale of assets decreased by \$6.8 million to a net loss of \$37,000 in fiscal 2004 compared to a net gain of \$6.8 million in fiscal 2003. In 2004, the Company sold one parcel of land, which resulted in the recognition of a gain of \$0.2 million and net proceeds of \$0.5 million. In addition, in 2004 the Company acquired the four joint ventures that owned the Spring Meadows Communities and simultaneously sold the Spring Meadows Communities to SHPII/CSL resulting in a net loss of \$0.2 million and net proceeds to the Company of \$0.8 million. In 2003, the Company sold two communities and two parcels of land, which resulted in the recognition of a gain of \$3.4 million and net proceeds to the Company of \$5.6 million. In addition, in 2003 the Company contributed a community to BRE/CSL, and as a result, the Company repaid \$7.4 million of long-term debt, received \$3.1 million in cash and has a 10% equity interest in the venture, resulting in the recognition of a gain of \$3.4 million. Other income decreased to \$0.2 million in fiscal 2004 compared to \$3.6 million in the prior fiscal year. Other income in 2004 results from the Company's net equity in the earnings of affiliates of \$0.2 million. Other income in fiscal 2003 results from the Company's equity in the earnings of affiliates of \$0.2 million along with the recognition of deferred income of \$3.4 million related to the liquidation of the HCP partnership. In December 2004, the Company refinanced 14 senior housing communities with GMAC. The total loan facility of \$128.4 million refinanced eight properties previously financed by GMAC and six properties previously financed under three separate loan agreements with Key Corporate Capital, Compass Bank and Bank of America, which have been repaid. The new loans with GMAC have a term of three years with two one-year extension options. The loans have an initial interest rate of LIBOR plus 350 basis point and the loan agreements provide for reduced rates once certain debt service coverage ratios are achieved. The Company incurred \$1.1 million in deferred financing costs related to these loans, which is being amortized over the three year loan term. During fiscal 2004, the Company wrote-off \$0.8 million in deferred financing costs related to the loans that were repaid. As a result of refinancing certain debt related to the Company's interest rate lock agreements with Key Bank and settling the Company's swap agreements with Key Bank the Company recognized a loss on the interest rate interest rate lock agreements of \$1.4 million and a gain on the interest rate swap agreements of \$1.4 million.

*Provision for income taxes.* Benefit for income taxes in 2004 was \$2.3 million or 25.1% effective tax rate compared to a provision for income taxes in 2003 of \$3.1 million or 38.3% effective tax rate. The effective tax rates for 2004 and 2003 differ from the statutory tax rates because of state income taxes and permanent tax differences. The permanent tax differences in the fiscal 2004 include \$2.7 million in net losses incurred by Triad I, which was consolidated under the provisions of FIN 46 for the first eleven months of fiscal 2004 prior to the Company's acquisition of Triad I on November 30, 2004.

*Minority interest.* Minority interest for both 2004 and 2003 represents the minority holders' share of the losses incurred by HCP. During 2003, HCP sold its remaining community and transferred its remaining assets to a liquidating trust.

*Net income.* As a result of the foregoing factors, net income decreased \$11.8 million to a net loss of \$6.8 million for 2004, as compared to a net income of \$5.0 million for 2003.

## Quarterly Results

The following table presents certain unaudited quarterly financial information for the four quarters ended December 31, 2005 and 2004. This information has been prepared on the same basis as the audited Consolidated Financial Statements of the Company appearing elsewhere in this report and include, in the opinion of management, all adjustments (consisting of normal recurring adjustments) necessary to present fairly the quarterly results when read in conjunction with the audited Consolidated Financial Statements of the Company and the related notes thereto.

	2005 Calendar Quarters			
	First	Second	Third	Fourth
	(In thousands, except per share amounts)			
Total revenues	\$24,238	\$24,436	\$25,084	\$31,472
Income from operations	2,655	2,613	2,969	2,725
Net loss	(758)	(2,181)	(588)	(1,827)
Net loss per share, basic	\$ (0.03)	\$ (0.08)	\$ (0.02)	\$ (0.07)
Net loss per share, diluted	\$ (0.03)	\$ (0.08)	\$ (0.02)	\$ (0.07)
Weighted average shares outstanding, basic	25,754	25,776	25,858	25,917
Weighted average shares outstanding, fully diluted	25,754	25,776	25,858	25,917

	2004 Calendar Quarters			
	First	Second	Third	Fourth
	(In thousands, except per share amounts)			
Total revenues	\$22,626	\$23,017	\$23,696	\$23,923
Income from operations	1,107	1,575	2,059	1,990
Net loss	(2,046)	(1,596)	(1,356)	(1,760)
Net loss per share, basic	\$ (0.09)	\$ (0.06)	\$ (0.05)	\$ (0.07)
Net loss per share, diluted	\$ (0.09)	\$ (0.06)	\$ (0.05)	\$ (0.07)
Weighted average shares outstanding, basic	23,698	25,668	25,733	25,744
Weighted average shares outstanding, fully diluted	23,698	25,668	25,733	25,744

## Liquidity and Capital Resources

In addition to approximately \$21.8 million of cash balances on hand as of December 31, 2005, the Company's principal sources of liquidity are expected to be cash flows from operations, proceeds from the sale of assets and cash flows from SHPII/CSL and Midwest. Of the \$21.8 million in cash balances, \$0.6 million relates to cash held by HCP. The Company expects its available cash and cash flows from operations, proceeds from the sale of assets and cash flows from SHPII/CSL and Midwest to be sufficient to fund its short-term working capital requirements. The Company's ability to meet its long-term capital requirements, including the repayment of certain long-term debt obligations, will depend, in part, on its ability to obtain additional financing or refinancings on acceptable terms from available financing sources, including mortgage financing, joint venture arrangements, by accessing the debt and/or equity markets and possibly through operating leases or other types of financing, such as lines of credit. There can be no assurance that the financing or refinancings will be available or that, if available, it will be on terms acceptable to the Company.

The Company had net cash provided by operating activities of \$2.0 million in fiscal 2005 compared to \$4.2 million and \$2.5 million in fiscal 2004 and 2003, respectively. In fiscal 2005, net cash provided by operating activities was primarily derived from net non-cash charges of \$12.4 million, a decrease in federal and state income tax receivable of \$0.7 million, an increase in accounts payable and accrued expenses of \$3.1 million and an increase in customer deposit of \$0.6 million offset by a net loss of \$5.4 million, an increase in property tax and insurance deposits of \$2.3 million, an increase in other assets of \$7.1 million. In fiscal 2004, net cash provided by operating activities was primarily derived from net non-cash charges of \$13.6 million, a decrease in prepaid and other expenses of \$0.3 million, a decrease in other assets of \$0.5 million, an increase in



accounts payable and accrued expenses of \$0.3 million and a decrease in customer deposit of \$0.1 million offset by a net loss of \$6.8 million, an increase in accounts receivable of \$1.5 million, an increase in property tax and insurance deposits of \$0.9 million and an increase in income taxes receivable of \$1.4 million. In fiscal 2003, net cash provided by operating activities was primarily derived from net income of \$5.0 million, a decrease in other assets of \$1.1 million, and a decrease in income taxes payable of \$0.2 million offset by net non-cash benefit of \$0.1 million, an increase in account receivable of \$0.3 million, an increase in prepaid expenses and other assets of \$0.8 million, a decrease in accounts payable of \$0.9 million, a decrease in accrued liabilities of \$1.2 million, and a increase in deposits of \$0.5 million.

The Company had net cash provided by investing activities of \$3.1 million and \$0.7 million in fiscal 2005 and 2003, respectively, compared to net cash used in investing activities of \$7.6 million in fiscal 2004. In fiscal 2005, the Company had net cash provided by investing activities primarily results from distributions from limited partnerships of \$6.4 million offset by capital expenditures of \$3.2 million. In fiscal 2004, the Company's net cash used in investing activities was primarily the result of capital expenditures of \$2.4 million, net cash paid for the acquisition of Triad I of \$4.0 million, net cash paid for the acquisition of CGIM of \$2.3 million and advances to affiliates of \$0.4 million offset by net cash acquired from the acquisition of the four Spring Meadows joint ventures of \$0.8 million, proceeds from the sale of one parcel of land of \$0.5 million, net of selling costs, and distributions from limited partnerships of \$0.2 million. In fiscal 2003, the Company's net cash provided by investing activities was primarily the result of proceeds from the sale of two communities and two parcels of land for \$5.5 million net of selling costs, proceeds from the contribution of one community to BRE/CSL of \$3.1 million, net cash acquired from the acquisition of the Triad Entities of \$0.1 million, net cash from the consolidation of Triad I of \$0.8 million and distributions from limited partnerships of \$0.2 million offset by advances to Triad I and the Triad Entities of \$7.4 million and capital expenditures of \$1.6 million.

The Company had net cash used in financing activities of \$2.8 million and \$8.4 million in fiscal 2005 and 2003, respectively compared to net cash provided by financing activities of \$16.3 million in fiscal 2004. In fiscal 2005, net cash used in financing activities primarily results from net payments on notes payable of \$1.0 million, cash restricted under certain debt agreements of \$1.0 million, distributions to minority partners of \$0.2 million and deferred loan cost paid of \$1.5 million offset by proceeds from the exercise of stock options of \$0.7 million and excess tax benefits on stock options exercised of \$0.2 million. In fiscal 2004, net cash provided by financing activities was primarily derived from proceeds from the Company's common stock offering of \$32.2 million, proceeds from the exercise of stock options of \$0.3 million, the release of restricted cash of \$7.2 million offset by net note repayments of \$21.8 million, cash paid to settle interest rate swap agreements of \$0.5 million and cash used in financing activities of \$1.1 million. For fiscal 2003 the net cash used in financing activities primarily results from repayments of notes payable of \$18.5 million, distributions to minority partners of \$0.3 million, deferred loan charges paid of \$0.2 million offset by proceeds from the issuance of notes payable of \$5.1 million, proceeds from the release of restricted cash of \$5.2 million and proceeds from the exercise of common stock options of \$0.3 million

The Company derives the benefits and bears the risks related to the communities it owns. The cash flows and profitability of owned communities depends on the operating results of such communities and are subject to certain risks of ownership, including the need for capital expenditures, financing and other risks such as those relating to environmental matters.

The Company's third-party management fees are primarily based on a percentage of gross revenues. As a result, the cash flow and profitability of such contracts to the Company are more dependent on the revenues generated by such communities and less dependent on net cash flow than for owned communities. Further, the Company is not responsible for capital investments in managed communities. The management contracts are generally terminable only for cause and upon the sale of a community, subject to the Company's rights to offer to purchase such community.

Effective as of November 30, 2004, the Company acquired Lehman's approximate 81% interest in the Spring Meadows Communities and simultaneously sold the Spring Meadows Communities to SHPII/CSL, which is owned 95% by SHPII and 5% by the Company. As a result these transactions, the Company paid



\$1.1 million for Lehman's interests in the joint ventures, received net assets of \$0.9 million and wrote-off the remainder totaling \$0.2 million. In addition, the Company contributed \$1.3 million to SHPII/CSL for its 5% interest. The Company manages the communities for SHPII/CSL under long-term management contracts.

Prior to SHPII/CSL's acquisition of the Spring Meadows Communities, the Company, in December 2002, acquired LCOR's approximate 19% member interests in the four joint ventures that owned the Spring Meadows Communities from LCOR as well as loans made by LCOR to the joint ventures for \$0.9 million in addition to funding \$0.4 million to the venture for working capital and anticipated negative cash requirements of the communities. The Company's interests in the joint ventures that owned the Spring Meadows Communities included interests in certain loans to the ventures and an approximate 19% member interest in each venture. The Company recorded its initial advances of \$1.3 million to the ventures as notes receivable as the amount assigned for the 19% member interests was nominal. The Company accounted for its investment in the Spring Meadows Communities under the equity method of accounting based on the provisions of the partnership agreements. The Company managed the Spring Meadows Communities since the opening of each community in late 2000 and early 2001 and continued to manage the communities under long-term management contracts until November 2004 when the joint ventures were sold. In addition, the Company received an asset management fee relating to each of the four communities. The Company had the obligation to fund certain future operating deficits of the Spring Meadows Communities to the extent of its 19% member interest. No amounts were funded by the Company under this obligation.

In September 2003, the Company sold its Carmichael community to SHPII, for \$11.7 million before closing costs of \$0.6 million. Carmichael is an independent living community located in Sacramento, California with a resident capacity of 156. As a result of the sale the Company retired \$7.4 million in debt and received \$3.6 million in cash and recognized a gain of \$3.1 million. The Company manages the Carmichael community for SHPII under a long-term management contract.

The Company formed BRE/CSL with Blackstone in December 2001, and the joint ventures are owned 90% by Blackstone and 10% by the Company. Pursuant to the terms of the joint ventures, each of the Company and Blackstone must approve any acquisitions made by BRE/CSL. Each party must also contribute its pro rata portion of the costs of any acquisition.

In December 2001, BRE/CSL acquired Amberleigh, a 394 resident capacity independent living facility. In connection with the acquisition of Amberleigh by BRE/CSL, the Company contributed \$1.8 million to BRE/CSL. During the second quarter of 2002, BRE/CSL obtained permanent financing for the Amberleigh community and the Company recovered \$1.4 million of its contribution to BRE/CSL.

On June 13, 2002, the Company contributed to BRE/CSL four of its senior living communities with a capacity of approximately 600 residents. As a result of the contribution, the Company repaid \$29.1 million of long-term debt to GMAC, received \$7.3 million in cash from BRE/CSL, has a 10% equity interest in the venture of \$1.2 million and wrote-off \$0.5 million in deferred loan costs.

In addition, on June 30, 2003, the Company contributed to BRE/CSL one of its senior living communities with a capacity of 182 residents. As a result of the contribution the Company repaid \$7.4 million of long-term debt, received \$3.1 million in cash from BRE/CSL, and has a 10% equity interest in BRE/CSL of \$0.4 million resulting in the recognition of a gain of \$3.4 million.

The Company managed the six communities owned by BRE/CSL under long-term management contracts. The Company accounted for the BRE/CSL investment under the equity method of accounting. The Company deferred management services revenue as a result of its 10% interest in the BRE/CSL joint venture.

Effective September 30, 2005, the six BRE/CSL communities were sold to Ventas for approximately \$84.6 million.

Effective as of July 1, 2003, the Company acquired the partnership interest of the general partners and the other third party limited partners' interests in the Triad Entities for \$1.3 million in cash, \$0.4 million in notes payable and the assumption of all outstanding debt and liabilities (\$109.6 million bank debts,

\$73.2 million debt due to the Company, and \$9.9 million net working capital liabilities). The total purchase price was \$194.4 million and the acquisition was treated as a purchase of property and the Company wholly owns each of the Triad Entities. This acquisition resulted in the Company acquiring ownership of 12 senior living communities with a combined resident capacity of approximately 1,670 residents. Subsequent to the end of the Company's third quarter of 2003, the Company repaid the \$0.4 million in notes payable related to this acquisition.

The purchase price was allocated as follows (in thousands):

Net cash acquired .....	\$ 122
Fair value of tangible assets acquired, net .....	10,584
Property and equipment .....	<u>183,737</u>
Total purchase price .....	<u>\$194,443</u>

Set forth below is information relating to the construction/permanent loan facilities the Company assumed as a result of the acquisition of the Triad Entities at July 1, 2003 (dollars in thousands):

<u>Entity</u>	<u>Number of Communities</u>	<u>Loan Facilities to Triad Entities</u>			
		<u>Commitment</u>	<u>Amount Outstanding</u>	<u>Type</u>	<u>Lender</u>
Triad II .....	3	\$26,900	\$ 26,003	mini-perm	Key Corporate Capital, Inc.
Triad III .....	6	\$56,300	\$ 56,270	mini-perm	Guaranty Bank
Triad IV .....	2	\$18,600	\$ 18,627	mini-perm	Compass Bank
Triad V .....	1	\$ 8,903	<u>\$ 8,698</u>	mini-perm	Bank of America
Total .....			<u>\$109,598</u>		

The following unaudited pro forma financial information combines the results of the Company and the Triad Entities as if the transaction had taken place at the beginning of fiscal 2003. The pro forma financial information is presented for informational purposes only and does not reflect the results of operations of the Company, which would have actually resulted if the purchase occurred as of the dates indicated, or future results of operations of the Company (in thousands).

	<u>Year Ended December 31, 2003</u>
Net revenues .....	\$75,449
Net income .....	\$ 778
Net income per share — basic .....	\$ 0.04
Net income per share — diluted .....	\$ 0.04

Effective as of November 30, 2004, the Company acquired Lehman's approximate 81% limited partner's interest in Triad I for \$4.0 million in cash and the issuance of a note with a net present value of \$2.8 million. In addition, the Company acquired the general partner's interest in Triad I by assuming a \$3.6 million note payable from the general partner to a subsidiary of the Company. The acquisition was recorded as a purchase of property. The entire purchase price of \$10.4 million was recorded as a step-up in basis of \$9.3 million and in addition the Company recorded a deferred tax asset of \$1.1 million as Triad I had been previously consolidated under FIN 46 as of December 31, 2003. These transactions resulted in the Company wholly owning Triad I. Triad I owned five Waterford senior living communities and two expansions. The two expansions were subsequently deeded to a subsidiary of the Company in order for the two expansions to be consolidated with their primary community.

In 2003, the Financial Accounting Standards Board issued FASB Interpretation No. 46 (Revised December 2003) "Consolidation of Variable Interest Entities" an interpretation of ARB No. 51, effective immediately for variable interest entities created after January 31, 2003 and effective as of December 31, 2003

for variable interest entities that existed prior to February 1, 2003. The Company adopted the provisions of this interpretation at December 31, 2003, and its adoption resulted in the Company consolidating the financial position of Triad I at December 31, 2003 and consolidating the operations of Triad I beginning in the Company's first quarter of 2004. The consolidation of Triad I under the provisions of FIN 46 as of December 31, 2003 resulted in an increase in property and equipment of \$62.5 million.

The following unaudited pro forma financial information combines the results of the Company and Triad I as if the provisions of FASB Interpretation No. 46 had been applied at the beginning of fiscal 2003. The pro forma financial information is presented for informational purposes only and does not reflect the results of operations of the Company, which would have actually resulted if Triad I had been consolidated as of the dates indicated, or future results of operations of the Company (in thousands):

	<u>Year Ended December 31, 2003</u>
Net revenue .....	\$80,320
Net income .....	\$ 1,601
Net income per share — basic .....	\$ 0.08
Net income per share — diluted .....	\$ 0.08

Prior to consolidation/acquisition the Company had a 1% limited partners' interest in Triad I and the Triad Entities and accounted for Triad I and the Triad Entities under the equity method of accounting based on the provisions of the partnership agreements. The Company recognized losses in Triad I and the Triad Entities of \$0.1 million as of December 31, 2003. The recognition of losses reduced the Company's investments in Triad I and the Triad Entities to zero and additional losses of \$0.5 million were recorded as a reduction to the Company's notes receivable from the Triad Entities.

Deferred interest income was being amortized into income over the life of the loan commitment that the Company had with Triad I and the Triad Entities. Deferred development and management fee income was being amortized into income over the expected remaining life of Triad I and Triad Entities' partnership. All deferred items were eliminated upon consolidation/acquisition.

Effective August 18, 2004, the Company acquired from Covenant all of the outstanding stock of Covenant's wholly owned subsidiary, CGIM. The Company paid approximately \$2.3 million in cash (including closing cost of approximately \$0.1 million) and issued a note with a fair value of approximately \$1.1 million, subject to various adjustments set forth in the purchase agreement, to acquire all of the outstanding stock of CGIM. The note is due in three installments of approximately \$0.3 million, \$0.4 million and \$0.7 million due on the first, third and fifth anniversaries of the closing, respectively, subject to reduction if the management fees earned from the third party owned communities with various terms are terminated and not replaced by substitute agreements during the period, and certain other adjustments. The total purchase price was \$3.5 million and the acquisition was treated as a purchase of property. The \$3.5 million purchase price was allocated to management contracts. In addition, the Company recorded a deferred tax liability of \$2.1 million related to the acquisition of these management contract rights. The Company's first installment payment under the Covenant note was reduced by \$0.2 million under the terms of the stock purchase agreement and the \$0.2 million installment reduction was recorded as an adjustment to the purchase price. This acquisition resulted in the Company assuming the management contracts on 14 senior living communities with a combined resident capacity of approximately 1,800 residents. In addition, the Company has the right to acquire seven of the properties owned by Covenant (which are part of the 14 communities managed by CGIM) based on sales prices specified in the stock purchase agreement.

The Company owned 57% of the HCP partnership and the assets, liabilities, minority interest, and the results of operations of HCP have been consolidated in the Company's financial statements. In 2003, HCP sold its remaining community for \$1.1 million, which resulted in the recognition of a gain of \$48,000 and net proceeds of \$1.0 million. Subsequent to the sale of this community, HCP has been dissolved with its remaining assets transferred to a liquidating trust. In connection therewith, the Company recognized deferred revenue of \$3.4 million in the fourth quarter of 2003 due to the liquidation.

## Disclosures About Contractual Obligations

The following table provides the amounts due under specified contractual obligations (including interest expense) for the periods indicated as of December 31, 2005 (in thousands):

	<u>Less Than One Year</u>	<u>One to Three Years</u>	<u>Four to Five Years</u>	<u>More Than Five Years</u>	<u>Total</u>
Long-term debt . . . . .	\$26,326	\$203,602	\$42,334	\$42,982	\$315,244
Operating leases . . . . .	8,924	17,278	16,731	39,768	82,701
Interest rate lock . . . . .	<u>2,912</u>	<u>2,218</u>	<u>1,991</u>	<u>1,716</u>	<u>8,837</u>
Total contractual cash Obligations . .	<u>\$38,162</u>	<u>\$223,098</u>	<u>\$61,056</u>	<u>\$84,466</u>	<u>\$406,782</u>

Long-term debt relates to the aggregate maturities of the Company's notes payable. The Company leases its corporate headquarters, an executive office in New York, seven senior living communities and certain equipment used at the Company's communities.

## Impact of Inflation

To date, inflation has not had a significant impact on the Company. However, inflation could affect the Company's future revenues and results of operations because of, among other things, the Company's dependence on senior residents, many of whom rely primarily on fixed incomes to pay for the Company's services. As a result, during inflationary periods, the Company may not be able to increase resident service fees to account fully for increased operating expenses. In structuring its fees, the Company attempts to anticipate inflation levels, but there can be no assurance that the Company will be able to anticipate fully or otherwise respond to any future inflationary pressures.

## ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISKS

The Company's primary market risk is exposure to changes in interest rates on debt instruments. As of December 31, 2005, the Company had \$260.5 million in outstanding debt comprised of various fixed and variable rate debt instruments of \$86.4 million and \$174.1 million, respectively.

Changes in interest rates would affect the fair market value of the Company's fixed rate debt instruments but would not have an impact on the Company's earnings or cash flows. Fluctuations in interest rates on the Company's variable rate debt instruments, which are tied to either LIBOR or the prime rate, would affect the Company's earnings and cash flows but would not affect the fair market value of the variable rate debt. Each percentage point change in interest rates would increase the Company's annual interest expense by approximately \$1.7 million based on the Company's outstanding variable debt as of December 31, 2005.

The following table summarizes information on the Company's debt instruments outstanding as of December 31, 2005. The table presents the principal due and weighted average interest rates by expected

maturity date for the Company's various debt instruments by fiscal year. Weighted average variable interest rates are based on the Company's floating rate as of December 31, 2005.

Principal Amount and Average Interest Rate by Expected Maturity Date at December 31, 2005 (\$ in thousands):

	<u>2006</u>	<u>2007</u>	<u>2008</u>	<u>2009</u>	<u>2010</u>	<u>Thereafter</u>	<u>Total</u>	<u>Fair Value</u>
Long-term debt:								
Fixed rate debt . . . . .	\$3,407	\$ 2,145	\$ 9,869	\$33,841	\$2,444	\$34,656	\$ 86,362	\$ 81,051
Average interest rate . . .	5.4%	5.9%	6.9%	7.9%	6.5%	5.5%		
Variable rate debt . . . . .	4,394	47,056	122,722	—	—	—	174,172	174,172
Average interest rate . . .	7.0%	6.5%	7.8%	—	—	—		
Interest rate lock . . . . .	2,573	818	818	818	818	1,705	<u>7,550</u>	<u>7,550</u>
Total Debt . . . . .							<u>\$268,084</u>	<u>\$262,773</u>

Effective January 31, 2005, the Company entered into interest rate cap agreements with two commercial banks to reduce the impact of increases in interest rates on the Company's variable rate loans. One interest rate cap agreement effectively limited the interest rate exposure on a \$50 million notional amount to a maximum LIBOR rate of 5% and expired on January 31, 2006. The second interest rate cap agreement effectively limits the interest rate exposure on \$100 million notional amount to a maximum LIBOR rate of 5%, as long as one-month LIBOR is less than 7%. If one-month LIBOR is greater than 7%, the agreement effectively limits the interest rate on the same \$100 million notional amount to a maximum LIBOR rate of 7%. This second agreement expires on January 31, 2008. The Company paid \$0.4 million for the interest rate caps and the costs of these agreements are being amortized to interest expense over the life of the agreements.

The Company used interest rate lock and interest rate swap agreements for purposes other than trading. The Company is party to interest rate lock agreements, which were used to hedge the risk that the costs of future issuance of debt may be adversely affected by changes in interest rates. Under the interest rate lock agreements, the Company agrees to pay or receive an amount equal to the difference between the net present value of the cash flows for a notional principal amount of indebtedness based on the locked rate at the date when the agreement was established and the yield of a United States Government 10-Year Treasury Note on the settlement date of January 3, 2006. The notional amounts of the agreements were not exchanged. These interest rate lock agreements were entered into with a major financial institution in order to minimize counterparty credit risk. The locked rates range from 7.5% to 9.1%. On December 30, 2004, the Company refinanced the underlying debt and this refinancing resulted in the interest rate lock agreements no longer qualifying as an interest rate hedge. The Company reflects the interest rate lock agreements at fair value in the Company's consolidated balance sheet (Other long-term liabilities, net of current portion of \$2.6 million) and related gains and losses are recognized in the consolidated statements of operations. The Company recognized a loss of \$0.6 million and \$1.4 million during fiscal 2005 and 2004, respectively, relating to the interest rate lock agreements. The Company settled the interest rate lock liability on January 3, 2006 by paying \$1.8 million in cash and converting the remaining balance of \$5.7 million to a five-year note. The note bears interest at LIBOR plus 250 with principal amortized over a seven year term. Prior to refinancing the underlying debt, the interest rate lock agreements were reflected at fair value in the Company's consolidated balance sheets (Other long-term liabilities) and the related gains or losses on these agreements were deferred in stockholders' equity (as a component of other comprehensive income).

In addition, the Company was party to interest rate swap agreements in fiscal 2004 and 2003 that were used to modify variable rate obligations to fixed rate obligations, thereby reducing the Company's exposure to market rate fluctuations. On December 30, 2004, the Company settled its interest rate swap agreements by paying its lender \$0.5 million. The differential paid or received as rates changed was accounted for under the accrual method of accounting and the amount payable to or receivable from counterparties was included as an adjustment to accrued interest. The interest rate swap agreements resulted in the recognition of an additional \$0.9 million and \$1.0 million in interest expense during fiscal 2004 and 2003, respectively.



## **ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA**

The financial statements are included under Item 15 of this Annual Report.

## **ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURES**

The Company had no disagreements on accounting or financial disclosure matters with its independent accountants to report under this Item 9.

### **ITEM 9A. CONTROLS AND PROCEDURES**

#### **(a) Evaluation of Disclosure Controls and Procedures**

The Company's management, with the participation of the Company's Chief Executive Officer ("CEO") and Chief Financial Officer ("CFO"), has evaluated the effectiveness of the Company's disclosure controls and procedures (as such term is defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act) as of the end of the period covered by this report. The Company's disclosure controls and procedures are designed to ensure that information required to be disclosed by the Company in the reports that it files or submits under the Securities Exchange Act of 1934, as amended, is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms. Disclosure controls and procedures are also designed to ensure that such information is accumulated and communicated to the Company's management, including the CEO and CFO, as appropriate to allow timely decisions regarding required disclosure. Based upon the evaluation described above, the Company's CEO and CFO concluded that the Company's disclosure controls and procedures were ineffective as of December 31, 2005 due to a material weakness in internal control over financial reporting related to accounting for income taxes as described below in Item 9A(b).

As a consequence of the material weakness noted above, the Company has applied other procedures designed to improve the reliability of its accounting for income taxes. Based on these other procedures, management (i) believes that the consolidated financial statements included in this report, as well as the Company's consolidated financial statements for each quarter in 2005, as previously reported, are fairly stated in all material respects, and (ii) does not believe the material weakness will result in any adjustments to previously released financial statements.

#### **(b) Management's Report on Internal Control Over Financial Reporting**

Management of the Company, including the CEO and the CFO, is responsible for establishing and maintaining adequate internal control over financial reporting, as defined in Rules 13a-15(f) and 15a-15(f) under the Securities Exchange Act of 1934. The Company's internal control system is a process designed by, or under the supervision of, the issuer's principal executive and principal financial officers, or persons performing similar functions, and effected by the issuer's board of directors, management and other personnel, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with U.S. generally accepted accounting principles (U.S. GAAP).

The Company's internal control over financial reporting includes policies and procedures that: pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect transactions and dispositions of assets; provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with U.S. GAAP, and that receipts and expenditures are being made only in accordance with the authorization of its management and directors; and provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition use or disposition of the Company's assets that could have a material effect on its consolidated financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that



controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

Management assessed the effectiveness of the Company's internal control over financial reporting as of December 31, 2005. In making this assessment, management used the criteria framework set forth by the Committee of Sponsoring Organizations of the Treadway Commission ("COSO") published in its report entitled *Internal Control — Integrated Framework*. As a result of its assessment, management identified a material weakness in the Company's internal control over financial reporting.

A material weakness is a control deficiency, or combination of control deficiencies, that results in more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected.

As a result of its assessment, the Company has identified the following material weakness in internal control over financial reporting relative to accounting for income taxes as of December 31, 2005:

The Company each year retains tax consultants and third-party income tax advisors to assist in the calculation of the income tax provision and in the analysis of deferred tax assets and liabilities, along with the impact of income taxes on purchase accounting. The Company's policies and procedures, and allocation of resources, did not provide for an effective review of the Company's accounting for income taxes, which was prepared by such consultants and advisors. As a result of this deficiency, the Company's preliminary accounting for income taxes included errors. The deficiency also results in more than a remote likelihood that a material misstatement of the Company's interim or annual consolidated financial statements would not be prevented or detected.

Based on the material weakness described above, management concluded that the Company's internal control over financial reporting was not effective as of December 31, 2005.

The independent registered public accounting firm that audited the Company's consolidated financial statements has issued an audit report on management's assessment of the Company's internal control over financial reporting as of December 31, 2005. This report appears in Item 9A (d).

### **(c) Changes in Internal Control Over Financial Reporting**

There have not been any changes in the Company's internal control over financial reporting (as such term is defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) during the fiscal quarter to which this report relates that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

Subsequent to December 31, 2005, the Company has taken and will take various corrective actions to remediate the material weakness noted above. These remedial actions are as follows:

- the Company will replace its third-party income tax advisors and tax consultants and will ensure that the third-party tax service providers have the required expertise for the more complex areas of the Company's income tax accounting; and
- the Company has increased the formality and rigor of controls and procedures over accounting for income taxes, including the allocation of additional internal resources to the income tax accounting process.

Notwithstanding the existence of the material weakness noted above, management believes that the accompanying consolidated financial statements fairly present, in all material respects, the financial condition, results of operations and cash flows for the fiscal years presented in this report on Form 10-K.

#### **(d) Report of Independent Registered Public Accounting Firm**

##### **Report of Independent Registered Public Accounting Firm**

The Board of Directors and Shareholders Capital Senior Living Corporation:

We have audited management's assessment, included in the accompanying Management's Report on Internal Control Over Financial Reporting (Item 9A(b)), that Capital Senior Living Corporation (the Company) did not maintain effective internal control over financial reporting as of December 31, 2005, because of the effect of the material weakness identified in management's assessment, based on criteria established in Internal Control — Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). The Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management's assessment and an opinion on the effectiveness of Capital Senior Living Corporation's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

A material weakness is a control deficiency, or combination of control deficiencies, that results in more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected. The following material weakness has been identified and included in management's assessment. The Company's policies and procedures, and allocation of resources, did not provide for an effective review of the Company's accounting for income taxes, which was prepared by tax consultants and third party advisors. As a result of this deficiency, the Company's preliminary accounting for income taxes included errors. The deficiency also results in more than a remote likelihood that a material misstatement of the Company's interim or annual consolidated financial statements would not be prevented or detected.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheet of Capital Senior Living Corporation as of December 31, 2005, and the related consolidated statements of operations, shareholders' equity, and cash flows for the year then ended. This material weakness was considered in determining the nature, timing, and extent of

audit tests applied in our audit of the 2005 consolidated financial statements, and this report does not affect our report dated March 31, 2006, which expressed an unqualified opinion on those consolidated financial statements.

In our opinion, management's assessment that Capital Senior Living Corporation did not maintain effective internal control over financial reporting as of December 31, 2005, is fairly stated, in all material respects, based on criteria established in Internal Control — Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Also, in our opinion, because of the effect of the material weakness described above on the achievement of the objectives of the control criteria, Capital Senior Living Corporation has not maintained effective internal control over financial reporting as of December 31, 2005, based on criteria established in Internal Control — Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

/s/ KPMG LLP

Dallas, Texas  
March 31, 2006

**ITEM 9B. OTHER INFORMATION.**

Not Applicable.

**PART III**

**ITEM 10. *DIRECTORS AND EXECUTIVE OFFICERS OF THE REGISTRANT***

Information contained under the caption “Election of Directors” in the Proxy Statement is incorporated herein by reference in response to this Item 10. See also the information in Item 1 under the heading “Executive Officers and Key Employees.”

**ITEM 11. *EXECUTIVE COMPENSATION***

Information contained under the captions “Executive Compensation” and “Election of Directors” in the Proxy Statement is incorporated herein by reference in response to this Item 11.

**ITEM 12. *SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS***

Information contained under the caption “Principal Stockholders and Stock Ownership of Management” in the Proxy Statement is incorporated herein by reference in response to this Item 12.

**ITEM 13. *CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS***

Information contained under the caption “Certain Relationships and Related Transactions” in the Proxy Statement is incorporated herein by reference in response to this Item 13.

**ITEM 14. *PRINCIPAL ACCOUNTANT FEES AND SERVICES***

Information contained under the caption “Fees Paid to Independent Auditors” in the Proxy Statement is incorporated herein by reference in response to this Item 14.

**PART IV**

**ITEM 15. *EXHIBITS AND FINANCIAL STATEMENT SCHEDULES***

The following documents are filed as part of this Report:

(1) Financial Statements:

The response to this portion of Item 15 is submitted as a separate section of this Report. See Index to Financial Statements at page F-1.

(2) Financial Statement Schedules:

All schedules have been omitted as the required information is inapplicable or the information is presented in the financial statements or related notes.

(3) Exhibits:

The exhibits listed on the accompanying Index To Exhibits at page E-1 are filed as part of this Report.

## SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned, hereunto duly authorized, on March 31, 2006.

### CAPITAL SENIOR LIVING CORPORATION

By:           /s/ LAWRENCE A. COHEN            
Lawrence A. Cohen  
Vice Chairman of the Board  
and Chief Executive Officer

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed by the following persons on behalf of the Registrant and in the capacities and on the dates indicated. Each person whose signature to this report appears below hereby appoints Lawrence A. Cohen and James A. Stroud and each of them, any one of whom may act without the joinder of the other, as his or her attorney-in-fact to sign on his behalf, individually and in each capacity stated below, and to file all amendments to this report, which amendment or amendments may make such changes in and additions to the report as any such attorney-in-fact may deem necessary or appropriate.

<u>Signature</u>	<u>Title</u>	<u>Date</u>
<u>          /s/ LAWRENCE A. COHEN          </u> Lawrence A. Cohen	Chief Executive Officer and Vice Chairman of the Board (Principal Executive Officer)	March 31, 2006
<u>          /s/ JAMES A. STROUD          </u> James A. Stroud	Chairman of the Company and Chairman of the Board	March 31, 2006
<u>          /s/ KEITH N. JOHANNESSEN          </u> Keith N. Johannessen	President and Chief Operating Officer and Director	March 31, 2006
<u>          /s/ RALPH A. BEATTIE          </u> Ralph A. Beattie	Executive Vice President and Chief Financial Officer (Principal Financial and Accounting Officer)	March 31, 2006
<u>          /s/ CRAIG F. HARTBERG          </u> Craig F. Hartberg	Director	March 31, 2006
<u>          /s/ JILL M. KRUEGER          </u> Jill M. Krueger	Director	March 31, 2006
<u>          /s/ JAMES A. MOORE          </u> James A. Moore	Director	March 31, 2006
<u>          /s/ VICTOR W. NEE          </u> Dr. Victor W. Nee	Director	March 31, 2006





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## **Report of Independent Registered Public Accounting Firm**

The Board of Directors and Shareholders  
Capital Senior Living Corporation:

We have audited the accompanying consolidated balance sheet of Capital Senior Living Corporation as of December 31, 2005, and the related consolidated statements of operations, shareholders' equity, and cash flows for the year then ended. These consolidated financial statements are the responsibility of Capital Senior Living Corporation's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (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, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Capital Senior Living Corporation as of December 31, 2005, and the results of its operations and its cash flows for the year then ended, in conformity with U.S. generally accepted accounting principles.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of Capital Senior Living Corporation's internal control over financial reporting as of December 31, 2005, based on criteria established in Internal Control — Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), and our report dated March 31, 2006 expressed an unqualified opinion on management's assessment of, and an adverse opinion on the effective operation of, internal control over financial reporting.

KPMG LLP

Dallas, TX  
March 31, 2006

## **Report of Independent Registered Public Accounting Firm**

The Board of Directors and Shareholders  
Capital Senior Living Corporation

We have audited the accompanying consolidated balance sheet of Capital Senior Living Corporation as of December 31, 2004 and the related consolidated statements of operations, shareholders' equity, and cash flows for each of the two years in the period ended December 31, 2004. 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 the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits 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 consolidated financial position of Capital Senior Living Corporation at December 31, 2004, and the consolidated results of their operations and their cash flows for each of the two years in the period ended December 31, 2004 in conformity with U.S. generally accepted accounting principles.

Ernst & Young LLP

Dallas, Texas  
March 8, 2005

**CAPITAL SENIOR LIVING CORPORATION**  
**CONSOLIDATED BALANCE SHEETS**

	December 31,	
	2005	2004
	(In thousands)	
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents .....	\$ 21,831	\$ 19,515
Restricted cash .....	973	—
Accounts receivable, net .....	2,586	2,073
Accounts receivable from affiliates .....	432	1,220
Federal and state income taxes receivable .....	1,840	2,572
Deferred taxes .....	591	642
Assets held for sale .....	2,034	1,008
Property tax and insurance deposits .....	5,081	2,731
Prepaid expenses and other .....	2,729	2,766
Total current assets .....	38,097	32,527
Property and equipment, net .....	373,007	381,051
Deferred taxes .....	8,217	7,011
Investments in limited partnerships .....	1,401	3,202
Assets held for sale .....	—	1,026
Other assets, net .....	13,329	6,358
Total assets .....	\$434,051	\$431,175
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
Current liabilities:		
Accounts payable .....	\$ 2,834	\$ 2,162
Accounts payable to affiliates .....	119	318
Accrued expenses .....	10,057	7,478
Current portion of notes payable .....	7,801	42,242
Current portion of interest rate lock .....	2,573	—
Current portion of deferred income .....	1,370	680
Customer deposits .....	2,483	1,936
Total current liabilities .....	27,237	54,816
Deferred income .....	3,641	—
Deferred income from affiliates .....	48	125
Other long-term liabilities .....	4,977	6,909
Notes payable, net of current portion .....	252,733	219,526
Minority interest in consolidated partnership .....	—	252
Commitments and contingencies		
Shareholders' equity:		
Preferred stock, \$.01 par value:		
Authorized shares — 15,000; no shares issued or outstanding .....	—	—
Common stock, \$.01 par value:		
Authorized shares — 65,000 Issued and outstanding shares — 26,290 and 25,751 in 2005 and 2004, respectively .....	263	258
Additional paid-in capital .....	126,180	124,963
Retained earnings .....	18,972	24,326
Total shareholders' equity .....	145,415	149,547
Total liabilities and shareholders' equity .....	\$434,051	\$431,175

See accompanying notes to consolidated financial statements.

**CAPITAL SENIOR LIVING CORPORATION**  
**CONSOLIDATED STATEMENTS OF OPERATIONS**

	Year Ended December 31,		
	<u>2005</u>	<u>2004</u>	<u>2003</u>
	(In thousands, except per share data)		
Revenues:			
Resident and health care revenue . . . . .	\$101,770	\$90,544	\$62,564
Unaffiliated management services revenue . . . . .	1,626	726	336
Affiliated management services revenue . . . . .	1,834	1,992	3,236
Affiliated development fees . . . . .	<u>—</u>	<u>—</u>	<u>189</u>
Total revenues . . . . .	105,230	93,262	66,325
Expenses:			
Operating expenses (exclusive of depreciation and amortization shown below) . . . . .	68,707	64,772	44,637
General and administrative expenses . . . . .	10,187	9,552	7,914
Provision for bad debts . . . . .	258	198	168
Facility lease expense . . . . .	2,070	—	—
Depreciation and amortization . . . . .	<u>13,046</u>	<u>12,009</u>	<u>7,791</u>
Total expenses . . . . .	94,268	86,531	60,510
Income from operations . . . . .	10,962	6,731	5,815
Other income (expense):			
Interest income . . . . .	133	572	4,278
Interest expense . . . . .	(18,595)	(15,769)	(12,481)
Gain (loss) on sale of properties . . . . .	104	(37)	6,751
Debt restructuring/derivative costs:			
Write-off of deferred loan costs . . . . .	(25)	(824)	—
Gain on interest rate swap agreement . . . . .	—	1,435	—
Loss on interest rate lock agreement . . . . .	(641)	(1,356)	—
Other income . . . . .	<u>416</u>	<u>182</u>	<u>3,616</u>
(Loss) income before income taxes and minority interest in consolidated partnership . . . . .	(7,646)	(9,066)	7,979
Benefit (provision) for income taxes . . . . .	<u>2,273</u>	<u>2,270</u>	<u>(3,098)</u>
(Loss) income before minority interest in consolidated partnership . . . . .	(5,373)	(6,796)	4,881
Minority interest in consolidated partnership . . . . .	<u>19</u>	<u>38</u>	<u>109</u>
Net (loss) income . . . . .	<u>\$ (5,354)</u>	<u>\$ (6,758)</u>	<u>\$ 4,990</u>
Per share data:			
Basic (loss) earnings per share . . . . .	<u>\$ (0.21)</u>	<u>\$ (0.27)</u>	<u>\$ 0.25</u>
Diluted (loss) earnings per share . . . . .	<u>\$ (0.21)</u>	<u>\$ (0.27)</u>	<u>\$ 0.25</u>
Weighted average shares outstanding — basic . . . . .	<u>25,827</u>	<u>25,213</u>	<u>19,784</u>
Weighted average shares outstanding — diluted . . . . .	<u>25,827</u>	<u>25,213</u>	<u>19,975</u>

See accompanying notes to consolidated financial statements.

**CAPITAL SENIOR LIVING CORPORATION**  
**CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY**

	<u>Common Stock</u>		<u>Additional Paid-In Capital</u>	<u>Retained Earnings</u>	<u>Total</u>
	<u>Shares</u>	<u>Amount</u>			
	(In thousands)				
Balance at January 1, 2003 .....	19,737	\$197	\$ 91,990	\$26,094	\$118,281
Exercise of stock options .....	110	1	346	—	347
Other comprehensive income:					
Net income .....	—	—	—	4,990	4,990
Unrealized gain on interest rate lock .....	—	—	—	749	749
Total other comprehensive income .....	—	—	—	5,739	5,739
Balance at December 31, 2003 .....	19,847	\$198	\$ 92,336	\$31,833	\$124,367
Exercise of stock options .....	154	2	528	—	530
Secondary stock offering, net of offering costs of \$2.3 million .....	5,750	58	32,099	—	32,157
Other comprehensive loss:					
Net loss .....	—	—	—	(6,758)	(6,758)
Unrealized loss on interest rate lock .....	—	—	—	(749)	(749)
Total other comprehensive loss .....	—	—	—	(7,507)	(7,507)
Balance at December 31, 2004 .....	25,751	\$258	\$124,963	\$24,326	\$149,547
Exercise of stock options .....	182	2	972	—	974
Restricted stock awards .....	357	3	—	—	3
Stock-based compensation .....	—	—	245	—	245
Net loss .....	—	—	—	(5,354)	(5,354)
Balance at December 31, 2005 .....	<u>26,290</u>	<u>\$263</u>	<u>\$126,180</u>	<u>\$18,972</u>	<u>\$145,415</u>

See accompanying notes to consolidated financial statements.



**CAPITAL SENIOR LIVING CORPORATION**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**

	Year Ended December 31,		
	2005	2004	2003
	(In thousands)		
<b>Operating Activities</b>			
Net (loss) income	\$ (5,354)	\$ (6,758)	\$ 4,990
Adjustments to reconcile net (loss) income to net cash provided by operating activities:			
Depreciation	12,338	11,865	7,791
Amortization	708	144	—
Amortization of deferred financing charges	747	903	1,080
Minority interest in consolidated partnership	(19)	(38)	(109)
Deferred income from affiliates	(77)	23	(340)
Deferred income	274	568	96
Deferred income from liquidation of HCP partnership	—	—	(3,406)
Deferred income taxes	(2,213)	(714)	1,605
Equity in the earnings of affiliates	(416)	(182)	(210)
(Gain) loss on sale of properties	(104)	37	(6,751)
(Gain) loss on interest rate swap and interest rate lock agreements	641	(79)	—
Provision for bad debts	258	198	168
Write-off of deferred loan costs	25	824	—
Stock compensation expense	245	—	—
Changes in operating assets and liabilities, net of acquisitions:			
Accounts receivable	(771)	(881)	(364)
Accounts receivable from affiliates	788	(616)	47
Property tax and insurance deposits	(2,350)	(876)	(380)
Prepaid expenses and other	37	312	(785)
Other assets	(7,110)	542	1,122
Accounts payable	473	116	(917)
Accrued expenses	2,579	170	(1,152)
Federal and state income taxes receivable/payable	732	(1,416)	170
Customer deposits	547	81	(114)
Net cash provided by operating activities	1,978	4,223	2,541
<b>Investing Activities</b>			
Capital expenditures	(3,236)	(2,391)	(1,591)
Net cash acquired in acquisition of Spring Meadows joint ventures	—	838	—
Net cash acquired in acquisition of the Triad Entities	—	—	122
Net cash upon the purchase in 2004/consolidation in 2003 of Triad I	—	(4,000)	832
Net cash paid in the acquisition of CGIM	—	(2,317)	—
Proceeds from sale of assets	—	516	5,458
Proceeds from sale of assets to BRE/CSL	—	—	3,088
Distributions from (advances to) affiliates	—	(391)	(7,381)
Investments in limited partnerships	6,378	149	197
Net cash provided by (used in) investing activities	3,142	(7,596)	725
<b>Financing Activities</b>			
Proceeds from notes payable	43,417	132,005	5,114
Repayments of notes payable	(44,467)	(153,813)	(18,480)
Restricted cash	(973)	7,187	5,169
Cash proceeds from the exercise of stock options	718	368	256
Cash proceeds from the issuance of common stock	3	32,157	—
Excess tax benefits on stock options exercised	256	—	—
Cash paid to settle interest rate swap agreement	—	(497)	—
(Distributions to) refund from minority partners	(233)	9	(296)
Deferred financing charges paid	(1,525)	(1,122)	(203)
Net cash provided by (used in) financing activities	(2,804)	16,294	(8,440)
Increase (decrease) in cash and cash equivalents	2,316	12,921	(5,174)
Cash and cash equivalents at beginning of year	19,515	6,594	11,768
Cash and cash equivalents at end of year	\$ 21,831	\$ 19,515	\$ 6,594
<b>Supplemental Disclosures</b>			
Cash paid during the year for:			
Interest	\$ 16,666	\$ 15,223	\$ 11,503
Income taxes	\$ 889	\$ 942	\$ 1,748

See accompanying notes to consolidated financial statements.

**CAPITAL SENIOR LIVING CORPORATION**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**December 31, 2005**

**1. Organization**

Capital Senior Living Corporation, a Delaware corporation (together with its subsidiaries, the “Company”), is one of the largest operators of senior living communities in the United States in terms of resident capacity. The Company owns, operates, develops and manages senior living communities throughout the United States. As of December 31, 2005, the Company operated 55 senior living communities in 20 states with an aggregate capacity of approximately 8,900 residents, including 33 senior living communities which the Company owned or in which the Company had an ownership interest, seven senior living communities that the Company leased and 15 senior living communities it managed for third parties. As of December 31, 2005, the Company also operated one home care agency. The accompanying consolidated financial statements include the financial statements of Capital Senior Living Corporation and its subsidiaries. All material intercompany balances and transactions have been eliminated in consolidation.

**2. Summary of Significant Accounting Policies**

*Cash and Cash Equivalents and Restricted Cash*

The Company considers all highly liquid investments with original maturities of three months or less at the date of acquisition to be cash equivalents. The Company has deposits in banks that exceed Federal Deposit Insurance Corporation insurance limits. Management believes that credit risk related to these deposits is minimal. Cash and cash equivalents, at December 31, 2005 and 2004, includes the cash and cash equivalents of the HealthCare Properties, L.P. (“HCP”) of \$0.6 million in both fiscal years. Restricted cash represented amounts held in deposits that were required as collateral under the terms of certain loan agreements.

*Long-Lived Assets*

Property and equipment are stated at cost and depreciated on a straight-line basis over the estimated useful lives of the assets. The estimated useful lives are 10 to 40 years for buildings and building improvements, 3 to 10 years for leasehold improvements, 5 to 20 years for land improvements and 5 to 10 years for furniture, equipment and automobiles.

At each balance sheet date, the Company reviews the carrying value of its property and equipment to determine if facts and circumstances suggest that they may be impaired or that the depreciation period may need to be changed. The Company considers external factors relating to each asset, including contract changes, local market developments, and other publicly available information. The carrying value of a long-lived asset is considered impaired when the anticipated undiscounted cash flows from such asset is separately identifiable and is less than its carrying value. In that event, a loss is recognized based on the amount the carrying value exceeds the fair market value, generally based on discounted cash flows, of the long-lived asset. The Company analyzed certain long-lived assets with operating losses, under the undiscounted cash flow method, for impairment. The Company does not believe there are any indicators that would require and the cash flow analysis did not require an adjustment to the carrying value of the property and equipment or their remaining useful lives as of December 31, 2005 and 2004.

*Assets Held for Sale*

The Company determines the fair value, net of costs of disposal, of an asset on the date the asset is categorized as held for sale, and the asset is recorded at the lower of its fair value, net of cost of disposal, or carrying value on that date. The Company periodically reevaluates assets held for sale to determine if the assets are still recorded at the lower of fair value, net of cost of disposal, or carrying value. The Company has four parcels of land held for sale at December 31, 2005. The fair value of these properties is generally

**CAPITAL SENIOR LIVING CORPORATION**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)**

determined based on market rates, industry trends and recent comparable sales transactions. The actual sales price of these assets could differ significantly from the Company's estimates.

The Company estimates the four parcels of land that were held for sale at December 31, 2005, have an aggregate fair value, net of costs of disposal, that exceeds the carrying value of \$2.0 million. The amounts the Company will ultimately realize could differ materially from this estimate.

During 2004, the Company sold one parcel of land that was held for sale. During 2003, the Company sold one parcel of land and one community that were held for sale.

*Investments in Partnerships and Joint Ventures*

*Spring Meadow Communities:* The Company formed four joint ventures (collectively "SHPII/CSL") with Senior Housing Partners II, LP ("SHPII"), in November 2004, and the joint ventures are owned 95% by SHPII and 5% by the Company. The Company accounts for its investment in SHPII/CSL under the equity method of accounting. The Company recorded its investment at cost and adjusts its investment for its share of earnings and losses of SHPII/CSL. The Company defers 5% of its management fee income earned from SHPII/CSL. Deferred management fee income is being amortized into income over the term of the Company's management contracts. As of December 31, 2005, the Company had deferred income of approximately \$48,000 relating to SHPII/CSL.

Prior to SHPII/CSL's acquisition of the Spring Meadows Communities, the Company, in December 2002, acquired from affiliates of LCOR Incorporated ("LCOR") its approximate 19% member interests in the four joint ventures that owned the Spring Meadows Communities as well as loans made by LCOR to the joint ventures for \$0.9 million in addition to funding \$0.4 million to the venture for working capital and anticipated negative cash requirements of the communities. The Company's interests in the joint ventures that owned the Spring Meadows Communities included interests in certain loans to the ventures and an approximate 19% member interest in each venture. The Company recorded its initial advances of \$1.3 million to the ventures as notes receivable as the amount assigned for the 19% member interests was nominal. The Company accounted for its investment in the Spring Meadows Communities under the equity method of accounting based on the provisions of the partnership agreements. The Company managed the Spring Meadows Communities since the opening of each community in late 2000 and early 2001 and continued to manage the communities under long-term management contracts until November 2004 when the joint ventures were sold. In addition, the Company received an asset management fee relating to each of the four communities. The Company had the obligation to fund certain future operating deficits of the Spring Meadows Communities to the extent of its 19% member interest. No amounts were funded by the Company under this obligation.

*BRE/CSL:* The Company formed three joint ventures (collectively "BRE/CSL") with an affiliate of Blackstone Real Estate Advisors ("Blackstone"), and the joint ventures are owned 90% by Blackstone and 10% by the Company. The Company accounted for its investment in BRE/CSL under the equity method of accounting. The Company recorded its investment at cost and adjusted its investment for its share of earnings and losses of BRE/CSL. The Company deferred 10% of its management fee income earned from BRE/CSL. Deferred management fee income was amortized into income over the term of the Company's management contract. Effective September 30, 2005, Ventas Healthcare Properties, Inc. ("Ventas") acquired the six communities owned by BRE/CSL and the Company entered into a series of lease agreements (the "Ventas Lease Agreements") whereby the Company leases the six communities from Ventas.

*Triad Entities:* Effective as of July 1, 2003, the Company acquired the partnership interest of the general partners and the other third party limited partners' interests in four partnerships (Triad Senior Living II, LP, Triad Senior Living III, LP, Triad Senior Living IV, LP and Triad Senior Living V, LP, collectively the "Triad Entities") for \$1.3 million in cash, \$0.4 million in notes payable and the assumption of

## CAPITAL SENIOR LIVING CORPORATION

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

all outstanding debt and liabilities. The total purchase price was \$194.4 million and the acquisition was treated as a purchase of property. This acquisition resulted in the Company acquiring 12 senior living communities owned by the Triad Entities with a combined resident capacity of approximately 1,670 residents. Subsequent to the end of the Company's third quarter of 2003, the Company repaid the \$0.4 million in notes payable related to this acquisition. Prior to this acquisition, the Company had an approximate 1% of the limited partners' interests in the Triad Entities and had accounted for these investments under the equity method of accounting based on the provisions of the Triad Entities partnership agreements. In addition, prior to acquiring the Triad Entities, the Company managed the communities owned by the Triad Entities under a series of long-term management contracts.

*Triad I:* Effective as of November 30, 2004, the Company acquired from affiliates of Lehman Brothers ("Lehman") its approximate 81% limited partnership interest in Triad Senior Living I, LP ("Triad I") for \$4.0 million in cash and the issuance of a note with a net present value of \$2.8 million. In addition, the Company acquired the general partner's interest in Triad I by assuming a \$3.6 million note payable from the general partner to a subsidiary of the Company. The acquisition was recorded as a purchase of property. The purchase price of \$10.4 million was recorded as a step-up in basis of \$9.3 million and in addition the Company recorded a deferred tax asset of \$1.1 million as Triad I had been previously consolidated under FASB Interpretation No. 46, revised December 2003, ("FIN 46"), as of December 31, 2003. These transactions resulted in the Company wholly owning Triad I. Triad I owned five Waterford senior living communities and two expansions. The two expansions were subsequently deeded to a subsidiary of the Company in order for the two expansions to be consolidated with their primary community. Prior to acquiring the remaining interests of the general partner and the other third party limited partner the Company had an approximate 1% limited partner's interests in Triad I and had accounted for these investments under the equity method of accounting based on the provisions of the Triad I partnership agreement until December 31, 2003. In addition, prior to acquiring the Triad I, the Company managed the communities owned by the Triad I under a series of long-term management contracts.

In 2003, the Financial Accounting Standards Board ("FASB") issued FIN 46 "Consolidation of Variable Interest Entities", an interpretation of ARB No. 51, effective immediately for variable interest entities created after January 31, 2003 and effective as of December 31, 2003, for variable interest entities that existed prior to February 1, 2003. The Company adopted the provisions of this interpretation, as of December 31, 2003, which resulted in the Company consolidating Triad I's financial position as of December 31, 2003 and consolidating Triad I's results of operations beginning January 1, 2004. The consolidation of Triad I under the provisions of FIN 46 as of December 31, 2003 resulted in an increase in property and equipment of \$62.5 million.

#### *Income Taxes*

The Company accounts for income taxes under the liability method. Deferred income taxes reflect the net tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes. Management regularly evaluates the future realization of deferred tax assets and provides a valuation allowance, if considered necessary, based on such evaluation.

#### *Revenue Recognition*

Resident and health care revenue is recognized at estimated net realizable amounts, based on historical experiences, due from residents in the period to which the rental and other services are provided.

Revenues from the Medicare and Medicaid programs accounted for 7%, 8%, and 9% in 2005, 2004 and 2003, respectively of the Company's net revenues. One community is a provider of services under the Medicaid program. Accordingly, the community is entitled to reimbursement under the foregoing program at

**CAPITAL SENIOR LIVING CORPORATION**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)**

established rates that are lower than private pay rates. Patient service revenue for Medicaid patients is recorded at the reimbursement rates as the rates are set prospectively by the state upon the filing of an annual cost report. Two communities are providers of services under the Medicare program and are entitled to payment under the foregoing programs in amounts determined based rates established by the federal government.

Laws and regulations governing the Medicare and Medicaid programs are complex and subject to interpretation. The Company believes that it is in compliance with all applicable laws and regulations and is not aware of any pending or threatened investigations involving allegations of potential wrongdoing. While no such regulatory inquiries have been made, compliance with such laws and regulations can be subject to future government review and interpretation as well as significant regulatory action including fines, penalties, and exclusion from the Medicare and Medicaid programs.

Management services revenue, resident and healthcare revenue and development fees are recognized when earned. Management services revenue relates to providing certain management and administrative support services under management contracts, which have terms expiring through 2019. Management services revenue is shown net of reimbursed expenses. The reimbursed expenses from affiliates were \$10.5 million, \$12.3 million and \$21.5 million, for the years ended December 31, 2005, 2004 and 2003, respectively. Reimbursed expenses from unaffiliated parties were \$9.9 million, \$3.4 million, and \$0.3 million, for the years ended December 31, 2005, 2004 and 2003, respectively.

The Company's management contracts include contingent management services revenue, usually based on exceeding certain gross revenue targets. These contingent revenues are recognized based on actual results according to the calculations specified in the various management agreements.

***Leases Accounting***

The Company determines whether to account for its leases as either operating, capital or financing leases depending on the underlying terms of the lease agreement. This determination of classification is complex and requires significant judgment relating to certain information including the estimated fair value and remaining economic life of the community, the Company's cost of funds, minimum lease payments and other lease terms. As of December 31, 2005, the Company leased seven communities and classified each of the leases as an operating lease. Facility lease expense in the Company's statement of operations includes the actual rent paid plus amortization expense relating to leasehold acquisition costs.

At December 30, 2005, the Company had \$1.5 million in deferred leasehold acquisition costs. These costs are being amortized on a straight-line basis over the initial term of the lease agreements. Accumulated amortization, at December 30, 2005, was \$37,000. Amortization expense for fiscal 2005 was \$37,000.

***Financial Instruments***

Effective January 31, 2005, the Company entered into interest rate cap agreements with two commercial banks to reduce the impact of increases in interest rates on the Company's variable rate loans. One interest rate cap agreement effectively limited the interest rate exposure on a \$50 million notional amount to a maximum LIBOR rate of 5% and expired on January 31, 2006. The second interest rate cap agreement effectively limits the interest rate exposure on \$100 million notional amount to a maximum LIBOR rate of 5%, as long as one-month LIBOR is less than 7%. If one-month LIBOR is greater than 7%, the agreement effectively limits the interest rate on the same \$100 million notional amount to a maximum LIBOR rate of 7%. This second agreement expires on January 31, 2008. The Company paid \$0.4 million for the interest rate caps and the costs of these agreements are being amortized to interest expense over the life of the agreements.

The Company is party to interest rate lock agreements, which were used to hedge the risk that the costs of future issuance of debt may be adversely affected by changes in interest rates. Under the interest rate lock



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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)**

agreements, the Company agrees to pay or receive an amount equal to the difference between the net present value of the cash flows for a notional principal amount of indebtedness based on the locked rate at the date when the agreement was established and the yield of a United States Government 10-Year Treasury Note on the settlement date of January 3, 2006. The notional amounts of the agreements were not exchanged. These interest rate lock agreements were entered into with a major financial institution in order to minimize counterparty credit risk. The locked rates range from 7.5% to 9.1%. On December 30, 2004, the Company refinanced the underlying debt and this refinancing resulted in the interest rate lock agreements no longer qualifying as an interest rate hedge. The Company reflects the interest rate lock agreements at fair value in the Company's consolidated balance sheet (Other long-term liabilities, net of current portion of \$2.6 million) and related gains and losses are recognized in the consolidated statements of operations. The Company recognized a loss of \$0.6 million and \$1.4 million during fiscal 2005 and 2004, respectively, relating to the interest rate lock agreements. The Company settled the interest rate lock liability on January 3, 2006 by paying \$1.8 million in cash and converting the remaining balance of \$5.7 million to a five-year note. The note bears interest at LIBOR plus 250 basis points with principal amortized on a straight-line basis over a seven year term. Prior to refinancing the underlying debt, the interest rate lock agreements were reflected at fair value in the Company's consolidated balance sheets (Other long-term liabilities) and the related gains or losses on these agreements were deferred in stockholders' equity (as a component of other comprehensive income).

In addition, the Company was party to interest rate swap agreements in fiscal 2004 and 2003 that were used to modify variable rate obligations to fixed rate obligations, thereby reducing the Company's exposure to market rate fluctuations. On December 30, 2004, the Company settled its interest rate swap agreements by paying its lender \$0.5 million. The differential paid or received as rates changed was accounted for under the accrual method of accounting and the amount payable to or receivable from counterparties was included as an adjustment to accrued interest. The interest rate swap agreements resulted in the recognition of an additional \$0.9 million and \$1.0 million in interest expense during fiscal 2004 and 2003, respectively.

***Credit Risk***

The Company's resident receivables are generally due within 30 days. Credit losses on resident receivables have been within management's expectations, and management believes that the allowance for doubtful accounts adequately provides for any expected losses.

***Advertising***

Advertising is expensed as incurred. Advertising expenses for the years ended December 31, 2005, 2004 and 2003 were \$4.8 million, \$5.1 million and \$3.6 million, respectively.

***Net (Loss) Income Per Share***

Basic net (loss) income per share is calculated by dividing net (loss) income by the weighted average number of common shares outstanding during the period. Diluted net (loss) income per share considers the dilutive effect of outstanding options calculated using the treasury stock method. The average daily price of the stock during 2005, 2004 and 2003 was \$7.20, \$5.46 and \$3.73, respectively, per share. Due to net losses in fiscal 2005 and 2004 no common stock equivalents were considered in the calculation of diluted earnings per share. The diluted earnings per share calculation for fiscal 2003 excluded 0.6 million common stock equivalents from the calculation as their effect would have been anti-dilutive.



**CAPITAL SENIOR LIVING CORPORATION**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)**

The following table set forth the computation of basic and diluted net (loss) income per share (in thousands, except for per share amounts):

	<u>Year Ended December 31,</u>		
	<u>2005</u>	<u>2004</u>	<u>2003</u>
Net (loss) income .....	<u>\$ (5,354)</u>	<u>\$ (6,758)</u>	<u>\$ 4,990</u>
Weighted average shares outstanding — basic .....	25,827	25,213	19,784
Effect of dilutive securities:			
Employee stock options .....	<u>—</u>	<u>—</u>	<u>191</u>
Weighted average shares outstanding — diluted .....	<u>25,827</u>	<u>25,213</u>	<u>19,975</u>
Basic (loss) earnings per share .....	<u>\$ (0.21)</u>	<u>\$ (0.27)</u>	<u>\$ 0.25</u>
Diluted (loss) earnings per share .....	<u>\$ (0.21)</u>	<u>\$ (0.27)</u>	<u>\$ 0.25</u>

***Stock-Based Compensation***

On December 16, 2004, the Financial Accounting Standards Board issued FASB Statement No. 123, revised 2004 (“Statement 123(R)”), Share-Based Payment, which is a revision of FASB Statement 123, Accounting for Stock-Based Compensation. Statement 123(R) supersedes APB Opinion No. 25 Accounting for Stock Issued to Employees, and amends FASB Statement No. 95, Statement of Cash Flows. Generally the approach in Statement 123(R) is similar to the approach described in Statement 123. However, Statement 123(R) requires all share based payments to employees, including grants of employee stock options, to be recognized in the income statement based on their fair values. Pro forma disclosure is no longer an alternative. Statement 123(R) is effective for public entities in the first interim or annual reporting period beginning after June 15, 2005.

Statement 123(R) permits public companies to adopt its requirements using one of two methods:

1. A “modified prospective” method in which compensation cost is recognized beginning with the effective date (a) based on the requirements of Statement 123(R) for all share-based payments granted after the effective date and (b) based on the requirements of Statement 123 for all awards granted to employees prior to the effective date of Statement 123(R) that remain unvested on the effective date.

3. A “modified retrospective” method which includes the requirements of the modified prospective method described above, but also permits entities to restate based on the amounts previously recognized under Statement 123 for purposes of pro forma disclosures either (a) all prior periods presented or (b) prior interim periods of the year of adoption.

Effective July 1, 2005, the Company early adopted Statement 123(R). The Company adopted Statement 123(R) using the modified prospective method. Under the modified prospective method the Company recognized compensation expense for new share-based awards and recognized compensation expense for the remaining vesting period of awards that had been included in pro-forma disclosures in prior periods. The Company has not adjusted prior period financial statements under the modified prospective method. The impact of expensing stock awards resulted in stock compensation expense of \$0.2 million (\$0.2 million net of tax) in fiscal 2005.

Under APB No. 25, pro forma expense for stock awards with pro-rata vesting was calculated on a straight line basis over the awards vesting period which typically ranges from one to five years. Upon the adoption of Statement 123(R), the Company records stock compensation expense on a straight line basis over the awards vesting period, which ranges from one to five years.

**CAPITAL SENIOR LIVING CORPORATION**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)**

The following table shows the effect on net income and earnings per share as if the fair value method had been applied to all outstanding awards in fiscal 2005, 2004 and 2003.

	<u>Year Ended December 31,</u>		
	<u>2005</u>	<u>2004</u>	<u>2003</u>
Net (loss) income as reported .....	\$(5,354)	\$(6,758)	\$ 4,990
Add: Stock-based employee compensation expense included in reported net income, net of related tax effects .....	160	—	—
Deduct: Total stock-based employee compensation expense determined under the fair value method for all awards, net of related tax effects .....	<u>(776)</u>	<u>(696)</u>	<u>(438)</u>
Pro forma net loss .....	<u>(5,970)</u>	<u>(7,454)</u>	<u>4,552</u>
Net (loss) income per share — basic			
As reported .....	<u>\$ (0.21)</u>	<u>\$ (0.27)</u>	<u>\$ 0.25</u>
Pro forma .....	<u>\$ (0.23)</u>	<u>\$ (0.30)</u>	<u>\$ 0.23</u>
Net (loss) income per share — diluted			
As reported .....	<u>\$ (0.21)</u>	<u>\$ (0.27)</u>	<u>\$ 0.25</u>
Pro forma .....	<u>\$ (0.23)</u>	<u>\$ (0.30)</u>	<u>\$ 0.23</u>

Prior to adopting Statement 123(R), the Company used the Black-Scholes option pricing model to estimate the grant date fair value of its stock awards and the Company elected to continue to use the Black-Scholes option pricing model to estimate the grant date fair value of its stock awards, subsequent to the adoption of Statement 123(R).

The Black-Scholes model requires the input of certain assumptions including expected volatility, expected dividend yield, expected life of the option and the risk free interest rate. The expected volatility used by the Company is based primarily on an analysis of historical prices of the Company's common stock. The expected term of options granted is based primarily on historical exercise patterns on the Company's outstanding stock options. The risk free rate is based on zero-coupon U.S. Treasury yields in effect at the date of grant with the same period as the expected option life. The Company does not expect to pay dividends on its common stock and therefore has used a dividend yield of zero in determining the fair value of its awards. The option forfeiture rate assumption used by the Company, which affects the expense recognized as opposed to the fair value of the award, is based on the Company's historical option forfeiture patterns.

The following table presents the Company's assumptions utilized to estimate the grant date fair value of stock options:

	<u>Year Ended</u> <u>December 31,</u>		
	<u>2005</u>	<u>2004</u>	<u>2003</u>
Expected volatility .....	53%	54%	58%
Expected dividend yield .....	0%	0%	0%
Expected term in years .....	7.5	7.5	7.5
Risk free rate .....	4.3%	4.6%	4.6%
Expected forfeiture rate .....	8.0%	—	—

On February 10, 2005, the Company's Compensation Committee of the Board of Directors accelerated the vesting on 151,976 unvested stock options, with an option price of \$6.30, awarded to officers and

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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)**

employees. These options were originally scheduled to vest in December 2005. The market price of the Company's common stock at the close of business on February 10, 2005 was \$5.61. The Compensation Committee's decision to accelerate the vesting of these options was in response to the FASB's issuance of Statement 123(R). By accelerating the vesting of these options, the Company was not required to recognize any compensation expense related to these options in its statement of operations.

***Recently Issued Accounting Standards***

In March 2005, the FASB issued FASB Interpretation No. 47 ("FIN 47"), Accounting for Conditional Asset Retirement Obligations, to clarify the requirement to record liabilities stemming from a legal obligation to perform an asset retirement activity in which the timing or method of settlement is conditional on a future event. The Company adopted FIN 47 on December 31, 2005. No conditional retirement obligations were recognized and, accordingly, the adoption of FIN 47 had no effect on the Company's financial statements.

***Segment Information***

The Company evaluates the performance and allocates resources of its senior living facilities based on current operations and market assessments on a property-by-property basis. The Company does not have a concentration of operations geographically or by product or service as its management functions are integrated at the property level. As such, the Company operates in one segment.

***Reclassifications***

Certain reclassifications have been made to prior year amounts to conform to current year presentation. During fiscal 2005, the Company reclassified certain property level expenses from general and administrative expense to operating expense. This reclassification results in the Company's general and administrative expenses being classified similar to other public companies in the senior housing industry.

***Use of Estimates and Critical Accounting Policies***

The preparation of financial statements in conformity with U.S. generally accepted accounting principles requires management to make estimates and assumptions that affect the amounts reported in the accompanying financial statements and related footnotes. Management bases its estimates and assumptions on historical experience, observance of industry trends and various other sources of information and factors, the results of which form the basis for making judgments about the carrying value of assets and liabilities that are not readily apparent from other sources. Actual results could differ from these estimates. Critical accounting policies are defined as those that are reflective of significant judgments and uncertainties, and potentially could result in materially different results under different assumptions and conditions. The Company believes revenue recognition, investments in limited partnerships, leases, long-lived assets and assets held for sale are its most critical accounting policies and require management's most difficult, subjective and complex judgments.

**3. Transactions with Affiliates**

***BRE/CSL:*** The Company formed BRE/CSL with Blackstone in December 2001. BRE/CSL is owned 90% by Blackstone and 10% by the Company. Pursuant to the terms of the joint ventures, each of the Company and Blackstone must approve any acquisitions made by BRE/CSL. Each party must also contribute its pro rata portion of the costs of any acquisition.

In December 2001, BRE/CSL acquired Amberleigh, a 394 resident capacity independent living facility. In connection with the acquisition of Amberleigh by BRE/CSL, the Company contributed \$1.8 million to

**CAPITAL SENIOR LIVING CORPORATION**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)**

BRE/CSL. During the second quarter of 2002, BRE/CSL obtained permanent financing for the Amberleigh community and the Company recovered \$1.4 million of its contribution to BRE/CSL.

On June 13, 2002, the Company contributed to BRE/CSL four of its senior living communities with a capacity of approximately 600 residents. As a result of the contribution, the Company repaid \$29.1 million of long-term debt to GMAC Commercial Mortgage Corporation (“GMAC”), received \$7.3 million in cash from BRE/CSL, has a 10% equity interest in the venture of \$1.2 million and wrote-off \$0.5 million in deferred loan costs.

In addition, on June 30, 2003, the Company contributed to BRE/CSL one of its senior living communities with a capacity of 182 residents. As a result of the contribution the Company repaid \$7.4 million of long-term debt, received \$3.1 million in cash from BRE/CSL, and has a 10% equity interest in BRE/CSL of \$0.4 million resulting in the recognition of a gain of \$3.4 million. As part of the contribution to BRE/CSL, the Company guaranteed 25%, or \$1.9 million, of BRE/CSL’s debt with Bank One. The Company made this guarantee to induce Bank One to allow the debt to be assumed by BRE/CSL. The Company estimated the carrying value of its obligation under this guarantee as nominal.

The Company managed the six communities owned by BRE/CSL under long-term management contracts. The Company accounted for the BRE/CSL investment under the equity method of accounting and the Company recognized earnings in the equity of BRE/CSL of \$0.2 million, \$0.3 million and \$0.3 million for the year ended December 31, 2005, 2004 and 2003, respectively. Effective September 30, 2005, the six BRE/CSL communities were sold to Ventas for approximately \$84.6 million.

*Spring Meadows:* In December 2002, the Company acquired from affiliates of LCOR its approximate 19% member interests in the four joint ventures, which owned the Spring Meadows Communities as well as loans made by LCOR to the joint ventures for \$0.9 million in addition to funding \$0.4 million for working capital and anticipated negative cash requirements of the communities. The Company’s interests in the four joint ventures that owned the Spring Meadows Communities included interests in certain loans to the ventures and an approximate 19% member interest in each venture. The Company recorded its initial advances of \$1.3 million to the ventures as notes receivable as the amount assigned for the 19% member interests was nominal. The Company accounted for its investment in the Spring Meadows Communities under the equity method of accounting based on the provisions of the partnership agreements. The Company had the obligation to fund certain future operating deficits of the Spring Meadows Communities to the extent of its 19% member interest. No amount were funded by the Company under this obligation.

In November 2004, the Company formed SHPII/CSL with Prudential Real Estate Investors (“Prudential”). Effective as of November 30, 2004, the Company acquired Lehman’s interest in four joint ventures that owned the Spring Meadows Communities and simultaneously sold the Spring Meadows Communities to SHPII/CSL, which is owned 95% by SHPII and 5% by the Company. As a result these transactions, the Company paid \$1.1 million for Lehman’s interest in the joint ventures, received \$0.9 million in net assets and wrote-off the remainder totaling \$0.2 million. In addition, the Company contributed \$1.3 million to SHPII/CSL for its 5% interest. The Company accounts for its investment in SHPII/CSL under the equity method of accounting and the Company recognized earnings in the equity of SHPII/CSL of \$0.2 million and \$13,000 for the years ended December 31, 2005 and 2004, respectively. The Company defers 5% of its management fee income earned from SHPII/CSL. Deferred management fee income is being amortized into income over the term of the Company’s management contract. As of December 31, 2005, the Company had deferred income of approximately \$48,000 relating to SHPII/CSL.

*Triad I:* Effective as of November 30, 2004, the Company acquired Lehman’s approximate 81% limited partner’s interest in Triad I for \$4.0 million in cash and the issuance of a note with a net present value of \$2.8 million. In addition, the Company acquired the general partner’s interest in Triad I by assuming a \$3.6 million note payable from the general partner to a subsidiary of the Company. These transactions resulted

## CAPITAL SENIOR LIVING CORPORATION

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

in the Company wholly owning Triad I. Triad I owned five Waterford senior living communities and two expansions. The two expansions were subsequently deeded to a subsidiary of the Company in order for the two expansions to be consolidated with their primary community. Prior to the acquisition of the Triad I the Company accounted for its investments in the Triad I under the equity method of accounting.

*Triad Entities:* Effective as of July 1, 2003, the Company acquired the partnership interest of the general partners and the other third party limited partners' interests in the Triad Entities for \$1.3 million in cash, \$0.4 million in notes payable and the assumption of all outstanding debt and liabilities. The total purchase price was \$194.4 million and the acquisition was treated as a purchase of property. The Company wholly owns each of the Triad Entities. This acquisition resulted in the Company acquiring the 12 senior living communities owned by the Triad Entities with a combined resident capacity of approximately 1,670 residents. Subsequent to the end of the Company's third quarter of 2003, the Company repaid the \$0.4 million in notes payable related to this acquisition. Prior to the acquisition of the Triad Entities the Company accounted for its investments in the Triad Entities under the equity method of accounting.

#### 4. Ventas Transactions

Effective as of June 30, 2005, BRE/CSL entered into a Purchase and Sale Agreement (the "Ventas Purchase Agreement") with Ventas Healthcare Properties, Inc. ("Ventas") to sell the six communities owned by BRE/CSL to Ventas for \$84.6 million. In addition, Ventas and the Company enter into Master Lease Agreements (the "Ventas Lease Agreements") whereby the Company would lease the six communities from Ventas. Effective September 30, 2005, Ventas completed the purchase of the six BRE/CSL communities and the Company began consolidating the operations of the six communities in its consolidated statement of operations under the terms of the Ventas Lease Agreements. The Ventas Lease Agreements each have an initial term of ten years, with two five year renewal extensions available at the Company's option. The initial lease rate under the Ventas Lease Agreements is 8% and is subject to certain conditional escalation clauses. The Company incurred \$1.3 million in lease acquisition costs related to the Ventas Lease Agreements. These deferred lease acquisition costs are being amortized over the initial 10 year lease term and are included in facility lease expense in the Company's statement of operations. The Company has accounted for each of the Ventas Lease Agreements as operating leases. The sale of the six BRE/CSL communities to Ventas resulted in the Company recording a gain of approximately \$4.2 million, which has been deferred and is being recognized in the Company's statement of operations over the initial 10 year lease term.

On October 18, 2005, the Company entered into an agreement with Ventas to lease a senior living community ("Georgetowne Place") which Ventas acquired for approximately \$19.5 million. Georgetowne Place is located in Fort Wayne, Indiana and is a 162 unit senior living community with a capacity of 247 residents. The lease which the Company executed with Ventas has an initial term of ten years, with two 5 year renewal extensions available at the Company's option. The initial lease rate is 8% and is subject to conditional escalation provisions. The Company incurred \$0.2 million in lease acquisition costs related to the Georgetowne Place lease. These deferred lease acquisition costs are being amortized over the initial 10 year lease term and are included in facility lease expense in the Company's statement of operations. The Company has accounted for the Georgetowne Place lease as an operating lease.

#### 5. Acquisitions

*Triad I:* Effective as of November 30, 2004, the Company acquired Lehman's approximate 81% limited partner's interest in Triad I for \$4.0 million in cash and the issuance of a note with a net present value of \$2.8 million. In addition, the Company acquired the general partner's interest in Triad I by assuming a \$3.6 million note payable from the general partner to a subsidiary of the Company. The acquisition was recorded as a purchase of property. The entire purchase price of \$10.4 million was recorded as a step-up in basis of \$9.3 million and in addition the Company recorded a deferred tax asset of \$1.1 million as Triad I had

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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)**

been previously consolidated under FIN 46 as of December 31, 2003. These transactions resulted in the Company wholly owning Triad I. Triad I owned five Waterford senior living communities and two expansions. The two expansions were subsequently deeded to a subsidiary of the Company in order for the two expansions to be consolidated with their primary community.

In 2003, the Financial Accounting Standards Board issued FASB Interpretation No. 46 revised December 2003 “Consolidation of Variable Interest Entities” an interpretation of ARB No. 51, effective immediately for variable interest entities created after January 31, 2003 and effective as of December 31, 2003 for variable interest entities that existed prior to February 1, 2003. The Company adopted the provisions of this interpretation at December 31, 2003, and its adoption resulted in the Company consolidating the financial position of Triad I at December 31, 2003 and consolidating the operations of Triad I beginning in the Company first quarter of 2004. The consolidation of Triad I under the provisions of FIN 46 as of December 31, 2003 resulted in an increase in property and equipment of \$62.5 million.

The following unaudited pro forma financial information combines the results of the Company and Triad I as if the provisions of FASB Interpretation No. 46 had been applied at the beginning of fiscal 2003. The pro forma financial information is presented for informational purposes only and does not reflect the results of operations of the Company, which would have actually resulted if Triad I had been consolidated as of the dates indicated, or future results of operations of the Company (in thousands):

	<b>Year Ended December 31, 2003</b>
Net revenue .....	\$80,320
Net income .....	\$ 1,601
Net income per share — basic .....	\$ 0.08
Net income per share — diluted .....	\$ 0.08

*Triad Entities:* Effective as of July 1, 2003, the Company acquired the partnership interest of the general partners and the other third party limited partners’ interests in the Triad Entities for \$1.3 million in cash, \$0.4 million in notes payable and the assumption of all outstanding debt and liabilities (\$109.6 million bank debts, \$73.2 million debt due to the Company, and \$9.9 million net working capital liabilities). The total purchase price was \$194.4 million and the acquisition was treated as a purchase of property. The Company wholly owns each of the Triad Entities. This acquisition resulted in the Company acquiring ownership of 12 senior living communities with a combined resident capacity of approximately 1,670 residents. Subsequent to the end of the Company’s third quarter of 2003, the Company repaid the \$0.4 million in notes payable related to this acquisition.

The purchase price was allocated as follows:

Net cash acquired .....	\$ 122
Fair value of tangible assets acquired, net .....	10,584
Property and equipment .....	<u>183,737</u>
Total purchase price .....	<u><u>\$194,443</u></u>



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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)**

Set forth below is information relating to the construction/permanent loan facilities the Company assumed as a result of the acquisition of the Triad Entities at July 1, 2003 (dollars in thousands):

<u>Entity</u>	<u>Number of Communities</u>	<u>Loan Facilities to Triad Entities</u>			
		<u>Commitment</u>	<u>Amount Outstanding</u>	<u>Type</u>	<u>Lender</u>
Triad II .....	3	\$26,900	\$ 26,003	mini-perm	Key Corporate Capital, Inc.
Triad III .....	6	\$56,300	\$ 56,270	mini-perm	Guaranty Bank
Triad IV .....	2	\$18,600	\$ 18,627	mini-perm	Compass Bank
Triad V .....	1	\$ 8,903	\$ 8,698	mini-perm	Bank of America
Total .....			<u>\$109,598</u>		

The following unaudited pro forma financial information combines the results of the Company and the Triad Entities as if the transaction had taken place at the beginning of fiscal 2003. The pro forma financial information is presented for informational purposes only and does not reflect the results of operations of the Company, which would have actually resulted if the purchase occurred as of the dates indicated, or future results of operations of the Company (in thousands).

	<u>Year Ended December 31, 2003</u>
Net revenue .....	\$75,449
Net income .....	\$ 778
Net income per share — basic .....	\$ 0.04
Net income per share — diluted .....	\$ 0.04

Prior to consolidation/acquisition the Company had a 1% limited partners' interest in Triad I and the Triad Entities and accounted for Triad I and the Triad Entities under the equity method of accounting based on the provisions of the partnership agreements. The Company recognized losses in Triad I and the Triad Entities of \$0.1 million as of December 31, 2003. The recognition of losses reduced the Company's investments in Triad I and the Triad Entities to zero and additional losses of \$0.5 million were recorded as a reduction to the Company's notes receivable from the Triad Entities.

Deferred interest income was being amortized into income over the life of the loan commitment that the Company had with Triad I and the Triad Entities. Deferred development and management fee income was being amortized into income over the expected remaining life of Triad I and Triad Entities' partnership. All deferred items were eliminated upon consolidation/acquisition.

*CGIM:* Effective August 18, 2004, the Company acquired from Covenant Group of Texas ("Covenant") all of the outstanding stock of Covenant's wholly owned subsidiary, CGI Management, Inc. ("CGIM"). The Company paid approximately \$2.3 million in cash (including closing cost of approximately \$0.1 million) and issued a note with a fair value of approximately \$1.1 million, subject to various adjustments set forth in the purchase agreement, to acquire all of the outstanding stock of CGIM. The note is due in three installments of approximately \$0.3 million, \$0.4 million and \$0.7 million due on the first, third and fifth anniversaries of the closing, respectively, subject to reduction if the management fees earned from the third party owned communities with various terms are terminated and not replaced by substitute agreements during the period, and certain other adjustments. The total purchase price was \$3.5 million and the acquisition was treated as a purchase. The Company's first installment payment under the Covenant note was reduced by \$0.2 million under the terms of the stock purchase agreement and the \$0.2 million installment reduction was recorded as an adjustment to the purchase price. This acquisition resulted in the Company assuming the

**CAPITAL SENIOR LIVING CORPORATION**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)**

management contracts on 14 senior living communities with a combined resident capacity of approximately 1,800 residents. In addition, the Company has the right to acquire seven of the properties owned by Covenant (which are part of the 14 communities managed by CGIM) based on sales prices specified in the stock purchase agreement.

The purchase price of \$3.5 million was allocated to management contracts. In addition, the Company recorded a deferred tax liability of \$2.1 million related to the acquisition of these management contract rights. Management contract rights are included in other assets on the consolidated balance sheet. The Company is amortizing the management contract rights over the remaining life of the management contracts acquired and accumulated amortization was \$0.9 million and \$0.1 million at December 31, 2005 and 2004, respectively. Future amortization of contract rights for the next five years will be \$0.6 million per year.

**6. Property and Equipment**

Property and equipment consists of the following (in thousands):

	<u>December 31,</u>	
	<u>2005</u>	<u>2004</u>
Land .....	\$ 24,063	\$ 24,063
Land improvements .....	816	653
Buildings and building improvements .....	380,034	377,188
Furniture and equipment .....	13,267	12,448
Automobiles .....	485	451
Leasehold improvements .....	383	98
Construction in progress .....	147	—
	<u>419,195</u>	<u>414,901</u>
Less accumulated depreciation .....	<u>46,188</u>	<u>33,850</u>
Property and equipment, net .....	<u>\$373,007</u>	<u>\$381,051</u>

Effective as of November 30, 2004, the Company acquired the partnership interest owned by non-Company parties in Triad I. The acquisition was treated as a purchase of property. The purchase price of \$10.4 million was recorded as a step up in basis of \$9.3 million and in addition the Company recorded a deferred tax asset of \$1.1 million. Prior to acquiring the remaining partnership interests the Company consolidated Triad I under the provisions of FASB Interpretation No. 46, effective December 31, 2003, which, resulted in an increase in property and equipment of \$62.5 million. During 2004, the Company sold one parcel of land for \$0.5 million, which resulted in the recognition of a gain of \$0.2 million and net proceeds of \$0.5 million.

**7. Accrued Expenses**

Accrued expenses consists of the following (in thousands):

	<u>December 31,</u>	
	<u>2005</u>	<u>2004</u>
Accrued salaries, bonuses and related expenses .....	\$ 2,953	\$2,009
Accrued property taxes .....	3,644	3,360
Accrued interest .....	1,598	628
Accrued health claims .....	921	882
Other .....	941	599
	<u>\$10,057</u>	<u>\$7,478</u>

**CAPITAL SENIOR LIVING CORPORATION**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)**

**8. Notes Payable**

Notes payable consists of the following:

	December 31,	
	2005	2004
	(In thousands)	
Prudential mortgage loans, bearing interest ranging from 7.08% to 7.69%, payable in monthly installments of principal and interest of \$0.1 million, maturing on various dates thru January 2010, secured by a certain property with a net book value of \$9.3 million at December 31, 2005 .....	\$ 7,193	\$ 7,388
Lehman mortgage loan, bearing interest at 8.20%, payable in monthly installments of principal and interest of \$0.3 million, maturing on September 2009, secured by certain properties with a net book value of \$47.6 million at December 31, 2005 .....	34,694	35,370
Insurance premium financings, bearing interest ranging from 4.9%, to 5.1% payable in monthly installments of principal and interest of \$0.4 million, maturing on various dates through May 2006 .....	1,700	1,894
GMAC mortgage loans, bearing interest at LIBOR plus 350 (7.79% and 5.92% at December 31, 2005 and 2004, respectively), payable in monthly installments of principal and interest of \$1.0 million, maturing in January 2008, secured by certain properties with a net book value of \$188.3 million at December 31, 2005 .....	126,544	128,409
GMAC mortgage loans, bearing interest at 5.46% at December 31, 2005 payable in monthly installments of principal and interest of \$0.3 million, maturing in August 2015 secured by certain properties with a net book value of \$47.6 million at December 31, 2005 .....	38,915	—
GMAC mortgage loans, bearing interest at LIBOR plus 240 (4.69%) at December 31, 2004 .....	—	34,585
Guaranty mortgage loans, bearing interest at LIBOR, plus 225 basis points (6.47% and 4.64% at December 31, 2005 and 2004, respectively), payable in monthly installments of principal and interest of \$0.5 million, maturing in January 2007, secured by certain properties with a net book value of \$78.2 million at December 31, 2005 .....	47,628	50,186
Covenant Group of Texas, Inc. acquisition financing bearing no interest (face amount \$1.4 million, discounted 5.7%) and payable in three installment of \$0.3 million, \$0.5 million and \$0.7 million on August 18, 2005, 2007 and 2009, respectively .....	894	1,134
Lehman Brothers acquisition financing bearing no interest (discounted 5.7%). The note will be deemed paid in full under any of the following three conditions: 1) the Company makes a payment of \$3.5 million before November 29, 2008; 2) the Company makes a payment of \$4.3 million before November 29, 2009; or 3) the Company makes a payment of \$5.0 million before November 29, 2010 .....	<u>2,966</u>	<u>2,802</u>
	260,534	261,768
Less current portion .....	<u>7,801</u>	<u>42,242</u>
	<u>\$252,733</u>	<u>\$219,526</u>

**CAPITAL SENIOR LIVING CORPORATION**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)**

The aggregate maturities of notes payable at December 31, 2005, are as follows (in thousands):

2006 .....	\$ 7,801
2007 .....	49,201
2008 .....	132,591
2009 .....	33,841
2010 .....	2,444
Thereafter .....	<u>34,656</u>
	<u>\$260,534</u>

In July 2005, the Company refinanced the debt on four senior housing communities with GMAC. The total loan facility of 39.2 million refinanced \$34.3 million of debt that was schedule to mature in September 2005. The new loans include ten-year terms with the interest rates fixed at 5.46% and amortization of principal and interest payments over 25 years. The Company incurred \$0.7 million in deferred financing costs related to these loans, which is being amortized over ten years.

Effective January 31, 2005, the Company entered into interest rate cap agreements with two commercial banks to reduce the impact of increases in interest rates on the Company's variable rate loans. One interest cap agreement effectively limits the interest rate exposure on a \$50 million notional amount to a maximum LIBOR rate of 5% and expired on January 31, 2006. The second interest rate cap agreement effectively limits the interest rate exposure on \$100 million notional amount to a maximum LIBOR rate of 5%, as long as one-month LIBOR is less than 7%. If one-month LIBOR is greater than 7%, the agreement effectively limits the interest rate on the same \$100 million notional amount to a maximum LIBOR rate of 7%. This second agreement matures on January 31, 2008.

Effective December 29, 2004, the Company refinanced the debt of 14 senior housing communities with GMAC. The total loan facility of \$128.4 million refinanced eight properties previously financed by GMAC and six properties previously financed under three separate loan agreements with Key Corporate Capital, Compass Bank and Bank of America, which have been repaid. The new loans with GMAC have a term of three years with two one-year extension options. The loans have an initial interest rate of LIBOR plus 350 basis points and the loan agreements provide for reduced rates once certain debt service coverage ratios are achieved. The Company incurred \$1.1 million in deferred financing costs related to these loans, which is being amortized over three years.

In connection with the Company's loan commitments above the Company incurred \$1.5 million and \$1.1 million in fiscal 2005 and 2004, respectively, in financing charges that were deferred and amortized over the life of the notes. Accumulated amortization was \$1.0 million and \$1.3 million at December 31, 2005 and 2004, respectively. In connection with the refinancings and the repayment of notes, the Company wrote-off \$25,000 and \$0.8 million in deferred loan cost in fiscal 2005 and 2004, respectively.

The Company must maintain certain levels of tangible net worth and comply with other restrictive covenants under the terms of the notes. The Company was in compliance with or obtained waivers for all of its debt covenants at December 31, 2005 and 2004.

**9. Equity**

The Company is authorized to issue preferred stock in series and to fix and state the voting powers and such designations, preferences and relative participating, optional or other special rights of the shares of each such series and the qualifications, limitations and restrictions thereof. Such action may be taken by the Board without stockholder approval. The rights, preferences and privileges of holders of common stock are subject to the rights of the holders of preferred stock.

**CAPITAL SENIOR LIVING CORPORATION**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)**

In December 2003, the Company filed a shelf registration statement with the SEC to offer up to \$50.0 million in the aggregate of common stock. In the first quarter of fiscal 2004, the Company sold 5,750,000 shares of common stock at a price of \$6.00 per share. The net proceeds to the Company after commissions and expenses were approximately \$32.2 million. The Company used \$13.7 million of the net proceeds to retire debt that was scheduled to mature in October 2004 and which had a current interest rate of 9.0% and the remaining amount was used for general corporate purposes.

**10. Stock-Based Compensation**

The Company adopted a stock incentive plan in 1997 (the “1997 Plan”), providing for the grant of nonqualified stock options, restricted stock and other stock-based awards to employees and directors. The 1997 Plan, as amended, provides for 2.6 million shares and 1.8 million shares of common stock are reserved for future issuance under the 1997 Plan.

Shares available for the granting of nonqualified stock options, restricted stock and other stock-based awards at December 31, 2005, 2004 and 2003, were 642,974; 985,124; and 413,054, respectively.

During fiscal 2005, the Company expensed \$0.2 million (\$0.2 million after tax) in compensation expense related to awards of restricted stock and stock options.

***Restricted Stock***

On July 1, 2005, the Company awarded 320,750 shares of restricted stock to certain employees of the Company. The market value of the common stock on the date of grant was \$7.00. These restricted shares vest ratably over a three and one half year period for 298,750 shares and over a four year period for 22,000 shares.

On October 19, 2005, the Company awarded 26,000 shares of restricted stock to certain employees of the Company. The market value of the common stock on the date of grant was \$7.75. These restricted shares vest ratably over a four year period.

On December 15, 2005, the Company awarded 12,000 shares of restricted stock to certain employees of the Company. The market value of the common stock on the date of grant was \$10.11. These restricted shares vest ratably over a four year period.

***Stock Options***

The option exercise price and vesting provisions of options are fixed when the options are granted. The options expire four to ten years from the date of grant and vest from one to five years. The option exercise price is the fair market value of a share of common stock on the date the option is granted.

**CAPITAL SENIOR LIVING CORPORATION**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)**

A summary of the Company's stock option activity and related information for the years ended December 31, 2005, 2004 and 2003 is presented below:

	<u>Shares</u>	<u>Weighted Average Exercise Price</u>	<u>Option Price per Share</u>
Outstanding at January 1, 2003 . . . . .	1,602,312	4.83	\$1.80 to \$13.50
Granted . . . . .	529,030	5.90	\$ 2.73 to \$6.30
Exercised . . . . .	109,853	2.33	\$ 1.80 to \$4.14
Forfeited . . . . .	563,886	7.72	\$1.80 to \$13.50
Expired . . . . .	—	—	—
Outstanding at December 31, 2003 . . . . .	1,457,603	\$4.29	\$1.80 to \$10.50
Granted . . . . .	50,000	5.11	\$ 4.50 to \$6.63
Exercised . . . . .	154,257	2.26	\$ 1.80 to \$4.14
Forfeited . . . . .	47,070	3.78	\$ 1.80 to \$6.30
Expired . . . . .	—	—	—
Outstanding at December 31, 2004 . . . . .	1,306,276	\$4.57	\$1.80 to \$10.50
Granted . . . . .	12,000	5.90	\$ 5.90
Exercised . . . . .	182,451	3.95	\$ 1.80 to \$6.30
Forfeited . . . . .	26,600	4.51	\$ 2.20 to \$6.63
Expired . . . . .	—	—	—
Outstanding at December 31, 2005 . . . . .	<u>1,109,225</u>	\$4.69	\$1.80 to \$10.50
Exercisable at December 31, 2005 . . . . .	<u>1,047,725</u>	\$4.71	\$1.80 to \$10.50
Exercisable at December 31, 2004 . . . . .	<u>1,024,050</u>	\$4.42	\$1.80 to \$10.50
Exercisable at December 31, 2003 . . . . .	<u>967,623</u>	\$3.91	\$1.80 to \$10.50

The weighted average fair values of stock options granted during the year ended 2005, 2004 and 2003 was \$5.90, \$5.11 and \$5.90 per option granted, respectively.

The following table summarizes information relating to the Company's options outstanding and options exercisable as of December 31, 2005.

<u>Range of Exercise Prices</u>	<u>Options Outstanding</u>			<u>Options Exercisable</u>	
	<u>Number Outstanding at 12/31/05</u>	<u>Weighted Average Remaining Contractual Life</u>	<u>Weighted Average Exercise Price</u>	<u>Number Exercisable at 12/31/05</u>	<u>Weighted Average Exercise Price</u>
\$1.80 to \$2.73 . . . . .	265,199	5.79	\$1.86	251,199	\$1.83
\$3.02 to \$4.85 . . . . .	311,483	4.95	\$3.72	284,983	\$3.69
\$5.30 to \$10.50 . . . . .	<u>532,543</u>	6.77	\$6.66	<u>511,543</u>	\$6.69
\$1.80 to \$10.50 . . . . .	<u>1,109,225</u>	6.02	\$4.69	<u>1,047,725</u>	\$4.71

On February 10, 2005, the Company's Compensation Committee of the Board of Directors accelerated the vesting on 151,976 unvested stock options, with an option price of \$6.30, awarded to certain officers and employees of the Company. These options were originally scheduled to vest in December 2005. The market price of the Company's common stock at the close of business on February 10, 2005 was \$5.61. The Compensation Committee's decision to accelerate the vesting of these options was in response to the FASB's



**CAPITAL SENIOR LIVING CORPORATION**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)**

issuance of Statement 123(R). By accelerating the vesting of these options, the Company was not required to recognize any compensation expense related to these options.

In May 2003, certain employees of the Company elected to forfeit 452,500 options originally priced at \$7.06. These options were added back to the pool of options available to grant in May 2003.

**11. Income Taxes**

The (benefit) provision for income taxes consists of the following (in thousands):

	<u>Year Ended December 31,</u>		
	<u>2005</u>	<u>2004</u>	<u>2003</u>
Current:			
Federal .....	\$ (178)	\$(2,720)	\$1,243
State .....	513	(264)	249
Deferred:			
Federal .....	(2,547)	561	1,341
State .....	<u>(61)</u>	<u>153</u>	<u>265</u>
	<u>\$ (2,273)</u>	<u>\$ (2,270)</u>	<u>\$ 3,098</u>

The provision for income taxes differed from the amounts computed by applying the U.S. federal income tax rate to income before provision for income taxes as a result of the following (in thousands):

	<u>Year Ended December 31,</u>		
	<u>2005</u>	<u>2004</u>	<u>2003</u>
Tax expense at federal statutory rates .....	\$ (2,593)	\$(3,069)	\$2,750
State income tax expense, net of federal benefit .....	(426)	(179)	336
Losses not deductible for federal income tax purposes .....	—	933	—
Prior period federal and state income tax true-ups .....	526	—	—
Other .....	<u>220</u>	<u>45</u>	<u>12</u>
	<u>\$ (2,273)</u>	<u>\$ (2,270)</u>	<u>\$ 3,098</u>

A summary of the Company's deferred tax assets and liabilities, are as follows (in thousands):

	<u>December 31,</u>	
	<u>2005</u>	<u>2004</u>
Deferred tax assets:		
Tax basis in excess of book basis on assets acquired .....	\$ —	\$4,788
Net operating loss carryforward (expiring 2024) .....	4,273	1,638
Fair value of treasury interest rate locks .....	2,881	—
Deferred gain on sales/leaseback transaction .....	1,548	—
Investment in Partnership .....	1,807	—
Other .....	<u>3,296</u>	<u>3,166</u>
Total deferred tax assets .....	13,805	9,592
Deferred tax liabilities .....	<u>4,997</u>	<u>1,939</u>
Total deferred tax assets, net .....	<u>\$ 8,808</u>	<u>\$ 7,653</u>

## CAPITAL SENIOR LIVING CORPORATION

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

Deferred income taxes reflect the net tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes. Management regularly evaluates the future realization of deferred tax assets and provides a valuation allowance, if considered necessary, based on such evaluation. The ultimate realization of deferred tax assets is dependent on the generation of future taxable income during the periods in which those temporary differences become deductible. Management has considered its possible sources of future taxable income, including various tax planning strategies that it believes are both prudent and feasible and that utilize net built-in gains on the Company's appreciated assets. Based on its overall evaluation, management believes that it is more likely than not that it will generate sufficient taxable income to realize the net deferred tax assets.

The Company has \$11.2 million in net operating losses, which are being carried forward and expire in 2024.

#### 12. Employee Benefit Plans

The Company has a 401(k) salary deferral plan (the "Plan") in which all employees of the Company meeting minimum service and age requirements are eligible to participate. Contributions to the Plan are in the form of employee salary deferrals, which are subject to employer matching contributions of up to 2% of the employee's annual salary. The Company's contributions are funded semi-monthly to the Plan administrator. Matching contributions of \$0.3 million, \$0.2 million and \$0.2 million were contributed to the Plan in 2005, 2004 and 2003, respectively. The Company incurred administrative expenses related to the Plan of \$10,000, \$21,000 and \$17,000 in 2005, 2004 and 2003, respectively.

#### 13. Contingencies

In the fourth quarter of 2002, the Company (and two of its management subsidiaries), Buckner Retirement Services, Inc. ("Buckner"), and a related Buckner entity, and other unrelated entities were named as defendants in a lawsuit in district court in Fort Bend County, Texas brought by the heir of a former resident who obtained nursing home services at Parkway Place from September 1998 to March 2001. The Company managed Parkway Place for Buckner through December 31, 2001. The Company and its subsidiaries denied any wrongdoing. On March 16, 2004, the Court granted the Company's Motion to Dismiss.

In February 2004, the Company and certain subsidiaries, along with numerous other senior living companies in California, were named as defendants in a lawsuit in the superior court in Los Angeles, California. This lawsuit was brought by two public interest groups on behalf of seniors in California residing at the California facilities of the defendants. The plaintiffs alleged that pre-admission fees charged by the defendants' facilities were actually security deposits that must be refunded in accordance with California law. On November 30, 2004, the court approved a settlement involving the Company's independent living communities. Under the terms of the settlement, (a) all non-refundable fees collected at the independent living facilities since January 1, 2003 will be treated as a refundable security deposits and (b) the attorney for the plaintiffs received nominal attorney fees. There were no other settlement costs to the Company or its affiliates and the Company's assisted living community in California was not named.

In April 2005, the Company filed a claim before the American Arbitration Association in Dallas, Texas against a former brokerage consultant and her company (collectively, "Respondents") for (1) a declaratory judgment that it has fulfilled certain obligations to Respondents under contracts the parties had signed related to the Covenant transaction, (2) for damages resulting from alleged breach of a confidentiality provision, and (3) for damages for unpaid referral fees. Respondent has filed a counterclaim for causes of action including breach of contract, duress, and undue infliction of emotional distress. The counterclaim seeks damages of "up to \$1,291,500 (or more)". Respondent also seeks to recover unspecified amounts of additional damages if the Company acquires any of the Covenant owned properties on which she claims to be entitled to recover

**CAPITAL SENIOR LIVING CORPORATION**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)**

brokerage fees. The proceeding is in the discovery phase. The Company's management believes strongly that its position has merit and intends to vigorously defend the counterclaim.

On January 11, 2006, the Company received a demand letter from the Texas Property and Casualty Insurance Guaranty Association ("TPCIGA") for repayment of \$199,737.45 in worker's compensation payments allegedly made by TPCIGA on behalf of Company employees. The Company has also received other correspondence for repayment of \$45,357.82. TPCIGA's letter states that it has assumed responsibility for insureds of Reliance Insurance Company ("Reliance") which was declared insolvent and ordered into liquidation in October of 2001 by the Commonwealth Court of Pennsylvania. Reliance had been the Company's worker's compensation carrier. TPCIGA's demand letter states that under the Texas Insurance Code, TPCIGA is entitled to seek reimbursement from an insured for sums paid on its behalf if the insured's net worth exceeds \$50 million at the end of the year immediately proceeding the impaired insurer's insolvency. TPCIGA states that it pursues reimbursement of these payments from the Company pursuant to this "net worth" provision. The Company has requested additional information from TPCIGA to verify that the Company was indeed the employer of the individuals on whose behalf the TPCIGA has paid claims. The TPCIGA has not provided sufficient documentation at this time for the Company to be able to fully evaluate all of these claims.

The Company has other pending claims not mentioned above ("Other Claims") incurred in the course of its business. Most of these Other Claims are believed by management to be covered by insurance, subject to normal reservations of rights by the insurance companies and possibly subject to certain exclusions in the applicable insurance policies. Whether or not covered by insurance, these Other Claims, in the opinion of management, based on advice of legal counsel, should not have a material effect on the consolidated financial statements of the Company if determined adversely to the Company.

**14. Fair Value of Financial Instruments**

The carrying amounts and fair values of financial instruments at December 31, 2005 and 2004 are as follows (in thousands):

	2005		2004	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
Cash and cash equivalents.....	\$21,831	\$21,831	\$19,515	\$19,515
Restricted cash .....	973	973	—	—
Interest Rate Lock .....	7,550	7,550	6,909	6,909
Notes payable .....	260,534	255,223	261,768	264,591

The following methods and assumptions were used in estimating its fair value disclosures for financial instruments:

*Cash and cash equivalents and restricted cash:* The carrying amounts reported in the balance sheet for cash and cash equivalents approximate fair value.

*Interest Rate Lock:* The interest rate lock is adjusted to fair value with gains or losses recorded in the Company's Statement of Operations.

*Notes payable:* The fair value of notes payable is estimated using discounted cash flow analysis, based on current incremental borrowing rates for similar types of borrowing arrangements.

**CAPITAL SENIOR LIVING CORPORATION**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)**

**15. Investments in Limited Partnerships**

The investments in limited partnerships balance consists of the following (in thousands):

	<b>December 31,</b>	
	<b>2005</b>	<b>2004</b>
BRE/CSL limited partnership interest . . . . .	—	1,892
SHPII/CSL limited partnership interest . . . . .	1,401	1,310
	<b>\$1,401</b>	<b>\$3,202</b>

*BRE/CSL:* The Company formed BRE/CSL with an affiliate of Blackstone in December 2001 and BRE/CSL is owned 90% by Blackstone and 10% by the Company. The Company accounted for its investment in this joint venture under the equity method of accounting. The Company recorded its investment at cost and adjusted its investment for its share of earnings and losses of BRE/CSL. The Company deferred 10% of its management fee income earned from BRE/CSL. Deferred management fee income was being amortized into income over the term of the Company's management contract. On September 30, 2005, BRE/CSL sold its six communities to Ventas and the Company entered into the Ventas Lease Agreements whereby the Company would lease the six communities from Ventas for an initial term of 10 years. As a result of this sale/leaseback the Company received net proceeds of \$6.1 million and recorded a gain of \$4.2 million which has been deferred and is being amortized into income over the initial 10 year lease term.

*Spring Meadows/SHPII/CSL:* In December 2002, the Company acquired from affiliates of LCOR its approximate 19% member interests in the four joint ventures which owned the Spring Meadows Communities as well as loans made by LCOR to the joint ventures for \$0.9 million in addition to funding \$0.4 million for working capital and anticipated negative cash requirements of the communities. The Company's interests in the four joint ventures that owned the Spring Meadows Communities included interests in certain loans to the ventures and an approximate 19% member interest in each venture. The Company recorded its initial advances of \$1.3 million to the ventures as notes receivable as the amount assigned for the 19% member interests was nominal. The Company accounted for its investment in the Spring Meadows Communities under the equity method of accounting based on the provisions of the partnership agreements and the Company recognized a loss in the equity of the Spring Meadows Communities of \$0.1 million for the year ended December 31, 2004. The Company had the obligation to fund certain future operating deficits of the Spring Meadows Communities to the extent of its 19% member interest. No amounts were funded by the Company under this obligation.

In November 2004, the Company formed SHPII/CSL with Prudential. Effective as of November 30, 2004, SHPII/CSL acquired the Spring Meadows Communities which have a combined capacity of 698 residents. In connection with this acquisition the Company contributed \$1.3 million for to SHPII/CSL for its 5% interest. The Company has managed the Spring Meadows Communities since the opening of each community in late 2000 and early 2001 and continues to manage the communities under long-term management contracts with SHPII/CSL. The Company accounts for its investment in SHPII/CSL under the equity method of accounting and recorded its investment at cost and will adjust its investment for its share of earnings and losses of SHPII/CSL. The Company defers 5% of its management fee income earned from SHPII/CSL. Deferred management fee income is being amortized into income over the term of the Company's management contract. As of December 31, 2005, the Company had deferred income of approximately \$48,000 relating to SHPII/CSL.

*HCP:* HCP is consolidated in the accompanying consolidated financial statements. At December 31, 2005, 2004 and 2003, the Company owned approximately 57% of HCP's limited partner units. HCP was dissolved during 2003 and the net assets of HCP have been transferred to a liquidating trust.

**CAPITAL SENIOR LIVING CORPORATION**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)**

**16. Allowance for Doubtful Accounts**

The components of the allowance for doubtful accounts and notes receivable are as follows (in thousands):

	December 31,		
	2005	2004	2003
Balance at beginning of year .....	\$ 717	\$ 648	\$1,343
Provision for bad debts .....	258	198	168
Write-offs and other .....	(209)	(193)	(847)
Recoveries .....	3	64	(16)
Balance at end of year .....	\$ 769	\$ 717	\$ 648

**17. Leases**

The Company leases its corporate headquarters, an office in New York City and seven senior living facilities under operating lease agreements. Additionally, the Company's senior living communities have entered into various contracts for services for duration of 5 years or less and are on a fee basis as services are rendered. The lease on the Company headquarters expires in February 2008. The Ventas Lease Agreements, which cover the seven leased senior living facilities, each have an initial term of ten years, with two five year renewal extensions available at the Company's option. The initial lease rate under the Ventas Lease Agreements is 8% and is subject to certain conditional escalation clauses which will be recognized when estimatable or incurred. The initial term on each of the leases expires in October 2015. The Company incurred \$1.5 million in lease acquisition costs related to the Ventas Lease Agreements. These deferred lease acquisition costs are being amortized over the initial 10 year lease term and are included in facility lease expense in the Company's statement of operations. The Company has accounted for each of the Ventas Lease Agreements as operating leases. Rent expense under these leases was \$2.6 million, \$0.6 million and \$0.6 million for 2005, 2004 and 2003, respectively. Future commitments are as follows (in thousands):

2006 .....	\$ 8,924
2007 .....	8,823
2008 .....	8,455
2009 .....	8,370
2010 .....	8,361
Thereafter .....	39,768
	\$82,701

**18. Subsequent Events**

On January 13, 2006, the Company announced the formation of a joint venture, Midwest Portfolio Holdings, Inc. ("Midwest") with GE Healthcare Financial Services ("GE Healthcare") to acquire five senior housing communities from a third party. Midwest agreed to pay approximately \$46.9 million for the five communities. The five communities comprise 293 assisted living units with a resident capacity of 389. Effective February 1, 2006, Midwest acquired four of the five communities and expects to close on the fifth community during the second quarter of fiscal 2006. The Company has an approximate 11% interest in Midwest and manages the four communities already acquired under long-term management agreements with Midwest.

**CAPITAL SENIOR LIVING CORPORATION**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)**

On February 1, 2006, the Company announced that it had entered into an agreement to sell the Company's Towne Centre community to Ventas in a sale/leaseback transaction valued at approximately \$29.0 million. The lease agreement will have an initial term of ten years, with two five year renewal extensions available at the Company's option. The initial lease rate under the Towne Centre lease agreement will be 8% and will be subject to certain conditional escalation clauses. The Company expects to account for this lease as an operating lease. The sale of the Towne Centre community to Ventas is expected to result in the Company recording a gain of approximately \$14.5 million, which will be deferred and recognized in the Company's statement of operations over the initial 10 year lease term. The Towne Centre sale/leaseback transaction is expected to close in the Company's first quarter of fiscal 2006.

On March 6, 2005, the Company awarded 18,000 shares of restricted stock to certain employees of the Company. The market value of the common stock on the date of grant was \$10.40. These restricted shares vest ratably over a four year period.

On March 8, 2006, the Company announced that it had entered into an agreement to sale three communities owned by the Company to Healthcare Property Investor, Inc. ("HCPI") in a sale/leaseback transaction valued at approximately \$54.0 million. The lease agreements will have an initial term of ten years. The initial lease rate under the lease agreements will be 8% and will be subject to certain conditional escalation clauses. The Company expects to account for this lease as an operating lease. The sale of the three communities to HCPI is expected to result in the Company recording a gain of approximately \$13.0 million, which will be deferred and recognized in the Company's statement of operations over the initial 10 year lease term.

On March 13, 2006, The Company announced that it had exercised its option to acquire the seven communities owned by Covenant and upon completion of the acquisitions, will immediately sell six of the seven communities to HCPI in a sale/leaseback transaction valued at approximately \$43.0 million. The Company is currently marketing the seventh community and intends to complete a sale as soon as possible. The Company expects the transaction to result in the recognition of a gain between \$3.0 and \$4.0 million and the gain will be recognized over the initial 10 year lease term. The initial lease rate under the lease agreements will be 8% and will be subject to certain conditional escalation clauses. The Company expects to account for this lease as an operating lease.



## INDEX TO EXHIBITS

The following documents are filed as a part of this report. Those exhibits previously filed and incorporated herein by reference are identified below. Exhibits not required for this report have been omitted.

<u>Exhibit Number</u>	<u>Description</u>
*3.1	— Amended and Restated Certificate of Incorporation of the Registrant (Exhibit 3.1)
(i)3.1.1	— Amendment to Amended and Restated Certificate of Incorporation of the Registrant (Exhibit 3.1)
*3.2	— Amended and Restated Bylaws of the Registrant
(i)3.2.1	— Amendments to Amended and Restated Bylaws of the Registrant (Exhibit 3.2)
(v)3.2.2	— Amendment No. 2 to Amended and Restated Bylaws of the Registrant (Exhibit 3.2.2)
(aa)4.1	— Rights Agreement, dated as of March 9, 2000, between Capital Senior Living Corporation and ChaseMellon Shareholder Services, L.L.C., which includes the form of Certificate of Designation of Series A Junior Participating Preferred Stock, \$.01 par value, as Exhibit A, the form of Right Certificate as Exhibit B, and the Summary of Rights as Exhibit C (Exhibit 4.1)
4.2	— Form of Certificate of Designation of Series A Junior Participating Preferred Stock, \$.01 par value (included as Exhibit A to the Rights Agreement, which is Exhibit 4.1 hereto)
4.3	— Form of Right Certificate (included as Exhibit B to the Rights Agreement, which is Exhibit 4.1 hereto)
4.4	— Form of Summary of Rights (included as Exhibit C to the Rights Agreement, which is Exhibit 4.1 hereto)
4.5	— Specimen of legend to be placed, pursuant to Section 3(c) of the Rights Agreement, on all new Common Stock certificates issued after March 20, 2000 and prior to the Distribution Date upon transfer, exchange or new issuance (included in Section 3(c) of the Rights Agreement, which is Exhibit 4.1 hereto)
(m)10.1	— 1997 Omnibus Stock and Incentive Plan for Capital Senior Living Corporation, as amended (Exhibit 4.1)
(m)10.1.1	— Form of Stock Option Agreement (Exhibit 4.2)
*10.2	— Amended and Restated Employment Agreement, dated as of May 7, 1997, by and between Capital Senior Living, Inc. and James A. Stroud (Exhibit 10.10)
*10.3	— Employment Agreement, dated as of November 1, 1996, by and between Capital Senior Living Corporation and Lawrence A. Cohen (Exhibit 10.11)
*10.4	— Employment Agreement, dated as of November 26, 1996, by and between Capital Senior Living, Inc. and David R. Brickman (Exhibit 10.12)
*10.5	— Employment Agreement, dated as of November 26, 1996, by and between Capital Senior Living, Inc. and Keith N. Johannessen (Exhibit 10.13)
*10.6	— Engagement Letter, dated as of June 30, 1997, by and between Lehman Brothers Holdings Inc. d/b/a Lehman Capital, A Division of Lehman Brothers Holdings Inc. and Capital Senior Living Corporation (Exhibit 10.14)
*10.7	— Lease Agreement, dated as of June 1, 1997, by and between G&L Gardens, LLC, as lessor, and Capital Senior Management 1, Inc., as lessee (Exhibit 10.15)
(a)10.8	— Amended and Restated Loan Agreement, dated as of December 10, 1997, by and between Bank One, Texas, N.A. and Capital Senior Living Properties, Inc. (Exhibit 10.33)
(a)10.9	— Alliance Agreement, dated as of December 10, 1997, by and between LCOR Incorporated and Capital Senior Living Corporation (Exhibit 10.34)
(b)10.10	— Draw Promissory Note, dated April 1, 1998, of Triad Senior Living I, L.P. in favor of Capital Senior Living Properties, Inc. (Exhibit 10.39)

<u>Exhibit Number</u>	<u>Description</u>
(c)10.11	—Draw Promissory Note, dated September 24, 1998, of Triad Senior Living II, L.P., in favor of Capital Senior Living Properties, Inc. (Exhibit 10.1)
(d)10.12	—Loan Agreement, dated as of September 30, 1998, by and between Capital Senior Living Properties 2-NHPCT, Inc. and Lehman Brothers Holdings Inc. d/b/a Lehman Capital, a division of Lehman Brothers Holdings Inc. (Exhibit 2.3)
(e)10.13	—Multifamily Note, dated December 4, 1997, of Gramercy Hill Enterprises in favor of Washington Mortgage Financial Group, Ltd. (Exhibit 2.5)
(e)10.14	—Multifamily Deed of Trust, dated December 4, 1997, among Gramercy Hill Enterprises, Tigor Title Insurance Company and Washington Mortgage Financial Group, Inc. (Exhibit 2.5)
(e)10.15	—Multifamily Note, dated October 28, 1998, of Capital Senior Living Properties 2-Gramercy, Inc. in favor of WMF Washington Mortgage Corp. (Exhibit 2.7)
(e)10.16	—Multifamily Deed of Trust, Assignment of Rents and Security Agreement, dated October 28, 1998, among Capital Senior Living Properties 2-Gramercy, Inc., Chicago Title Insurance Company and WMF Washington Mortgage Corp. (Exhibit 2.8)
(f)10.17	—Employment Agreement, dated as of December 10, 1996, by and between Capital Senior Living, Inc. and Rob L. Goodpaster (Exhibit 10.50)
(f)10.18	—Draw Promissory Note dated November 1, 1998 of Triad Senior Living III, L.P., in favor of Capital Senior Living Properties, Inc. (Exhibit 10.51)
(f)10.19	—Draw Promissory Note dated December 30, 1998 of Triad Senior Living IV, L.P., in favor of Capital Senior Living Properties, Inc. (Exhibit 10.52)
(f)10.20	—Form of Development and Turnkey Services Agreement by and between Capital Senior Development, Inc. and applicable Triad Entity (Exhibit 10.53)
(f)10.21	—Form of Development Agreement by and between Capital Senior Development, Inc. and applicable Triad Entity (Exhibit 10.54)
(f)10.22	—Form of Management Agreement by and between Capital Senior Living, Inc. and applicable Triad Entity (Exhibit 10.55)
(f)10.23	—Agreement of Limited Partnership of Triad Senior Living I, L.P. dated April 1, 1998 (Exhibit 10.56)
(f)10.24	—Agreement of Limited Partnership of Triad Senior Living II, L.P. dated September 23, 1998 (Exhibit 10.57)
(f)10.25	—Agreement of Limited Partnership of Triad Senior Living III, L.P. dated November 10, 1998 (Exhibit 10.58)
(f)10.26	—Agreement of Limited Partnership of Triad Senior Living IV, L.P. dated December 22, 1998 (Exhibit 10.59)
(g)10.27	—1999 Amended and Restated Loan Agreement, dated as of April 8, 1999, by and among Capital Senior Living Properties, Inc., Bank One, Texas, N.A. and the other Lenders signatory thereto. (Exhibit 10.11)
(g)10.28	—Amended and Restated Draw Promissory note, dated March 31, 1999, of Triad Senior Living I, L.P., in favor of Capital Senior Living Properties, Inc. (Exhibit 10.21)
(g)10.29	—Amended and Restated Draw Promissory Note (Fairfield), dated January 15, 1999, of Triad Senior Living II, L.P., in favor of Capital Senior Living Properties, Inc. (Exhibit 10.3)
(g)10.30	—Amended and Restated Draw Promissory Note (Baton Rouge), dated January 15, 1999, of Triad Senior Living II, L.P., in favor of Capital Senior Living Properties, Inc. (Exhibit 10.1)
(g)10.31	—Amended and Restated Draw Promissory Note (Oklahoma City), dated January 15, 1999, of Triad Senior Living II, L.P., in favor of Capital Senior Living Properties, Inc. (Exhibit 10.51)
(h)10.32	—Amended and Restated Draw Promissory Note dated June 30, 1999 of Triad Senior Living I, L.P. in favor of Capital Senior Living Properties, Inc. (Exhibit 10.1)

<u>Exhibit Number</u>	<u>Description</u>
(h)10.33	—Amended and Restated Draw Promissory Note (Plano, Texas) dated January 15, 1999 of Triad Senior Living II, L.P. in favor of Capital Senior Living Properties, Inc. (Exhibit 10.2)
(h)10.34	—Letter Agreement dated July 28, 1999 among the Company and ILM Senior Living, Inc. and ILM II Senior Living, Inc. (Exhibit 10.3)
(i)10.35	—Draw Promissory Note dated July 1, 1999 of Triad Senior Living V, L.P. in favor of Capital Senior Living Properties, Inc. (Exhibit 10.1)
(i)10.36	—First Amendment to Amended and Restated Employment Agreement of James A. Stroud, dated March 22, 1999, by and between James A. Stroud and Capital Senior Living Corporation (Exhibit 10.2)
(i)10.37	—Second Amendment to Amended and Restated Employment Agreement of James A. Stroud, dated May 31, 1999, by and between James A. Stroud and Capital Senior Living Corporation (Exhibit 10.3)
(i)10.38	—Employment Agreement, dated May 26, 1999, by and between Lawrence A. Cohen and Capital Senior Living Corporation (Exhibit 10.4)
(j)10.39	—Agreement and Plan of Merger, dated February 7, 1999, by and among Capital Senior Living Corporation, Capital Senior Living Acquisition, LLC, Capital Senior Living Trust I and ILM Senior Living, Inc. (Exhibit 10.1)
(k)10.40	—Agreement and Plan of Merger, dated February 7, 1999, by and among Capital Senior Living Corporation, Capital Senior Living Acquisition, LLC, Capital Senior Living Trust I and ILM II Senior Living, Inc. (Exhibit 10.1)
(l)10.41	—Amended and Restated Agreement and Plan of Merger, dated October 19, 1999, by and among Capital Senior Living Corporation, Capital Senior Living Acquisition, LLC and ILM Senior Living, Inc. (Exhibit 10.1)
(m)10.42	—Amended and Restated Agreement and Plan of Merger, dated October 19, 1999, by and among Capital Senior Living Corporation, Capital Senior Living Acquisition, LLC and ILM II Senior Living, Inc. (Exhibit 10.1)
(o)10.43	—Employment Agreement, dated May 25, 1999, by and between Ralph A. Beattie and Capital Senior Living Corporation (Exhibit 10.76)
(o)10.44	—Consulting/Severance Agreement, dated May 20, 1999, by and between Jeffrey L. Beck and Capital Senior Living Corporation (Exhibit 10.77)
(o)10.45	—Second Amended and Restated Agreement of Limited Partnership of Triad Senior Living I, L.P. (Exhibit 10.78)
(u)10.45.1	—Amendment No. 1 to Second Amended and Restated Agreement of Limited Partnership of Triad Senior Living I, LP. (Exhibit 10.105)
(p)10.46	—Form of GMAC Loan Agreement, Promissory Note and Exceptions to Nonrecourse Guaranty (Exhibit 10.1)
(p)10.47	—Newman Pool B Loan Agreement, Promissory Note and Guaranty (Exhibit 10.2)
(p)10.48	—Newman Pool C Loan Agreement, Promissory Note and Guaranty (Exhibit 10.3)
(p)10.49	—First Amendment to Triad II Partnership Agreement (Exhibit 10.4)
(p)10.50	—Second Modification Agreement to the Bank One Loan Agreement (Exhibit 10.5)
(p)10.51	—Assignment of Note, Liens and Other Loan Documents between Fleet National Bank and CSLI (Exhibit 10.6)
(q)10.52	—Second Amendment to Amended and Restated Agreement and Plan of Merger, dated November 28, 2000 (Exhibit 10.1)
(q)10.53	—First Amendment to Agreement, dated November 28, 2000 (Exhibit 10.2)

<u>Exhibit Number</u>	<u>Description</u>
(r)10.54	— Assignment of Partnership Interest, dated as of October 1, 2000, by and between Capital Senior Living Properties, Inc., a Texas corporation, and Triad Senior Living, Inc., a Texas limited partnership (Exhibit 82)
(r)10.55	— Assignment of Partnership Interest, dated as of October 1, 2000, by and between Capital Senior Living Properties, Inc., a Texas corporation, and Triad Senior Living II, L.P., a Texas limited partnership (Exhibit 88)
(r)10.56	— Assignment of Partnership Interest, dated as of October 1, 2000, by and between Capital Senior Living Properties, Inc., a Texas corporation, and Triad Senior Living III, L.P., a Texas limited partnership (Exhibit 89)
(r)10.57	— Assignment of Partnership Interest, dated as of October 1, 2000, by and between Capital Senior Living Properties, Inc., a Texas corporation, and Triad Senior Living IV, L.P., a Texas limited partnership (Exhibit 90)
(r)10.58	— Assignment of Partnership Interest, dated as of October 1, 2000, by and between Capital Senior Living Properties, Inc., a Texas corporation, and Triad Senior Living V, L.P., a Texas limited partnership (Exhibit 91)
(s)10.59	— BRE/CSL LLC Agreement (Exhibit 92)
(s)10.60	— BRE/CSL Management Agreement (Amberleigh) (Exhibit 93)
(s)10.61	— Third Modification Agreement to the Bank One Loan Agreement (Exhibit 94)
(s)10.62	— Fourth Modification Agreement to the Bank One Loan Agreement (Exhibit 95)
(s)10.63	— Third Amendment to Amended and Restated Employment Agreement of James A. Stroud, dated May 31, 1999, by and between James A. Stroud and Capital Senior Living Corporation (Exhibit 96)
(t)10.64	— Amendment to Amended and Restated Limited Liability Company Agreement of BRE/CSL Portfolio L.L.C., dated as of June 13, 2002 among BRE/CSL Holdings L.L.C., Capital Senior Living A, Inc. and Capital Senior Living Properties, Inc. (Exhibit 10.97)
(t)10.65	— Contribution Agreement dated December 31, 2001 between Capital Senior Living A, Inc. and BRE/CSL Holdings L.L.C. (Exhibit 10.98)
(u)10.66	— Third Amendment to Promissory Note and Loan Agreement dated October 15, 2002 by and between Capital Senior Living ILM — B, Inc. and Newman Financial Services, Inc. (Newman Pool B loan) (Exhibit 10.99)
(u)10.67	— Third Amendment to Promissory Note and Loan Agreement dated October 15, 2002 by and between Capital Senior Living ILM — C, Inc. and Newman Financial Services, Inc. (Newman Pool C loan) (Exhibit 10.100)
(u)10.68	— Omnibus Modification Agreement dated September 25, 2002 by and between Capital Senior Living Properties, Inc. and Bank One N.A. (Exhibit 10.101)
(u)10.69	— Support Agreement dated as of September 11, 2002 by and between Capital Senior Living, Inc., Triad I, Triad II, Triad III, Triad IV and Triad V. (Exhibit 10.102)
(u)10.70	— Form of Amendments to Loan Agreement, Promissory Note, Mortgage and Guaranty between GMAC and Capital entities owning Sedgwick, Canton Regency, and Towne Centre property. (Exhibit 10.103)
(u)10.71	— Amended and Restated Account Control Agreement with GMAC Relating to the Sedgwick property. (Exhibit 10.104)
(v)10.72	— Fourth Amendment to Amended and Restated Employment Agreement of James A. Stroud, dated January 17, 2003 by and between James A. Stroud and Capital Senior Living Corporation (Exhibit 10.105)
(v)10.73	— Second Amendment to the Employment Agreement of Lawrence A. Cohen, dated January 27, 2003 by and between Lawrence A. Cohen and Capital Senior Living Corporation (Exhibit 10.106)

<u>Exhibit Number</u>	<u>Description</u>
(v)10.74	— First Amendment to the Employment Agreement of Keith N. Johannessen, dated January 17, 2003 by and between Keith N. Johannessen and Capital Senior Living Corporation (Exhibit 10.107)
(v)10.75	— First Amendment to the Employment Agreement of Ralph A. Beattie, dated January 21, 2003 by and between Ralph A. Beattie and Capital Senior Living Corporation (Exhibit 10.108)
(v)10.76	— Second Amendment to the Employment Agreement of David R. Brickman, dated January 27, 2003 by and between David R. Brickman and Capital Senior Living Corporation (Exhibit 10.109)
(v)10.77	— Amended and Restated Draw Promissory Note, dated February 1, 2003, of Triad Senior Living I, L.P. in favor of Capital Senior Living Properties, Inc. (Exhibit 10.110)
(v)10.78.1	— Amended and Restated Draw Promissory Note (Fairfield), dated February 1, 2003, of Triad Senior Living II, L.P. in favor of Capital Senior Living Properties, Inc. (Exhibit 10.111.1)
(v)10.78.2	— Amended and Restated Draw Promissory Note (Oklahoma City), dated February 1, 2003, of Triad Senior Living II, L.P. in favor of Capital Senior Living Properties, Inc. (Exhibit 10.111.2)
(v)10.78.3	— Amended and Restated Draw Promissory Note (Plano), dated February 1, 2003, of Triad Senior Living II, L.P. in favor of Capital Senior Living Properties, Inc. (Exhibit 10.111.3)
(v)10.79	— Amended and Restated Draw Promissory Note, dated February 1, 2003, of Triad Senior Living III, L.P. in favor of Capital Senior Living Properties, Inc. (Exhibit 10.112)
(v)10.80	— Amended and Restated Draw Promissory Note, dated February 1, 2003, of Triad Senior Living IV, L.P. in favor of Capital Senior Living Properties, Inc. (Exhibit 10.113)
(v)10.81	— Amended and Restated Draw Promissory Note, dated February 1, 2003, of Triad Senior Living V, L.P. in favor of Capital Senior Living Properties, Inc. (Exhibit 10.114)
(v)10.82	— Form of Partnership Interest Purchase Agreements, dated as of March 25, 2003, between Capital Senior Living Properties, Inc. and the Triad Entities (with the exception of Triad I), regarding the exercise of the Company's options to purchase the partnership interests in the Triad Entities (with the exception of Triad I) owned by non-Company parties. (Exhibit 10.115)
(v)10.83	— Assignment and Assumption Agreement, dated as of December 20, 2002, among LCOR entities, Capital Senior Living Properties 4, Inc. and owners, regarding 4 Spring Meadows Properties (Exhibit 10.116)
(v)10.84	— Form of Fourth Amended and Restated Limited Liability Company Agreement, dated as of December 20, 2002, between Capital Senior Living Properties 4, Inc. and PAMI Senior Living Inc. for each of the 4 Spring Meadows properties. (Exhibit 10.117)
(v)10.85	— Form of First Amended and Restated Management and Marketing Agreement, dated as of December 20, 2002, between Capital Senior Living Inc. and owner for each of the 4 Spring Meadows properties. (Exhibit 10.118)
(w)10.86	— Contribution Agreement dated June 30, 2003 between Capital Senior Living Properties, Inc. and BRE/CSL Holdings II, L.L.C. (Exhibit 10.11)
(w)10.87	— BRE/CSL II L.L.C. Limited Liability Company Agreement. (Exhibit 10.2)
(y)10.88	— Third Amendment to the Employment Agreement of Lawrence A. Cohen. (Exhibit 10.1)
(z)10.89	— Stock Purchase Agreement dated July 30, 2004, by and between Capital Senior Management 1, Inc. and the Covenant Group of Texas, Inc. (Exhibit 10.1)
(bb)10.90	— Amendment to Stock Purchase Agreement, dated August 17, 2004, by and between Covenant Group of Texas, Inc. and Capital Senior Management 1, Inc. (Exhibit 10.1)
(bb)10.91	— Promissory Note, dated August 18, 2004, by Capital Senior Management 1, Inc. in favor of Covenant Group of Texas, Inc. (Exhibit 10.2)



<u>Exhibit Number</u>	<u>Description</u>
(bb)10.92	— Security Agreement, dated as of August 18, 2004, by and between Covenant Group of Texas, Inc. and Capital Senior Management 1, Inc. (Exhibit 10.3)
(bb)10.93.1	— Right of First Refusal Agreement, dated August 18, 2004, by and between Covenant Place of Abilene, Inc. and Capital Senior Living Acquisition, LLC (Exhibit 10.4.1)
(bb)10.93.2	— Schedule identifying substantially identical agreements to Exhibit 10.93.1 (Exhibit 10.4.2)
(bb)10.94.1	— Option to Purchase, dated as of August 18, 2004, by and between Covenant Place of Abilene, Inc. and Capital Senior Living Acquisition, LLC (Exhibit 10.5.1)
(bb)10.94.2	— Schedule identifying substantially identical agreements to Exhibit 10.94.1 (Exhibit 10.5.2)
(cc)10.95	— Form of Restricted Stock Award Under the 1997 Omnibus Stock and Incentive Plan for Capital Senior Living Corporation (Exhibit 10.1)
(dd)10.96	— Loan Agreement, dated as of December 29, 2004, by and between Triad Senior Living I, L.P., Triad Senior Living II, L.P., Triad Senior Living IV, L.P., Triad Senior Living V, L.P., Capital Senior Living A, Inc., Capital Senior Living ILM-B, Inc., and GMAC Commercial Mortgage Corporation (Exhibit 10.96)
(dd)10.97	— Assignment, dated November 30, 2004, by and between LB Triad Inc. and Capital Senior Living Properties, Inc. (Exhibit 10.97)
(dd)10.98	— Assignment of Partnership Interest, dated November 30, 2004, by Triad Senior Living, Inc. in favor of Capital Senior Living Properties 5, Inc. (Exhibit 10.98)
(dd)10.99	— Termination and Mutual Release Agreement, dated as of November 30, 2004, by and between Lehman Brothers Holdings Inc., d/b/a Lehman Capital, a division of Lehman Brothers Holdings Inc., LB Triad Inc. and Capital Senior Living Corporation, Capital Senior Living Properties, Inc. and Triad Senior Living I, L.P. (Exhibit 10.99)
(ee)10.100	— Master Lease Agreement, dated June 30, 2005, between Ventas Amberleigh, LLC and Capital Senior Management 2, Inc. (Exhibit 10.1)
(ee)10.101	— Schedule identifying substantially identical agreements to Exhibit 10.100 (Exhibit 10.2)
(ff)10.102	— Loan Agreement, dated July 18, 2005, by Capital Senior Living Peoria, LLC and GMAC Commercial Mortgage Bank (Exhibit 10.1)
(ff)10.103	— Schedule identifying substantially identical agreements to Exhibit 10.102 (Exhibit 10.2)
(gg)10.104	— Master Lease Agreement, dated October 18, 2005, between Ventas Georgetowne, LLC and Capital Senior Management 2, Inc. (Exhibit 10.1)
(hh)10.105	— Contract of Acquisition, dated as of March 7, 2006, between Health Care Property Investors, Inc. and Capital Senior Living Properties 2 — Crosswood Oaks, Inc., Capital Senior Living Properties 2 — Tesson Heights, Inc. and Capital Senior Living Properties 2 — Veranda Club, Inc. (Exhibit 10.1)
(hh)10.106	— Contract of Acquisition, dated as of March 7, 2006, between Texas HCP Holding, L.P. and Capital Senior Living Acquisition, LLC (Exhibit 10.2)
(hh)10.107	— Agreement of Purchase and Sale of Real Property, dated March 10, 2006, by and between Covenant Place of Abilene, Inc. and Capital Senior Living Acquisition, LLC (Exhibit 10.3)
(hh)10.108	— Schedule identifying substantially identical agreements to Exhibit 10.107 (Exhibit 10.4)
(ii)21.1	— Subsidiaries of the Company
(ii)23.1	— Consent of KPMG LLP
(ii)23.2	— Consent of Ernst & Young LLP
(ii)31.1	— Certification of Chief Executive Officer required by Rule 13a-14(a) or Rule 15d-14(a)
(ii)31.2	— Certification of Chief Financial Officer required by Rule 13a-14(a) or Rule 15d-14(a)
(ii)32.1	— Certification of Lawrence A. Cohen pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.



<u>Exhibit Number</u>	<u>Description</u>
(ii) 32.2	— Certification of Ralph A. Beattie pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
*	Incorporated by reference to exhibit from the Registration Statement No. 333-33379 on Form S-1 filed by the Company with the Securities and Exchange Commission.
(a)	Incorporated by reference to exhibit from the Company's Annual Report on Form 10-K for the year ended December 31, 1997, filed by the Company with the Securities and Exchange Commission.
(b)	Incorporated by reference to the exhibit from the Company's Quarterly Report on Form 10-Q for the quarterly period ended March 31, 1998, filed by the Company with the Securities and Exchange Commission.
(c)	Incorporated by reference to the exhibit shown in parentheses from the Company's Quarterly Report on Form 10-Q for the quarterly period ended September 30, 1998, filed by the Company with the Securities and Exchange Commission.
(d)	Incorporated by reference to the exhibit shown in parentheses from the Company's Current Report on Form 8-K, dated September 30, 1998, filed by the Company with the Securities and Exchange Commission.
(e)	Incorporated by reference to the exhibit shown in parentheses from the Company's Current Report on Form 8-K, dated October 28, 1998, filed by the Company with the Securities and Exchange Commission.
(f)	Incorporated by reference to the exhibit shown in parentheses from the Company's Annual Report on Form 10-K for the year ended December 31, 1998, filed by the Company with the Securities and Exchange Commission.
(g)	Incorporated by reference to the exhibit shown in parentheses from the Company's Quarterly Report on Form 10-Q for the quarterly period ended March 31, 1999, filed by the Company with the Securities and Exchange Commission.
(h)	Incorporated by reference to the exhibit shown in parentheses from the Company's Quarterly Report on Form 10-Q for the quarterly period ended June 30, 1999, filed by the Company with the Securities and Exchange Commission.
(i)	Incorporated by reference to the exhibit shown in parentheses from the Company's Quarterly Report on Form 10-Q for the quarterly period ended September 30, 1999, filed by the Company with the Securities and Exchange Commission.
(j)	Incorporated by reference to the exhibit shown in parentheses from the Company's Current Report on Form 8-K, dated February 7, 1999, filed by the Company with the Securities and Exchange Commission.
(k)	Incorporated by reference to the exhibit shown in parentheses from the Company's Current Report on Form 8-K, dated February 7, 1999, filed by the Company with the Securities and Exchange Commission.
(l)	Incorporated by reference to the exhibit shown in parentheses from the Company's Current Report on Form 8-K, dated October 19, 1999, filed by the Company with the Securities and Exchange Commission.
(m)	Incorporated by reference to the exhibit shown in parentheses from the Company's Current Report on Form 8-K, dated October 19, 1999, filed by the Company with the Securities and Exchange Commission.
(n)	Incorporated by reference to the exhibit shown in parentheses from the Company's Registration Statement on Form S-8, filed on December 3, 1999, by the Company with Securities and Exchange Commission.

- (o) Incorporated by reference to the exhibit shown in parenthesis from the Company's Annual Report on Form 10-K, dated March 30, 2000, filed by the Company with the Securities and Exchange Commission.
- (p) Incorporated by reference to the exhibit shown in parenthesis from the Company's Current Report on Form 8-K, dated August 15, 2000, filed by the Company with the Securities and Exchange Commission.
- (q) Incorporated by reference to the exhibit shown in parenthesis from the Company's Current Report on Form 8-K, dated November 28, 2000, filed by the Company with the Securities and Exchange Commission.
- (r) Incorporated by reference to the exhibit shown in parenthesis from the Company's Annual Report on Form 10-K, dated March 20, 2001, filed by the Company with the Securities and Exchange Commission.
- (s) Incorporated by reference to the exhibit shown in parenthesis from the Company's Annual Report on Form 10-K, dated March 26, 2002, filed by the Company with the Securities and Exchange Commission.
- (t) Incorporated by reference to the exhibit shown in parentheses from the Company's Quarterly Report on Form 10-Q for the quarterly period ended June 30, 2002, filed by the Company with the Securities and Exchange Commission.
- (u) Incorporated by reference to the exhibit shown in parentheses from the Company's Quarterly Report on Form 10-Q for the quarterly period ended September 30, 2002, filed by the Company with the Securities and Exchange Commission.
- (v) Incorporated by reference to the exhibit shown in parenthesis from the Company's Annual Report on Form 10-K, dated March 26, 2003, filed by the Company with the Securities and Exchange Commission.
- (w) Incorporated by reference to the exhibit shown in parentheses from the Company's Quarterly Report on Form 10-Q for the quarterly period ended June 30, 2003, filed by the Company with the Securities and Exchange Commission.
- (x) Incorporated by reference to the exhibit shown in parentheses from the Company's Quarterly Report on Form 10-Q for the quarterly period ended September 30, 2003, filed by the Company with the Securities and Exchange Commission.
- (y) Incorporated by reference to the exhibit shown in parentheses from the Company's Quarterly Report on Form 10-Q for the quarterly period ended March 31, 2004, filed by the Company with the Securities and Exchange Commission.
- (z) Incorporated by reference to the exhibit shown in parentheses from the Company's Quarterly Report on Form 10-Q for the quarterly period ended June 30, 2004, filed by the Company with the Securities and Exchange Commission.
- (aa) Incorporated by reference to the exhibit of corresponding number from the Company's Current Report on Form 8-K, dated March 9, 2000, filed by the Company with the Securities and Exchange Commission
- (bb) Incorporated by reference to the exhibit shown in parentheses from the Company's Current Report on Form 8-K, dated August 23, 2004, filed by the Company with the Securities and Exchange Commission
- (cc) Incorporated by reference to the exhibit shown in parentheses from the Company's Current Report on Form 8-K, dated February 10, 2005, filed by the Company with the Securities and Exchange Commission
- (dd) Incorporated by reference to the exhibit shown in parentheses from the Company's Annual Report on Form 10-K for the year ended December 31, 2004, filed with the Securities and Exchange Commission.
- (ee) Incorporated by reference to the exhibit shown in parentheses from the Company's Current Report on Form 8-K/A, dated June 30, 2005, filed by the Company with the Securities and Exchange Commission on July 11, 2005.

- (ff) Incorporated by reference to the exhibit shown in parentheses from the Company's Current Report on Form 8-K/A, dated July 18, 2005, filed by the Company with the Securities and Exchange Commission.
- (gg) Incorporated by reference to the exhibit shown in parentheses from the Company's Current Report on Form 8-K/A, dated October 18, 2005, filed by the Company with the Securities and Exchange Commission.
- (hh) Incorporated by reference to the exhibit shown in parentheses from the Company's Current Report on Form 8-K, dated March 7, 2006, filed by the Company with the Securities and Exchange Commission.
- (ii) Filed herewith.









## Company Management

LAWRENCE A. COHEN  
*Chief Executive Officer*

JAMES A. STROUD  
*Chairman of the Company and Secretary*

KEITH N. JOHANNESSEN  
*President and Chief Operating Officer*

RALPH A. BEATTIE  
*Executive Vice President and  
Chief Financial Officer*

ROB L. GOODPASTER  
*Vice President, National Marketing*

DAVID W. BEATHARD  
*Vice President, Operations*

GLEN H. CAMPBELL  
*Vice President, Development*

DAVID R. BRICKMAN  
*Vice President and General Counsel*

GLORIA M. HOLLAND  
*Vice President, Finance*

JERRY D. LEE  
*Corporate Controller*

ROBERT F. HOLLISTER  
*Property Controller*

## Corporate Information

### CORPORATE HEADQUARTERS

14160 Dallas Parkway, Suite 300  
Dallas, Texas 75254  
(972) 770-5600  
(972) 770-5666 fax  
main@capitalsenior.com

NEW YORK OFFICE  
300 Park Avenue, Suite 1700  
New York, New York 10022  
(212) 551-1770  
(212) 551-1774 fax

CORPORATE WEB SITE  
www.capitalsenior.com

## Board of Directors

JAMES A. STROUD  
*Chairman of the Board  
Capital Senior Living Corporation  
Dallas, Texas*

LAWRENCE A. COHEN  
*Vice Chairman of the Board  
Capital Senior Living Corporation  
New York, New York*

KEITH N. JOHANNESSEN  
*President and Chief Operating Officer  
Capital Senior Living Corporation  
Dallas, Texas*

CRAIG F. HARTBERG<sup>1,2,3</sup>  
*Retired First Vice President  
Bank One, Texas, N.A.  
Baton Rouge, Louisiana*

JILL M. KRUEGER<sup>2</sup>  
*President and CEO  
Health Resources Alliance, Inc.  
Oakbrook, Illinois*

JAMES A. MOORE<sup>1,2,3</sup>  
*President  
Moore Diversified Services, Inc.  
Fort Worth, Texas*

VICTOR W. NEE, PH.D.<sup>1,3</sup>  
*Professor Emeritus  
Department of Aerospace & Mechanical Engineering  
University of Notre Dame  
Scottsdale, Arizona*

1 Member of the Board's Compensation Committee  
2 Member of the Board's Audit Committee  
3 Member of the Board's Nominating Committee

## Shareholder Information

### STOCK EXCHANGE LISTING

Capital Senior Living Corporation Common  
Stock is listed on the New York Stock  
Exchange and trades under the symbol CSU.

### TRANSFER AGENT AND REGISTRAR

Mellon Investor Services LLC  
480 Washington Boulevard  
Jersey City, New Jersey 07210  
(800) 635-9270  
www.melloninvestor.com

### AUDITORS

KPMG LLP  
717 North Harwood Street, Suite 3100  
Dallas, Texas 75201  
(214) 840-2000

## Regional Information

### EASTERN REGIONAL OFFICE

186 Old Stagecoach Road  
Ridgefield, Connecticut 06877  
(203) 894-9406  
(203) 894-9407 fax

### CENTRAL PLAINS REGIONAL OFFICE

2820 South 80th  
Omaha, Nebraska 68124  
(402) 884-1044  
(402) 884-0891 fax

### MIDWESTERN REGIONAL OFFICE

18 Larks Aire Place  
The Woodlands, Texas 77381  
(936) 273-0157  
(936) 273-0166 fax

### WESTERN REGIONAL OFFICE

5757 Cypress Avenue  
Carmichael, California 95608  
(916) 480-0634  
(916) 486-4375 fax

### SOUTHWESTERN REGIONAL OFFICE

14160 Dallas Parkway, Suite 300  
Dallas, Texas 75254  
(972) 770-5600  
(972) 770-5666 fax

### TEXAS REGIONAL OFFICE

2222 Walter Smith Road  
Azle, Texas 76020  
(817) 237-2496  
(817) 237-3496 fax

## Form 10-K

A copy of Capital Senior Living Corporation's  
2005 annual report to the SEC on Form 10-K  
is included herein and is available without  
charge upon written request to the Investor  
Relations Department at corporate headquar-  
ters. It can also be found on the Company's  
web site, www.capitalsenior.com.

## Annual Shareholders Meeting

May 9, 2006 at 10:00 am Central Time  
Bent Tree Country Club  
5201 Westgrove  
Dallas, Texas 75248  
(972) 931-3310



**Capital Senior Living Corporation**

14160 Dallas Parkway, Suite 300  
Dallas, Texas 75254  
(972) 770-5600 fax (972) 770-5666  
[www.capitalsenior.com](http://www.capitalsenior.com)

# CAPITAL SENIOR LIVING CORPORATION

14160 Dallas Parkway, Suite 300  
Dallas, Texas 75254

## NOTICE OF ANNUAL MEETING OF STOCKHOLDERS To Be Held May 9, 2006

To the Stockholders of Capital Senior Living Corporation:

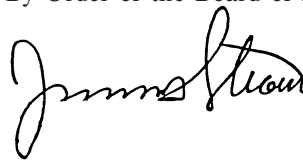
NOTICE IS HEREBY GIVEN that the Annual Meeting of Stockholders (the "Annual Meeting") of Capital Senior Living Corporation, a Delaware corporation (the "Company"), will be held at the Bent Tree Country Club, 5201 Westgrove Drive, Dallas, Texas 75248 at 10:00 a.m. (local time), on the 9th day of May, 2006, for the following purposes:

1. To elect three (3) directors of the Company to hold office until the Annual Meeting to be held in 2009 or until their respective successors are duly qualified and elected;
2. To ratify the Audit Committee's appointment of KPMG LLP, independent accountants, as the Company's independent auditors; and
3. To transact any and all other business that may properly come before the Annual Meeting or any adjournment(s) thereof.

The Board of Directors has fixed the close of business on March 10, 2006, as the record date (the "Record Date") for the determination of stockholders entitled to notice of and to vote at such meeting or any adjournment(s) or postponement(s) thereof. Only stockholders of record at the close of business on the Record Date are entitled to notice of and to vote at the Annual Meeting. The stock transfer books will not be closed. A list of stockholders entitled to vote at the Annual Meeting will be available for examination at the offices of the Company for 10 days prior to the Annual Meeting.

You are cordially invited to attend the Annual Meeting; however, whether or not you expect to attend the meeting in person, you are urged to mark, sign, date, and mail the enclosed WHITE proxy card promptly so that your shares of stock may be represented and voted in accordance with your wishes and in order to help establish the presence of a quorum at the Annual Meeting. If you attend the Annual Meeting and wish to vote in person, you may do so even if you have already dated, signed and returned your WHITE proxy card.

By Order of the Board of Directors



JAMES A. STROUD  
*Chairman of the Board and Secretary*

April 7, 2006  
Dallas, Texas



# CAPITAL SENIOR LIVING CORPORATION

14160 Dallas Parkway, Suite 300

Dallas, Texas 75254

## PROXY STATEMENT FOR ANNUAL MEETING OF STOCKHOLDERS

To Be Held May 9, 2006

### Solicitation and Revocability of Proxies

The accompanying proxy is solicited by the Board of Directors on behalf of Capital Senior Living Corporation, a Delaware corporation (the "Company"), to be voted at the 2006 Annual Meeting of Stockholders of the Company (the "Annual Meeting") to be held on May 9, 2006, at the time and place and for the purposes set forth in the accompanying Notice of Annual Meeting of Stockholders (the "Notice") and at any adjournment(s) or postponement(s) thereof. **When proxies in the accompanying form are properly executed and received, the shares represented thereby will be voted at the Annual Meeting in accordance with the directions noted thereon; if no direction is indicated, such shares will be voted "FOR" the election of directors and the ratification of the appointment of the independent auditors as set forth on the accompanying Notice.**

The executive offices of the Company are located at, and the mailing address of the Company is, 14160 Dallas Parkway, Suite 300, Dallas, Texas 75254.

Management does not intend to present any business at the Annual Meeting for a vote other than the matters set forth in the Notice and has no information that others will do so. If other matters requiring a vote of the stockholders properly come before the Annual Meeting, it is the intention of the persons named in the accompanying form of proxy to vote the shares represented by the proxies held by them in accordance with their judgment on such matters.

This proxy statement (the "Proxy Statement") and accompanying form of proxy are being mailed on or about April 7, 2006. The Company's Annual Report to Stockholders covering the Company's fiscal year ended December 31, 2005, mailed to the Company's stockholders on or about April 7, 2006, does not form any part of the materials for solicitation of proxies.

Any stockholder of the Company giving a proxy has the unconditional right to revoke his or her proxy at any time prior to the voting thereof either in person at the Annual Meeting by delivering a duly executed proxy bearing a later date or by giving written notice of revocation to the Company addressed to David R. Brickman, General Counsel, 14160 Dallas Parkway, Suite 300, Dallas, Texas 75254; no such revocation shall be effective, however, unless such notice of revocation has been received by the Company at or prior to the Annual Meeting.

In addition to the solicitation of proxies by use of the mail, officers and regular employees of the Company may solicit the return of proxies, either by mail, telephone, telecopy, or through personal contact. Such officers and employees will not be additionally compensated but will be reimbursed for out-of-pocket expenses. The Company has retained Georgeson Shareholder Communications Inc. ("Georgeson") to assist in soliciting proxies for the Annual Meeting for a fee of \$25,000. This amount includes fees payable to Georgeson, but excludes salaries and expenses of our officers, directors and employees. Brokerage houses and other custodians, nominees, and fiduciaries will, in connection with shares of common stock, par value \$0.01 per share (the "Common Stock"), registered in their names, be requested to forward solicitation material to the beneficial owners of such shares of Common Stock.

The cost of preparing, printing, assembling, and mailing the Annual Report, the Notice, this Proxy Statement, and the enclosed form of proxy, as well as the reasonable cost of forwarding solicitation materials to the beneficial owners of shares of the Company's Common Stock, and other costs of solicitation, are to be borne by the Company.

Some banks, brokers and other record holders have begun the practice of “householding” proxy statements and annual reports. “Householding” is the term used to describe the practice of delivering a single set of the proxy statement and annual report to any household at which two or more stockholders share an address. This procedure would reduce the volume of duplicate information stockholders receive and would also reduce the Company’s printing and mailing costs. The Company will deliver promptly, upon written or oral request, a separate copy of this Proxy Statement and the Company’s annual report to a share-owner at a shared address to which a single copy of the documents was delivered. A stockholder who wishes to receive a separate copy of the proxy statement and annual report, now or in the future, should submit this request to General Counsel, David R. Brickman, at the Company’s principal business office, 14160 Dallas Parkway, Suite 300, Dallas, Texas 75254 or calling (972) 770-5600. Beneficial owners sharing an address who are receiving multiple copies of proxy materials and annual reports and who wish to receive a single copy of such materials in the future will need to contact their broker, bank or other nominee to request that only a single copy of each document be mailed to all shareowners at the shared address in the future.

#### **Date for Receipt of Stockholder Proposals**

Stockholder proposals to be included in the proxy statement for the next Annual Meeting must be received by the Company at its principal executive offices on or before December 9, 2006 for inclusion in the Company’s Proxy Statement relating to that meeting.

The Company’s Amended and Restated Articles of Incorporation establish an advance notice procedure with regard to certain matters, including stockholder proposals and nominations of individuals for election to the Board of Directors to be made at an annual meeting of stockholders. In general, notice of a stockholder proposal or a director nomination to be brought at an annual meeting must be received by the Company not less than sixty (60) but not more than ninety (90) days before the date of the meeting and must contain specified information and conform to certain requirements set forth in the Company’s Amended and Restated Articles of Incorporation. The chairman of the meeting may disregard the introduction of your proposal or nomination if it is not made in compliance with the foregoing procedures or the applicable provisions of the Company’s Amended and Restated Articles of Incorporation.

#### **Quorum and Voting**

The record date for the determination of stockholders entitled to notice of and to vote at the Annual Meeting was the close of business on March 10, 2006 (the “Record Date”). On the Record Date, there were 26,297,183 shares of Common Stock issued and outstanding.

Each holder of Common Stock is entitled to one vote per share on all matters to be acted upon at the Annual Meeting, and neither the Company’s Amended and Restated Certificate of Incorporation nor its Amended and Restated Bylaws allow for cumulative voting rights. The presence, in person or by proxy, of the holders of a majority of the issued and outstanding shares of Common Stock entitled to vote at the Annual Meeting is necessary to constitute a quorum to transact business. If a quorum is not present or represented at the Annual Meeting, the stockholders entitled to vote at the Annual Meeting, present in person or by proxy, may adjourn the Annual Meeting from time to time without notice or other announcement until a quorum is present or represented. Assuming the presence of a quorum, the affirmative vote of the holders of a majority of the shares of Common Stock voting at the Annual Meeting is required for the election of directors and the ratification of the appointment of the independent auditors.

If you hold shares in your name, and you sign and return a proxy card without giving specific voting instructions, your shares will be voted as recommended by the Board of Directors on all matters and as the proxy holders may determine in their discretion with respect to any other matters that properly come before the meeting. If you hold your shares through a broker, bank or other nominee and you do not provide instructions on how to vote, your broker or other nominee may have authority to vote your shares on certain matters. NYSE regulations prohibit brokers or other nominees that are NYSE member organizations from voting in favor of proposals relating to equity compensation plans and certain other matters unless they receive specific instructions from the beneficial owner of the shares to vote in that manner. NASD member brokers



are also prohibited from voting on these types of proposals without specific instructions from beneficial holders. Abstentions and broker non-votes are each included in the determination of the number of shares present for determining a quorum. Each proposal is tabulated separately. Abstentions are counted in tabulations of votes cast on proposals presented to stockholders, whereas broker non-votes are not counted as voting for purposes of determining whether a proposal has received the necessary number of votes for approval of the proposal. With regard to the election of directors, votes may be cast in favor of or withheld from each nominee; votes that are withheld will be excluded entirely from the vote and will have no effect.

#### **Requests for Written Copies of 2005 Annual Report**

**The Company will provide, without charge, a copy of its Annual Report on Form 10-K for the year ended December 31, 2005, filed with the Securities and Exchange Commission, upon the written request of any registered or beneficial owner of common stock entitled to vote at the Annual Meeting.** Requests should be made by mailing General Counsel, David R. Brickman, at the Company's principal business office, 14160 Dallas Parkway, Suite 300, Dallas, Texas 75254 or calling (972) 770-5600. The Securities and Exchange Commission also maintains a website at [www.sec.gov](http://www.sec.gov) that contains reports, proxy statements and other information regarding registrants including the Company.

## PRINCIPAL STOCKHOLDERS AND STOCK OWNERSHIP OF MANAGEMENT

The following table sets forth certain information with respect to beneficial ownership of the Common Stock as of March 10, 2006, by: (i) each person known by the Company to be the beneficial owner of more than five percent of the Common Stock; (ii) each director of the Company; (iii) each of the executive officers named in the Summary Compensation Table (the “Named Executive Officers”); and (iv) all executive officers and directors of the Company as a group. Except as otherwise indicated, the address of each person listed below is 14160 Dallas Parkway, Suite 300, Dallas, Texas 75254.

<u>Name of Beneficial Owner</u>	<u>Shares Beneficially Owned (1) (2)</u>	
	<u>Number</u>	<u>Percent</u>
James Stroud .....	4,023,159 (3)	16.2%
FMR Corp. ....	2,688,600 (4)	10.2%
Edward C. Johnson 3d .....	2,688,600 (4)	10.2%
Mercury Real Estate Advisors LLC .....	2,569,700 (5)	9.8%
David R. Jarvis .....	2,569,700 (5)	9.8%
Malcomb F. MacLean IV .....	2,569,700 (5)	9.8%
Dimensional Fund Advisors Inc. ....	2,252,899 (6)	8.6%
Charles M. Gillman .....	1,935,000 (7)	7.4%
Boston Avenue Capital, L.L.C. ....	1,935,000 (7)	7.4%
Boulder Capital, L.L.C. ....	1,935,000 (7)	7.4%
Yorktown Avenue Capital, L.L.C. ....	1,935,000 (7)	7.4%
T. Rowe Price Associates, Inc. ....	1,644,800 (8)	6.3%
Wasatch Advisors, Inc. ....	1,661,695 (9)	6.3%
T. Rowe Price Small-Cap Value Fund, Inc. ....	1,561,500 (8)	5.9%
Harvey Hanerfeld .....	1,544,600 (10) (11)	5.9%
Roger Feldman .....	1,522,600 (10) (12)	5.8%
Lawrence A. Cohen .....	741,809 (13)	2.8%
Keith N. Johannessen .....	205,196 (14)	*
David R. Brickman .....	97,324 (15)	*
Ralph A. Beattie .....	68,010 (16)	*
James A. Moore .....	38,071 (17)	*
Dr. Victor W. Nee .....	35,271 (18)	*
Craig F. Hartberg .....	16,500 (19)	*
Jill M. Krueger .....	6,000 (20)	*
All directors and executive officers as a group (14 persons) .....	5,417,049 (21)	20.0%

\* Less than one percent.

- (1) Pursuant to Rule 13d-3 under the Securities Exchange Act of 1934 (the “Exchange Act”), a person has beneficial ownership of any securities as to which such person, directly or indirectly, through any contract, arrangement, undertaking, relationship or otherwise has or shares voting power and/or investment power and as to which such person has the right to acquire such voting and/or investment power within 60 days. Percentage of beneficial ownership as to any person as of a particular date is calculated by dividing the number of shares beneficially owned by such person by the sum of the number of shares outstanding as of such date and the number of shares as to which such person has the right to acquire voting and/or investment power within 60 days.
- (2) Except for the percentages of certain parties that are based on presently exercisable options which are indicated in the following footnotes to the table, the percentages indicated are based on

26,297,183 shares of Common Stock issued and outstanding on March 10, 2006. In the case of parties holding presently exercisable options, the percentage ownership is calculated on the assumption that the shares presently held or purchasable within the next 60 days underlying such options are outstanding.

- (3) Consists of 55,000 shares held by Mr. Stroud directly, 3,833,750 shares held indirectly over which Mr. Stroud has voting and dispositive power and 134,409 shares that Mr. Stroud may acquire upon the exercise of options immediately or within 60 days after March 10, 2006.
- (4) According to Schedule 13G, filed January 10, 2006. Fidelity Management & Research Company (“Fidelity”), 82 Devonshire Street, Boston, Massachusetts 02109, a wholly-owned subsidiary of FMR Corp., is the beneficial owner of 2,443,800 shares as a result of acting as investment adviser to various investment companies. The ownership of one investment company, Fidelity Small Cap Independence, amounted to 1,336,800 shares. Fidelity Small Cap Independence has its principal business office at 82 Devonshire Street, Boston, Massachusetts 02109. Mr. Johnson and FMR Corp., through its control of Fidelity and the funds each has sole power to dispose of the 2,443,800 shares owned by the funds. Mr. Johnson and FMR Corp., through control of Fidelity Management Trust Company, each has sole dispositive power over 133,600 shares and sole power to vote or to direct the voting of 133,600 shares owned by the institutional accounts, of which Fidelity Management Trust Company, 82 Devonshire Street, Boston, Massachusetts 02109, a wholly-owned subsidiary of FMR Corp., serves as investment manager. Fidelity International Limited (“FIL”), Pembroke Hall, 42 Crow Lane, Hamilton, Bermuda, is the beneficial owner of 111,200 shares. A partnership controlled predominantly by members of the family of Mr. Johnson owns shares of FIL voting stock with the right to cast approximately 38% of the total votes which may be cast by all holders of FIL voting stock. FMR Corp. and FIL are of the view that they are not acting as a group and that they are not otherwise required to attribute to each other the beneficial ownership of securities beneficially owned by the other corporation.
- (5) According to Schedule 13D/A, filed December 22, 2005. The address of each of Mercury Real Estate Advisors LLC, Mr. Jarvis and Mr. MacLean is c/o Mercury Real Estate Advisors LLC (“Advisors”), 100 Field Point Road, Greenwich, Connecticut 06830. Advisors, a Delaware limited liability company, is the investment advisor to the following investment funds that directly hold shares: Mercury Special Situations Fund LP, a Delaware limited partnership; Mercury Special Situations Offshore Fund, Ltd., a British Virgin Island company; Silvercrest Real Estate Fund (International), a class of the Silvercrest Master Series Trust, a Cayman Islands unit trust; Silvercrest Real Estate Fund, a class of the Silvercrest Master Series Trust, a Cayman Islands unit trust; Mercury Real Estate Securities Fund LP, a Delaware limited partnership; Mercury Real Estate Securities Offshore Fund, Ltd., a British Virgin Island company; and Silvercreek SAV LLC, a Delaware limited liability company. Messrs. Jarvis and MacLean are the managing members of Advisors.
- (6) According to Schedule 13G/A, filed February 6, 2006. The address of Dimensional Fund Advisors Inc. (“Dimensional”) is 1299 Ocean Avenue, 11th Floor, Santa Monica, California 90401. Consists of shares held in investment companies, trusts and accounts over which Dimensional possesses investment and/or voting power in its role as investment advisor or manager. Dimensional disclaims beneficial ownership of the shares.
- (7) According to Schedule 13D, filed May 12, 2005. The address of each of Charles M. Gillman, Boston Avenue Capital, LLC, an Oklahoma limited liability company, Boulder Capital, LLC, an Oklahoma limited liability company, and Yorktown Avenue Capital, LLC, an Oklahoma limited liability company, is 415 South Boston, 9th Floor, Tulsa, Oklahoma 74103. Mr. Gillman is the manager of all three entities.
- (8) According to Schedule 13G/A, filed February 15, 2006. The address of T. Rowe Price Associates, Inc, is 100 E. Pratt Street, Baltimore, Maryland 21202. These securities are owned by various individual and institutional investors, including T. Rowe Price Small-Cap Value Fund, Inc. (which owns 1,561,500 shares, representing approximately 5.9% of the shares outstanding), which T. Rowe Price Associates, Inc. (Price Associates) serves as investment adviser with power to direct investments and/or sole power to vote the securities. For purposes of the reporting requirements of the Securities Exchange

Act of 1934, Price Associates is deemed to be a beneficial owner of such securities; however, Price Associates expressly disclaims that it is, in fact, the beneficial owner of such securities.

- (9) According to Schedule 13G, filed February 14, 2005. The address of Wasatch Advisors is 150 Social Hall Avenue, Salt Lake City, Utah 84111.
- (10) According to Schedule 13G, filed February 14, 2006. The address for each of Mr. Hanerfeld and Mr. Feldman is 1919 Pennsylvania Avenue, NW, Suite 275, Washington, DC 20006. As sole stockholders, directors and executive officers of West Creek Capital, Inc., a Delaware corporation that is the general partner of West Creek Capital, L.P., a Delaware limited partnership that is the investment adviser to (i) West Creek Partners Fund L.P., a Delaware limited partnership (the "Fund"), and (ii) certain private accounts (the "Accounts"), Mr. Feldman and Mr. Hanerfeld may be deemed to have the shared power to direct the voting and disposition of the 705,000 shares of Common Stock owned by the Fund and 110,600 shares of Common Stock held in the Accounts. As voting members of Cumberland Investment Partners, L.L.C., a Delaware limited liability company ("Cumberland"), Mr. Feldman and Mr. Hanerfeld may be deemed to have the shared power to direct the voting and disposition of the 679,000 shares of Common Stock owned by Cumberland.
- (11) Includes 50,000 shares beneficially owned by Mr. Hanerfeld.
- (12) Includes 28,000 shares beneficially owned by Mr. Feldman.
- (13) Consists of 454,100 shares held by Mr. Cohen directly, 65,000 shares of restricted stock, 300 shares held by family members of Mr. Cohen, and 222,409 shares that Mr. Cohen may acquire upon the exercise of options immediately or within 60 days after March 10, 2006.
- (14) Consists of 65,000 shares of restricted stock and 140,196 shares that Mr. Johannessen may acquire upon the exercise of options immediately or within 60 days after March 10, 2006.
- (15) Consists of 15,000 shares of restricted stock and 82,324 shares that Mr. Brickman may acquire upon the exercise of options immediately or within 60 days after March 10, 2006.
- (16) Consists of 25,000 shares of restricted stock, and 43,010 shares that Mr. Beattie may acquire upon the exercise of options immediately or within 60 days after March 10, 2006.
- (17) Consists of 4,800 shares held by Mr. Moore directly and 33,271 shares that Mr. Moore may acquire upon the exercise of options immediately or within 60 days after March 10, 2006.
- (18) Consists of 1,000 shares held by Dr. Nee directly, 1,000 shares held by Mimi Nee, the spouse of Dr. Nee, and 33,271 shares that Dr. Nee may acquire upon the exercise of options immediately or within 60 days after March 10, 2006.
- (19) Consists of 16,500 shares that Mr. Hartberg may acquire upon the exercise of options immediately or within 60 days after March 10, 2006.
- (20) Consists of 6,000 shares that Ms. Krueger may acquire upon exercise of options immediately or within 60 days after March 10, 2006.
- (21) Includes 850,099 shares that such officers and/or directors, collectively, may acquire upon the exercise of options immediately or within 60 days after March 10, 2006.

**ELECTION OF DIRECTORS  
(PROPOSAL 1)**

**Nominees and Continuing Directors**

Unless otherwise directed in the enclosed proxy, it is the intention of the persons named in such proxy to vote the shares represented by such proxy for the election of the following named nominees for the office of director of the Company, each to hold office until the Annual Meeting to be held in 2009 and until his successor is duly qualified and elected or until his earlier resignation or removal. Each of the nominees is presently a director of the Company.

<u>Name</u>	<u>Age</u>	<u>Position(s) with the Company</u>	<u>Director's Term Expires</u>
<b>Nominees:</b>			
James A. Stroud . . . . .	55	Chairman of the Board and Chairman and Secretary of the Company	2009
Keith N. Johannessen . . . . .	49	President and Chief Operating Officer of the Company and Director	2009
Jill M. Krueger . . . . .	47	Director	2009
<b>Continuing Directors:</b>			
James A. Moore . . . . .	71	Director	2007
Dr. Victor W. Nee . . . . .	70	Director	2007
Lawrence A. Cohen . . . . .	52	Vice Chairman of the Board and Chief Executive Officer of the Company	2008
Craig F. Hartberg . . . . .	69	Director	2008

*James A. Stroud* has served as a director and officer of the Company and its predecessors since January 1986. He currently serves as Chairman of the Board and Chairman and Secretary of the Company. Mr. Stroud also serves on the boards of various educational and charitable organizations and in varying capacities with several trade organizations, including as an Owner/Operator Advisory Group member to the National Investment Conference. Mr. Stroud has served as a member of the Founder's Council and Leadership Counsel of the Assisted Living Federation of America and as a Founding Sponsor of The Johns Hopkins University Senior Housing and Care Program. Mr. Stroud was the past President and a member of the board of directors of the National Association for Senior Living Industry Executives. He was also a Founder of the Texas Assisted Living Association and served as a member of its board of directors. Mr. Stroud has earned a Masters in Law, is a licensed attorney and is also a Certified Public Accountant. Mr. Stroud has had positions with businesses involved in senior living for 21 years.

*Lawrence A. Cohen* has served as a director and Vice Chairman of the Board since November 1996. He has served as Chief Executive Officer of the Company since May 1999 and was Chief Financial Officer from November 1996 to May 1999. From 1991 to 1996, Mr. Cohen served as President and Chief Executive Officer of Paine Webber Properties Incorporated, which controlled a real estate portfolio having a cost basis of approximately \$3.0 billion, including senior living facilities of approximately \$110.0 million. Mr. Cohen serves on the boards of various charitable organizations and was a founding member and is on the executive committee of the Board of the American Seniors Housing Association. Mr. Cohen has earned a Masters in Law, is a licensed attorney and is also a Certified Public Accountant. Mr. Cohen has had positions with businesses involved in senior living for 21 years.

*Keith N. Johannessen* has served as President of the Company and its predecessors since March 1994, and previously served as Executive Vice President from May 1993 to February 1994. Mr. Johannessen has served as a director and Chief Operating Officer since May 1999. From 1992 to 1993, Mr. Johannessen served as Senior Manager in the health care practice of Ernst & Young. From 1987 to 1992, Mr. Johannessen was Executive Vice President of Oxford Retirement Services, Inc. Mr. Johannessen has served on the State of the

Industry and Model Assisted Living Regulations Committees of the American Seniors Housing Association. Mr. Johannessen has been active in operational aspects of senior housing for 27 years.

*Craig F. Hartberg* has been a director since February 2001. Mr. Hartberg currently serves as a Small Business Advisor for the Louisiana Department of Development. Mr. Hartberg was in the banking industry for 28 years. From 1991 to 2000, Mr. Hartberg served as First Vice President, Senior Housing Finance for Bank One, Texas, N.A. From 1989 to 1991, Mr. Hartberg was the Senior Vice President, Manager Private Banking for Team Bank in Dallas, Texas. Mr. Hartberg graduated from the Southwestern Graduate School of Banking at Southern Methodist University. He earned his Masters of Business Administration at the University of Wyoming. Mr. Hartberg served as a member of the Board of Directors of the National Association of Senior Living Industry Executives and as a member of the Assisted Living Federation of America.

*James A. Moore* has been a director since October 1997. Mr. Moore is President of Moore Diversified Services, Inc., a senior living consulting firm engaged in market feasibility studies, investment advisory services, and marketing and strategic consulting in the senior living industry. Mr. Moore has over 40 years of industry experience and has conducted over 1,800 senior living consulting engagements in approximately 600 markets, in 47 states and six countries. Mr. Moore has authored numerous senior living and health care industry technical papers and trade journal articles, as well as the books *Assisting Living — Pure & Simple Development and Operating Strategies* and *Assisted Living 2000*, which are required assisted living certification course materials for the American College of Health Care Administrators. Mr. Moore's latest book, *Assisted Living Strategies for Changing Markets*, was released in May 2001. Mr. Moore holds a Bachelor of Science degree in Industrial Technology from Northeastern University in Boston and an MBA in Marketing and Finance from Texas Christian University in Fort Worth, Texas.

*Dr. Victor W. Nee* has been a director since October 1997. Mr. Nee has been a Professor in the Department of Aerospace and Mechanical Engineering at the University of Notre Dame since 1965. Dr. Nee is currently Professor Emeritus at the University of Notre Dame. In addition to his professorial duties, Dr. Nee served as Director of the Advanced Technology Center at the University of Massachusetts, Dartmouth from 1993 to 1995, and as Director of the Advanced Engineering Research Laboratory at the University of Notre Dame from 1991 to 1993. Dr. Nee received a Bachelors of Science from the National Taiwan University in Civil Engineering and a Ph.D. in Fluid Mechanics from The Johns Hopkins University. Dr. Nee holds international positions as an advisor to governmental, educational and industrial organizations in China.

*Jill M. Krueger* has been a director since February 2004. Ms. Krueger has served as President and Chief Executive of Health Resources Alliance, Inc. ("HRA"), a company specializing in providing for rehabilitative and wellness services, institutional pharmacy services and products and programs designed to promote independence, health and wellness for elderly persons. Ms. Krueger also manages Senior Care Network, a St. Louis based alliance, and Alliance Continuing Care Network, a New York based alliance, both of which create and implement innovative programs and services either to enhance quality of life for seniors through wellness and prevention or create cost efficiencies. Ms. Krueger was a partner at KPMG responsible for overseeing the firm's national Long-term Care and Retirement Housing Practice. Ms. Krueger served as a public commissioner for the Continuing Care Accreditation Commission ("CCAC") and as a member of the CCAC financial advisory board from 1987 to 2001. Ms. Krueger also served on the American Association for Homes and Services for Aged ("AAHSA") House of Delegates, the AAHSA Managed Care Committee, and has been a member of the Alexian Brothers Health Systems Strategic Planning Committee since 1996. Ms. Krueger has served on the Board of Directors and the Finance/Audit Committee for The Children Place, an organization dedicated to assisting children that are HIV or drug affected. Ms. Krueger has served on the Board of Directors and is the Chairperson for the Audit Committee for Franciscan Sisters Communities of Chicago since 2003.

The Board of Directors does not anticipate that any of the aforementioned nominees for director will refuse or be unable to accept election as a director of the Company, or be unable to serve as a director of the Company. Should any of them become unavailable for nomination or election or refuse to be nominated or to accept election as a director of the Company, then the persons named in the enclosed form of proxy intend to



vote the shares represented in such proxy for the election of such other person or persons as may be nominated or designated by the Board of Directors.

There are no family relationships among any of the directors, director nominees or executive officers of the Company.

**The Board of Directors unanimously recommends a vote “FOR” the election of each of the individuals nominated for election as a director.**

## **BOARD OF DIRECTORS AND COMMITTEES**

### **General**

The Company’s Board of Directors currently consists of seven directors. The Board of Directors has determined that Craig F. Hartberg, James A. Moore, Dr. Victor W. Nee and Jill M. Krueger are independent within the meaning of the corporate governance rules of the NYSE. The Company has adopted a Director Independence Policy, described below under the heading “— Director Independence Policy.” The Board of Directors determined that Ms. Krueger, Messrs. Hartberg and Moore and Dr. Nee are independent in accordance with this Policy.

The Board of Directors held ten meetings during 2005. No director attended fewer than 75% of the aggregate of (i) the total number of meetings of the Board of Directors and (ii) the total number of meetings held by all committees of the Board on which such director served. Under the Company’s Corporate Governance Guidelines, each director is expected to attend meetings of the Board of Directors, the annual shareholders meeting and meetings of the committees of the Board on which they serve. All directors then serving on the Board attended the Company’s 2005 Annual Meeting of Stockholders. At the start of each regularly scheduled executive session of the non-management directors, a presiding director is selected by a majority vote of the non-management directors.

### **Director Independence Policy**

The Board of Directors undertakes an annual review of the independence of all non-management directors. In advance of the meeting at which this review occurs, each non-management director is asked to provide the Board of Directors with full information regarding the director’s business and other relationships with the Company to enable the Board of Directors to evaluate the director’s independence. Directors have an affirmative obligation to inform the Board of Directors of any material changes in their circumstances or relationships that may impact their designation by the Board of Directors as “independent.” This obligation includes all business relationships between, on the one hand, directors or members of their immediate family, and, on the other hand, the Company, whether or not such business relationships are described above.

No director qualifies as “independent” unless the Board of Directors affirmatively determines that the director has no material relationship with the Company. The following guidelines are considered in making this determination:

- a director who is, or has been within the last three years, an employee of the Company, or whose immediate family member is, or has been within the last three years, an executive officer, of the Company is not “independent”;
- a director who received, or whose immediate family member received, during any twelve-month period within the last three years, more than \$100,000 in direct compensation from the Company, other than director and committee fees and pension or other forms of deferred compensation for prior service (provided such compensation is not contingent in any way on continued service), is not “independent”;
- a director (a) who is or whose immediate family member is a current partner of a firm that is the Company’s internal or external auditor, (b) who is a current employee of such a firm, (c) whose immediate family member is a current employee of such a firm and participates in the firm’s audit, assurance or tax compliance (but not tax planning) practice, or (d) who is or whose immediate family

member was within the last three years (but is no longer) a partner or employee of such a firm and personally worked on the Company's audit within that time, is not "independent";

- a director who is, or whose immediate family member is, or has been within the last three years, employed as an executive officer of another company where any of the Company's present executive officers at the same time serves or served on that other company's compensation committee is not "independent";
- a director who is a current employee, or whose immediate family member is a current executive officer, of a company that has made payments to, or received payments from, the Company for property or services in an amount which, in any of the last three fiscal years, exceeds the greater of \$1 million or 2% of such other company's consolidated gross revenues, is not "independent";
- a director who serves as an executive officer, or whose immediate family member serves as an executive officer, of a tax exempt organization that, within the preceding three years received contributions from the Company, in any single fiscal year, of an amount equal to the greater of \$1 million or 2% of such organization's consolidated gross revenue, is not "independent"; and
- a director who has a beneficial ownership interest of 10% or more in a company which has received remuneration from the Company in any single fiscal year in an amount equal to the greater of \$1 million or 2% of such Company's consolidated gross revenue is not "independent" until three years after falling below such threshold.

In addition, members of the Audit Committee may not accept any consulting, advisory or other compensatory fee from the Company or any of its subsidiaries or affiliates other than directors' compensation.

The term "Company" means Capital Senior Living Corporation and any direct or indirect subsidiary of Capital Senior Living Corporation which is part of the consolidated group. An "immediate family member" includes a person's spouse, parents, children, siblings, mothers and fathers-in-law, sons and daughters-in-law, brothers and sisters-in-law and anyone (other than domestic employees) who shares such person's home.

## **Committees**

Committees of the Board of Directors include the Audit Committee, the Nominating Committee and the Compensation Committee.

### ***Audit Committee***

The Audit Committee consists of Messrs. Hartberg and Moore and Ms. Krueger, each of whom is independent, as defined by the listing standards of the NYSE in effect as of the date of this Proxy Statement. The Board of Directors has determined that Ms. Krueger qualifies as an "audit committee financial expert" within the meaning of Securities and Exchange Commission regulations. The Board of Directors adopted in 2004 an amended and restated Audit Committee Charter which is available on the Company's website at <http://www.capitalsenior.com> in the Investor Relations section, is included as Appendix A to this Proxy Statement and is available in print to any shareholder who requests it. Pursuant to this Charter, the Audit Committee serves as an independent party to oversee the Company's financial reporting process and internal control system, to appoint, replace, provide for compensation of and to oversee the Company's independent accountants and provide an open avenue of communication among the independent accountants and the Company's senior management and the Board of Directors. The Audit Committee held seven meetings during 2005.

### ***Nominating Committee***

The Nominating Committee consists of Messrs. Hartberg and Moore and Dr. Nee, each of whom is independent, as defined by the listing standards of the NYSE in effect as of the date of this Proxy Statement. The Nominating Committee identifies individuals qualified to become Board members and recommends Board nominees to the Board of Directors. The Nominating Committee also oversees the evaluation of the

Board of Directors and management and develops and recommends for Board of Directors approval the Company's Code of Business Conduct and Ethics and Corporate Governance Guidelines. The amended and restated Nominating Committee Charter and the Company's Code of Business Conduct and Ethics and Corporate Governance Guidelines are available on the Company's website at <http://www.capitalsenior.com> in the Investor Relations section and are available in print to any shareholder who requests it. The Nominating Committee held one meeting during 2005.

### ***Compensation Committee***

The Compensation Committee consists of Messrs. Hartberg and Moore and Dr. Nee. The Compensation Committee held six meetings during 2005 and is responsible for approval of the compensation and objectives and goals of the Chief Executive Officer of the Company and for making recommendations to the Board of Directors concerning the Company's executive compensation policies for other senior officers and administering the 1997 Omnibus Stock and Incentive Plan. The Compensation Committee Charter is available on the Company's website at <http://www.capitalsenior.com> in the Investor Relations section and is available in print to any shareholder who requests it.

### **Director Nominations**

The Nominating Committee of the Board of Directors is responsible under its charter for identifying and recommending qualified candidates for election to the Board of Directors. In addition, shareholders who wish to recommend a candidate for election to the Board of Directors may submit the recommendation to the chairman of the Nominating Committee, in care of the General Counsel of the Company. Any recommendation must include name, contact information, background, experience and other pertinent information on the proposed candidate and must be received in writing by December 9, 2006 for consideration by the Nominating Committee for the 2007 Annual Meeting of Stockholders.

Although the Nominating Committee is willing to consider candidates recommended by shareholders, it has not adopted a formal policy with regard to the consideration of any director candidates recommended by shareholders. The Nominating Committee believes that a formal policy is not necessary or appropriate because of the small size of the Board of Directors and because the Company's current Board of Directors already has a diversity of business background, shareholder representation and industry experience.

The Nominating Committee does not have specific minimum qualifications that must be met by a candidate for election to the Board of Directors in order to be considered for nomination by the Committee. In identifying and evaluating nominees for director, the Committee considers each candidate's qualities, experience, background and skills, as well as any other factors which the candidate may be able to bring to the Board that the Board currently does not possess. The process is the same whether the candidate is recommended by a shareholder, another director, management or otherwise. The Company does not pay a fee to any third party for the identification of candidates, but the Company has paid a fee in the past to a third party for a background check for a candidate.

With respect to this year's nominees for director, each of Mr. Stroud, Mr. Johannessen and Ms. Krueger is a current director standing for re-election.

### **Website**

The Company's internet website [www.capitalsenior.com](http://www.capitalsenior.com) contains an Investor Relations section, which provides links to the Company's annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, proxy statements, Section 16 filings, amendments to those reports and filings, code of business conduct and ethics, corporate governance guidelines, director independence policy and charters of the committees of the Board of Directors. These documents are available in print free of charge to any stockholder who requests it as soon as reasonably practicable after such material is electronically filed with or furnished to the Securities and Exchange Commission. The materials on the website are not incorporated by reference into this Proxy Statement and do not form any part of the materials for solicitation of proxies.

## Communication with Directors

Correspondence may be sent to the directors, including the non-management directors individually (each of whom may be selected to serve as a presiding director at regularly scheduled executive sessions of the non-management directors) or as a group, in care of James A. Stroud, Chairman, with a copy to the General Counsel, David R. Brickman, at the Company's principal business office, 14160 Dallas Parkway, Suite 300, Dallas, Texas 75254.

All communication received as set forth above will be opened by the Chairman and General Counsel for the sole purpose of determining whether the contents represent a message to the Company's directors. Appropriate communications other than advertising, promotions of a product or service, or patently offensive material will be forwarded promptly to the addressee.

## Director Compensation

Directors who are employees of the Company do not receive additional compensation for serving as directors of the Company. Non-employee directors are entitled to an annual retainer of \$15,000 payable, in arrears, on the date of each Annual Meeting. Non-employee directors are also entitled to a fee of \$1,000 for each Board meeting attended by such director, and \$1,000 for each committee meeting attended by such director. All directors are entitled to reimbursement for their actual out-of-pocket expenses incurred in connection with attending meetings. In addition, non-employee directors receive options to purchase shares of Common Stock or shares of restricted stock in accordance with the provisions of the 1997 Omnibus Stock and Incentive Plan.

## Executive Compensation

The following table sets forth certain summary information concerning the compensation paid to any person who served as the Company's Chief Executive Officer and each of the other four most highly compensated executive officers whose salary exceeded \$100,000 for services rendered in all capacities to the Company for the fiscal years ended December 31, 2005, 2004 and 2003, respectively. All of the executive officers named below are referred to herein as the "Named Executive Officers."

**Summary Compensation Table**

Name and Principal Positions	Year	Annual Compensation(1)			Long-Term Compensation	
		Salary (\$)	Bonus (\$)	Other Annual Compensation (\$)(2)	Restricted Stock Awards (\$)	Securities Underlying Options/SARs
Lawrence A. Cohen . . . . .	2005	381,423	228,366	6,000	454,350	—
Chief Executive Officer and	2004	366,753	317,619	6,000	—	—
Vice Chairman of the Board	2003	352,647	254,262	6,000	—	100,000
James A. Stroud . . . . .	2005	317,852	126,851	10,836	—	—
Chairman and Secretary of	2004	305,627	216,114	10,035	—	—
the Company and Chairman	2003	293,872	197,756	8,151	—	—
of the Board						
Keith N. Johannessen . . . . .	2005	243,360	116,468	7,000	454,350	—
President and Chief	2004	234,000	167,123	6,500	—	—
Operating Officer	2003	225,000	151,516	6,000	—	56,540
Ralph A. Beattie . . . . .	2005	227,207	103,276	6,537	174,750	—
Executive Vice President and	2004	218,468	159,104	7,481	—	—
Chief Financial Officer	2003	210,066	138,835	6,000	—	—
David R. Brickman . . . . .	2005	180,988	40,000	3,511	104,850	—
Vice President — General	2004	174,446	45,000	3,255	—	—
Counsel	2003	168,547	30,000	3,018	—	41,120

- (1) Annual compensation does not include the cost to the Company of benefits that certain executive officers receive in addition to salary and cash bonuses. The aggregate amounts of such personal benefits, however, did not exceed the lesser of either \$50,000 or 10% of the total annual compensation of such executive officer.
- (2) Other annual compensation includes Employer 401(k) match and auto allowance.
- (3) Represents the value of shares of restricted stock issued pursuant to the Company's 1997 Stock Incentive Plan on July 1, 2005. The shares vest ratably over a three and one half year period, although the vesting schedule will be accelerated in the event of a change in control of the Company. Persons holding shares of restricted stock are entitled to receive any dividends declared prior to the date of vesting. The shares of restricted stock issued to the named executive officers were 65,000 to each of Mr. Cohen and Mr. Johannessen, 25,000 to Mr. Beattie and 15,000 to Mr. Brickman. The closing price of the Company's common stock on the date of grant was \$7.00. The value of these restricted stock awards, based upon the closing price of the Company's common stock of \$10.34 at December 30, 2005, was \$672,100 for Mr. Cohen and Mr. Johannessen, \$258,500 for Mr. Beattie and \$155,100 for Mr. Brickman. These shares of restricted stock represent the aggregate number of shares of restricted stock held by the named executive officers as of December 31, 2005.

**Aggregated Stock Option/SAR Exercises During 2005 and Stock  
Option/SAR Values as of December 31, 2005**

The following table provides information regarding the exercise of stock options during 2005 by the Named Executive Officers and describes for each of the Named Executive Officers the potential realizable values for their options at December 31, 2005:

**Aggregated Option/SAR Exercises in Last Fiscal Year and  
Option/SAR Values at December 31, 2005**

<u>Name</u>	<u>Shares Acquired on Exercise (#)</u>	<u>Value Realized (\$)</u>	<u>Number of Securities Underlying Unexercised Options/SARs at Fiscal Year End (#)</u>	<u>Value of Unexercised In-the-Money Options/SARs at Fiscal Year End(1)</u>
			<u>Exercisable/Unexercisable</u>	<u>Exercisable/Unexercisable</u>
Lawrence A. Cohen . . . . .	—	—	222,409/-0-	1,386,404/-0-
James A. Stroud . . . . .	—	—	134,409/-0-	558,884/-0-
Keith N. Johannessen . . . . .	—	—	140,196/-0-	899,553/-0-
Ralph A. Beattie . . . . .	—	—	43,010/-0-	288,597/-0-
David R. Brickman . . . . .	—	—	82,324/-0-	486,524/-0-

- (1) All of the options reflected above were granted at exercise prices ranging from \$1.80 to \$7.06. The closing price per share of the Company's Common Stock on December 30, 2005 was \$10.34.

**Employment Agreements**

The Company has entered into employment agreements with each of its named executive officers. Mr. Cohen entered into an employment agreement in November 1996 which was subsequently amended in May 1999, January 2003 and February 2004. Mr. Stroud entered into an employment agreement with the Company in May 1997 which was subsequently amended in March and May 1999, November 2000 and January 2003. Mr. Johannessen entered into an employment agreement with the Company in November 1996 which was subsequently amended in May 1999 and January 2003. Mr. Beattie entered into an employment agreement with the Company in May 1999 which was subsequently amended in January 2003. Mr. Brickman entered into an employment agreement with the Company in December 1996 which was subsequently amended in January 2003.



Mr. Cohen's employment agreement is for a term of three years and automatically extends for a two-year term on a consecutive basis, and the compensation thereunder consists of a minimum annual base salary of \$300,000, subject to annual adjustments, and a bonus of not less than 33% of his base salary in the event certain performance standards are met. Mr. Stroud's employment agreement contains terms that renew annually for successive four-year periods, and the compensation thereunder consists of a minimum base salary of \$250,000, subject to annual adjustments, and a bonus of not less than 33% of his base salary in the event certain performance standards are met. Mr. Johannessen's employment agreement is for a term of three years and automatically extends for a two-year term on a consecutive basis, and the compensation thereunder consists of an annual base salary of \$180,000, subject to annual adjustments, and a bonus of not less than 33% of his base salary in the event certain performance standards are met. Mr. Beattie's employment agreement is for a term of three years and automatically extends for a two-year term on a consecutive basis, and the compensation thereunder consists of an annual base salary of \$180,000 per annum, subject to adjustments, and a bonus of not less than 33% of his base salary in the event certain performance standards are met. Mr. Brickman's employment agreement is for a term of three years and automatically extends for a two-year term on a consecutive basis, and the compensation thereunder consists of an annual base salary of \$146,584 for 2001, subject to annual adjustments.

Annual bonus awards are determined by the Board of Directors or the Compensation Committee. Included in each employment agreement is a covenant of the employee not to compete with the Company during the term of his employment and for a period of one year thereafter.

Messrs. Cohen, Stroud, Johannessen and Beattie's employment agreements provide that if the employee is terminated by the Company, other than for cause or for reasons of death or disability or if he voluntarily resigns for good reason, then the Company will pay his base salary plus his annual bonus paid during the term of the employment agreement in the past 12 months for the balance of the term of the agreement, but not less than two years (base salary plus annual bonus paid during the term of his employment agreement in the past 12 months for three years if the termination is due to a Fundamental Change, as defined therein). Mr. Brickman's employment agreement provides that if the employee is terminated by the Company, other than for cause or for reasons of death or disability or the employee voluntarily resigns for good reason, then the Company will pay the employee his base salary for the balance of the term of the employment agreement, but in any event not to exceed two years, and not less than two years from the date of notice of the termination.

Under the Company's employment agreements with Mr. Cohen and Mr. Stroud, Mr. Cohen and Mr. Stroud are each entitled to certain rights with respect to the registration under the Securities Act of 1933, as amended (the "Securities Act"), of securities of the Company they hold. Under Mr. Cohen's employment agreement, if the Company proposes to register any of its securities under the Securities Act either for its own account or the account of other security holders, Mr. Cohen is entitled to notice of the registration and has the right to include the securities of the Company that he holds in the registration. Under Mr. Stroud's employment agreement he has similar registration rights as Mr. Cohen. These registration rights are subject to certain conditions, including the right of any underwriters of these offerings to limit the number of shares included in any of these registrations. The Company has agreed to pay all expenses related to these registrations, except for underwriting discounts and selling commissions. In addition to the rights described above, under Mr. Stroud's employment agreement, upon a registration event, as defined in the employment agreement, he has certain rights to require the Company to register the securities of the Company that he holds for resale.

### **Compensation Committee Report on Executive Compensation**

The Board of Directors has established a Compensation Committee to review and approve the compensation levels of executive officers of the Company, evaluate the performance of the executive officers and to review any related matters for the Company. The Compensation Committee is charged with reviewing with the Board of Directors in detail all aspects of the cash compensation for the executive officers of the Company. Equity compensation and other forms of compensation for the executive officers is also considered by the Compensation Committee. In 2005, the Compensation Committee consisted of Messrs. Hartberg and Moore and Dr. Nee.



The philosophy of the Company's compensation program is to employ, retain and reward executives capable of leading the Company in achieving its business objectives. These objectives include preserving a strong financial posture, increasing the assets of the Company, positioning the Company's assets and business operations in geographic markets and industry segments offering long-term growth opportunities, enhancing stockholder value and ensuring the competitiveness of the Company. The accomplishment of these objectives is measured against conditions prevalent in the industry within which the Company operates. In recent years, these conditions reflect a highly competitive market environment and rapidly changing regional, geographic and industry market conditions. However, the Compensation Committee is also mindful of the fact that several of the Company's executive officers have entered into employment agreements in connection with their agreements to join the Company; accordingly, with respect to those executive officers, the Compensation Committee recognizes that, to a large degree, compensation for such persons is set by contract.

In general, the Compensation Committee has determined that the available forms of executive compensation should include base salary, cash bonus awards, stock options and restricted stock. Performance of the Company will be a key consideration (to the extent that such performance can fairly be attributed or related to such executive's performance), as well as the nature of each executive's responsibilities and capabilities. The Company's compensation philosophy recognizes, however, that stock price performance is only one measure of performance and, given industry business conditions and the long-term strategic direction and goals of the Company, it may not necessarily be the best current measure of executive performance. Therefore, the Company's compensation philosophy also will give consideration to the Company's achievement of specified business objectives in the areas of earnings per share, corporate goals, individual goals and stock price goals when determining executive officer compensation. The Compensation Committee will endeavor to compensate the Company's executive officers based upon a Company-wide salary structure consistent for each position relative to its authority and responsibility compared to industry peers.

An additional objective of the Compensation Committee in determining compensation is to reward executive officers with equity compensation in addition to salary in keeping with the Company's overall compensation philosophy, which attempts to place equity in the hands of its employees in an effort to further instill stockholder considerations and values in the actions of all employees and executive officers. In making its determinations, some consideration will be given by the Compensation Committee to the number of options already held by such persons and the existing amount of Common Stock already owed by such persons. The Compensation Committee believes that the award of stock options and restricted stock represents an effective incentive to create value for the stockholders. During 2005, additional grants were authorized for new and existing key employees.

On the recommendation of the Compensation Committee, the 2005 base salary for Lawrence A. Cohen, the Company's Chief Executive Officer, was established at \$381,423 by the Company's Board of Directors effective for fiscal 2005. Mr. Cohen's base salary was generally based on the same factors and criteria outlined above, being compensation paid to chief executives of comparable companies, individual as well as corporate performance and a general correlation with compensation of other executive officers of the Company. The \$228,366 bonus paid to Mr. Cohen in 2005 was determined under the incentive compensation criteria described above. In considering whether a cash bonus would be awarded to Mr. Cohen, the Compensation Committee recognized Mr. Cohen's efforts to execute on the Company's 2005 Business Plan. The Compensation Committee also considered the goals and criteria which had been established for Mr. Cohen for fiscal 2005, the Company's results and the other factors described in its analysis above.

Section 162(m) of the Internal Revenue Code, enacted in 1993, generally disallows a tax deduction to public companies for compensation over \$1 million paid to the Chief Executive Officer or to any of the four other most highly compensated executive officers. Certain performance-based compensation, however, is specifically exempt from the deduction limit. The Company does not have a policy that requires or encourages the Compensation Committee to qualify stock options or restricted stock awarded to executive officers for deductibility under Section 162(m) of the Internal Revenue Code. However, the Compensation Committee will consider the net cost to the Company in making all compensation decisions.

Compensation Committee

CRAIG F. HARTBERG  
JAMES A. MOORE  
DR. VICTOR W. NEE

**Compensation Committee Interlocks and Insider Participation**

No member of the Compensation Committee is or has been an officer or employee of the Company or any of its subsidiaries or had any relationship requiring disclosure pursuant to Item 404 of Regulation S-K promulgated pursuant to the Securities Act. No executive officer of the Company served as a member of the compensation committee (or other board committee performing similar functions or, in the absence of any such committee, the entire board of directors) of another corporation, one of whose executive officers served on the Compensation Committee. No executive officer of the Company served as a director of another corporation, one of whose executive officers served on the Compensation Committee. No executive officer of the Company served as a member of the compensation committee (or other board committee performing equivalent functions or, in the absence of any such committee, the entire board of directors) of another corporation, one of whose executive officers served as a director of the Company.

**Report of the Audit Committee**

The Audit Committee oversees the Company's financial reporting process on behalf of the Board of Directors. Management has the primary responsibility for the financial statements and the reporting process including the systems of internal controls. In fulfilling its oversight responsibilities, the Audit Committee reviewed and discussed the audited financial statements in the Annual Report on Form 10-K with management, including a discussion of the quality, not just the acceptability, of the accounting principles, the reasonableness of significant judgments and the clarity of disclosures in the financial statements.

The Audit Committee reviewed with the independent auditors, who are responsible for expressing an opinion on the conformity of those audited financial statements with generally accepted accounting principles, their judgments as to the quality, not just the acceptability, of the Company's accounting principles and such other matters as are required to be discussed with the Audit Committee under generally accepted auditing standards. The Audit Committee also discussed with the independent auditors matters required to be discussed by Statement on Auditing Standards No. 61 (Communication with Audit Committees). The Company's independent auditors also provided to the Audit Committee the written disclosures required by Independence Standards Board Standard No. 1 (Independent Discussions with Audit Committees), and the Audit Committee discussed with the independent auditors their independence and the compatibility of nonaudit services with such independence.

The Audit Committee discussed with the independent auditors the overall scope and plans for their respective audits. The Audit Committee meets with the independent auditors, with and without management present, to discuss the results of their examinations, their evaluations of the Company's internal controls, and the overall quality of the Company's financial reporting. The Audit Committee held seven meetings during fiscal year 2005.

In reliance on the reviews and discussions referred to above, the Audit Committee recommended to the Board of Directors (and the Board has approved) that the audited financial statements be included in the Annual Report on Form 10-K for the year ended December 31, 2005 for filing with the Securities and Exchange Commission. The Audit Committee has also appointed, subject to shareholder ratification, KPMG LLP as the Company's independent auditors.

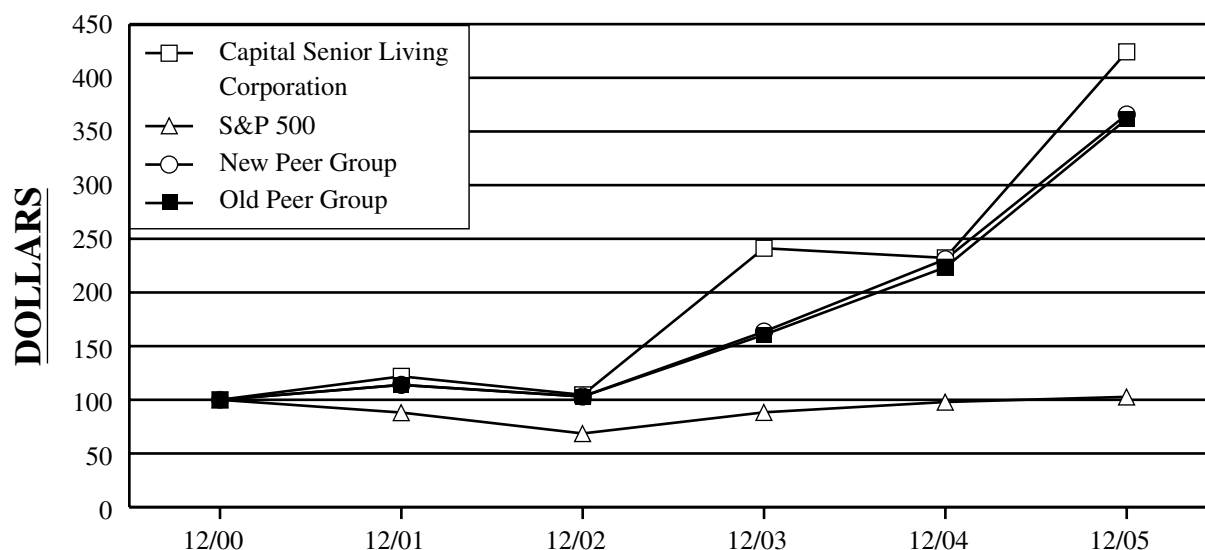
Audit Committee

CRAIG F. HARTBERG, CHAIRMAN  
JAMES A. MOORE  
JILL M. KRUEGER

## COMPARATIVE TOTAL RETURNS

The following Performance Graph shows the changes for the five year period ended December 31, 2005 in the value of \$100 invested in: (1) the Company's Common Stock; (2) the Standard & Poor's Broad Market Index (the "S&P 500"); and (3) the common stock of the Peer Group (as defined below) of companies, whose returns represent the arithmetic average for such companies. The values with each investment as of the beginning of each year are based on share price appreciation and the reinvestment with dividends on the respective ex-dividend dates. The change in the Company's performance for the year ended December 30, 2005, results from the price of the Company's Common Stock increasing from \$5.66 per share at December 31, 2004 to \$10.34 per share at December 30, 2005.

**COMPARISON OF FIVE YEAR CUMULATIVE TOTAL RETURN\*  
AMONG CAPITAL SENIOR LIVING CORPORATION,  
THE S&P 500 INDEX, THE NEW PEER GROUP AND THE OLD PEER GROUP**



The preceding graph assumes \$100 invested at the beginning of the measurement period, including reinvestment of dividends, in the Common Stock, the S&P 500, the New Peer Group and the Old Peer Group and was plotted using the following data:

	Cumulative Total Return					
	12/00	12/01	12/02	12/03	12/04	12/05
Capital Senior Living Corporation . . . . .	\$100.00	\$121.85	\$104.62	\$241.23	\$232.21	\$424.21
S&P 500 . . . . .	100.00	88.12	68.64	88.33	97.94	102.75
New Peer Group . . . . .	100.00	113.90	103.07	163.53	230.94	365.78
Old Peer Group . . . . .	100.00	113.90	103.07	160.58	223.45	361.56

The principal executive officers of the Company, after reviewing publicly filed documents of the companies in the Old Peer Group, consisting of American Retirement Corp., Emeritus Corporation and Sunrise Assisted Living, Inc., decided to add Five Star Quality Care, Inc. to the peer group. The Company believes the New Peer Group more closely matches the Company in terms of market capitalization and market niche.

## CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS

### Policy of the Board of Directors

The Company has implemented a policy requiring any material transaction (or series of related transactions) between the Company and related parties to be approved by a majority of the directors who have no beneficial or economic interest in such transaction, upon such directors' determination that the terms of the transaction are no less favorable to the Company than those that could have been obtained from third parties. There can be no assurance that these policies will always be successful in eliminating the influence of conflicts of interest.

### SECTION 16(a) BENEFICIAL OWNERSHIP REPORTING COMPLIANCE

Section 16(a) of the Exchange Act requires the Company's officers and directors, and persons who own more than 10% of a registered class of the Company's equity securities (the "10% Stockholders"), to file reports of ownership and changes of ownership with the Securities and Exchange Commission ("SEC") and the NYSE. Officers, directors and 10% Stockholders of the Company are required by SEC regulation to furnish the Company with copies of all Section 16(a) forms so filed. Based solely on review of copies of such forms received, the Company believes that, during the last fiscal year, all filing requirements under Section 16(a) applicable to its officers, directors and 10% Stockholders were timely met.

### PROPOSAL TO RATIFY APPOINTMENT OF INDEPENDENT AUDITORS

#### (PROPOSAL 2)

The Audit Committee of the Board of Directors has appointed KPMG LLP, independent auditors, to be the principal independent auditors of the Company and to audit its consolidated financial statements. KPMG LLP has served as the Company's independent auditors since June 21, 2005, and has reported on the Company's consolidated financial statements.

Representatives of the firm of KPMG LLP are expected to be present at the Annual Meeting and will have an opportunity to make a statement if they so desire and will be available to respond to appropriate questions.

The Audit Committee of Board of Directors has the responsibility for the selection of the Company's independent auditors. Although stockholder ratification is not required for the selection of KPMG LLP, and although such ratification will not obligate the Company to continue the services of such firm, the Board of Directors is submitting the selection for ratification with a view towards soliciting the stockholders' opinion thereon, which may be taken into consideration in future deliberations. If the appointment is not ratified, the Audit Committee of the Board of Directors must then determine whether to appoint other auditors before the end of the current fiscal year and, in such case, stockholders' opinions would be taken into consideration.

**The Board of Directors unanimously recommends a vote "FOR" the ratification of KPMG LLP as independent auditors of the Company.**

## FEES PAID TO INDEPENDENT AUDITORS

The aggregate fees billed by KPMG LLP, the Company's independent auditors, in fiscal 2005 and Ernst & Young LLP, the Company's former independent auditor, in 2004 were as follows:

<u>Services Rendered</u>	<u>Fees</u>	
	<u>2005</u>	<u>2004</u>
Audit fees(1) .....	\$465,600	\$692,410
Audit-Related fees(2) .....	—	20,627
Tax fees(3) .....	—	—
Total .....	<u>\$465,600</u>	<u>\$713,037</u>

- (1) Includes professional services for the audit of the Company's annual financial statements, reviews of the financial statements included in the Company's Form 10-Q filings, services that are normally provided in connection with statutory and regulatory filings or engagements. Audit services for fiscal 2005 include \$177,600 in fees related to Sarbanes-Oxley Section 404 compliance.
- (2) Includes fees associated with assurance and related services that are reasonably related to the performance of the audit or review of the Company's financial statement. This category includes fees related to the audit of the Company's 401(k) plan and consulting services.
- (3) Includes fees associated with tax compliance, tax advice and tax planning.

The Audit Committee has considered whether the provision of the above services other than audit services is compatible with maintaining KPMG LLP's independence and has concluded that it is.

The Audit Committee has the sole authority to appoint or replace the independent auditor and is directly responsible for the compensation and oversight of the work of the independent auditor. The Audit Committee is responsible for the engagement of the independent auditor to provide permissible non-audit services, which require preapproval by the Audit Committee (other than with respect to *de minimis* exceptions described in the rules of the NYSE or the SEC that are approved by the Audit Committee). The Audit Committee ensures that approval of non-audit services by the independent auditor are disclosed to investors in periodic reports filed with the SEC.

On June 21, 2005, the Company dismissed Ernst & Young LLP as the Company's independent registered public accounting firm.

The reports of Ernst & Young LLP on the financial statements of the Company as of and for the fiscal years ended December 31, 2004 and 2003 contained no adverse opinion or disclaimer of opinion and were not qualified or modified as to uncertainty, audit scope or accounting principles.

The Audit Committee of the Board of Directors of the Company approved the decision to dismiss Ernst & Young LLP.

During the fiscal years ended December 31, 2004 and 2003 and through June 21, 2005, there were no disagreements with Ernst & Young LLP on any matter of accounting principles or practices, financial statement disclosure, or auditing scope or procedure, which disagreement(s), if not resolved to the satisfaction of Ernst & Young LLP, would have caused it to make a reference to the subject matter of the disagreement(s) in connection with its reports.

During the fiscal years ended December 31, 2004 and 2003 and through June 21, 2005, there have been no "reportable events," as defined in Item 304(a)(1)(v) of Regulation S-K.

The Company has requested that Ernst & Young LLP furnish it with a letter addressed to the U.S. Securities and Exchange Commission stating whether or not it agrees with the above statements. A copy of such letter dated June 23, 2005, is attached as Exhibit 16.1 to the Company's Current Report on Form 8-K filed with the SEC on June 24, 2005.



On June 21, 2005, the Company engaged KPMG LLP as its new independent registered public accounting firm.

During the fiscal years ended December 31, 2004 and 2003 and through June 21, 2005, the Company has not consulted KPMG LLP regarding either (i) the application of accounting principles to a specified transaction, either completed or proposed; or the type of audit opinion that might be rendered on the Company's financial statements, and neither a written report was provided to the Company nor oral advice was provided that KPMG LLP concluded was an important factor considered by the Company in reaching a decision as to the accounting, auditing or financial reporting issue; or (ii) any manner that was either the subject of a disagreement (as defined in Item 304(a)(1)(iv) of Regulation S-K and the related instructions to Item 304 of Regulation S-K) or a reportable event (as described in Item 304(a)(1)(v) of Regulation S-K).

**OTHER BUSINESS  
(PROPOSAL 3)**

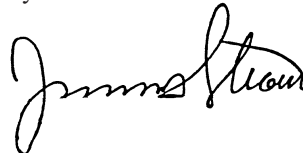
The Board knows of no other business to be brought before the Annual Meeting. If, however, any other business should properly come before the Annual Meeting, the persons named in the accompanying proxy will vote the proxy as in their discretion they may deem appropriate, unless directed by the proxy to do otherwise.

**GENERAL**

The cost of any solicitation of proxies by mail will be borne by the Company. Arrangements may be made with brokerage firms and other custodians, nominees and fiduciaries for the forwarding of material to and solicitation of proxies from the beneficial owners of Common Stock held of record by such persons, and the Company will reimburse such brokerage firms, custodians, nominees and fiduciaries for reasonable out of pocket expenses incurred by them in connection therewith. Brokerage houses and other custodians, nominees and fiduciaries, in connection with shares of Common Stock registered in their names, will be requested to forward solicitation material to the beneficial owners of such shares and to secure their voting instructions. The Company has retained Georgeson Shareholder Communications Inc. to assist in soliciting proxies for the Annual Meeting for a fee of \$25,000. The cost of such solicitation will be borne by the Company.

The information contained in this Proxy Statement in the sections entitled "Election of Directors — Compensation Committee Report on Executive Compensation," "— Report of the Audit Committee" and "— Comparison of Five Year Cumulative Total Return" shall not be deemed incorporated by reference by any general statement incorporating by reference any information contained in this Proxy Statement into any filing under the Securities Act , or the Exchange Act, except to the extent that the Company specifically incorporates by reference the information contained in such sections, and shall not otherwise be deemed filed under the Securities Act or the Exchange Act.

By Order of the Board of Directors



JAMES A. STROUD  
*Chairman of the Board and Secretary*

April 7, 2006  
Dallas, Texas



**CAPITAL SENIOR LIVING CORPORATION**  
**SECOND AMENDED AND RESTATED AUDIT COMMITTEE CHARTER**

**Statement of Purpose**

The audit committee shall provide assistance to the Board in fulfilling their oversight responsibility relating to:

- corporate accounting;
- the Company's system of internal controls regarding finance, accounting, legal compliance and ethics;
- reporting practices of the Company;
- the quality and integrity of financial statements of the Company;
- the Company's compliance with legal and regulatory requirements;
- the independent auditor's qualifications and independence; and
- the performance of the Company's internal audit function and the Company's independent auditors.

It is the responsibility of the audit committee to maintain free and open communication between the Board, the independent auditors, and the financial management of the Company. In discharging its oversight role, the committee is empowered to investigate any matter brought to its attention with full access to all books, records, facilities, and personnel of the Company and the power to retain outside counsel or other advisors for this purpose.

In carrying out its responsibilities, the audit committee believes its policies and procedures should remain flexible in order to best react to changing conditions and circumstances. The committee should take appropriate actions to set the overall corporate "tone" for quality financial reporting, sound business risk practices, and ethical behavior.

**Organization***Independence*

The audit committee of the board of directors of the Company (the "Board") shall be comprised of at least three directors. The audit committee members shall each be determined by the Board to be "independent" under Section 10A(m)(3) of the Securities Exchange Act of 1934 (the "Exchange Act"), Rule 10-A-3 of the Exchange Act, the rules of the New York Stock Exchange (the "NYSE") and the rules and regulations of the Securities and Exchange Commission (the "SEC").

*Financial Expertise*

Each member of the audit committee must be financially literate, as such qualification is interpreted by the Board in its business judgment; or must become financially literate within a reasonable period of time after appointment to the audit committee. In addition, at least one member of the audit committee must be an "audit committee financial expert" as such term is defined in Item 401(h) of Regulation S-K.

*Simultaneous Service*

If an audit committee member serves on the audit committee of more than three public companies, the Board shall determine whether such simultaneous service will impair the director's ability to effectively serve on the audit committee and disclose such determination in accordance with the regulations of the NYSE.

### ***Funding***

The Company shall provide for appropriate funding, as determined by the audit committee, for payment of compensation to the independent auditor for the purpose of preparing or issuing an audit report, or performing other audit, review or attest services for the Company, for payment of compensation to any advisors employed by the audit committee and for ordinary administrative expenses of the audit committee that are necessary or appropriate in carrying out its duties.

### **Appointment and Removal**

The members of the audit committee shall be appointed by the Board and shall serve for the term set forth in the By-Laws of the Company.

### **Chairperson**

Unless a Chairperson is elected by the Board, the members of the audit committee shall designate a Chairperson by the majority vote of the full audit committee membership. The Chairperson will chair all regular sessions of the audit committee and set the agenda for audit committee meetings.

### **Meetings**

The audit committee shall meet as often as it determines is necessary but no less than once per quarter, either in person or telephonically, and at such times and places as the audit committee shall determine.

The audit committee should meet periodically with management, the internal auditors and the independent auditor in separate sessions to discuss any matters that the audit committee or either of these groups believes should be discussed privately. In addition, the audit committee should discuss with the independent auditors and management the Company's annual and quarterly financial statements and adequacy of internal controls.

The audit committee may request any officer or employee of the Company or the Company's outside counsel, independent auditor or other advisor to attend a meeting of the Committee or to meet with any members of, or consultants to, the Committee.

### **Responsibilities**

#### ***Oversight of Financial Reporting Process***

The primary responsibility of the audit committee is to oversee the Company's financial reporting process on behalf of the Board and report the results of their activities regularly to the Board and to review with the Board any issues that arise with respect to the quality or integrity of the Company's financial statements, the Company's compliance with legal or regulatory requirements, the performance and independence of the Company's independent auditors and the performance of the internal audit function.

While the audit committee has the responsibilities and powers set forth in this Charter, it is not the duty of the audit committee to plan or conduct audits or to determine that the Company's financial statements are complete and accurate and are in accordance with generally accepted accounting principles. Management is responsible for preparing the Company's financial statements, and the independent auditors are responsible for auditing those financial statements. It is not the duty of the audit committee to conduct investigations, or to assure compliance with laws and regulations.

#### ***Appointment of Independent Auditor***

The audit committee shall have the sole authority to appoint or replace the independent auditor (subject, if applicable, to shareholder ratification). The audit committee shall be directly responsible for the retention, compensation and oversight of the work of the independent auditor (including resolution of disagreements between management and the independent auditor regarding financial reporting) for the purpose of preparing

or issuing an audit report or related work. The independent auditor shall report directly to the audit committee.

The audit committee has the responsibility to establish policies and procedures for the engagement of the independent auditor to provide permissible audit and non-audit services, which shall require preapproval by the audit committee (other than with respect to *de minimis* exceptions for non-audit services described in Section 10A(i)(1)(B) of the Exchange Act that are subsequently approved by the audit committee pursuant to such section). The audit committee shall ensure that approval of non-audit services by the independent auditor are disclosed to investors in periodic reports filed with the SEC.

In carrying out these responsibilities, the audit committee will:

A. Financial Reporting Process and Documents/Reports Review

- Meet with the independent auditors and financial management of the Company to review the scope of the proposed audit and timely quarterly reviews for the current year and the procedures to be utilized, the adequacy of the independent auditor's compensation, and at the conclusion thereof review such audit or review, including any comments or recommendations of the independent auditors.
- Review with the independent auditors, internal auditor and financial and accounting personnel, the adequacy and effectiveness of the accounting, financial and internal controls of the Company, and elicit any recommendations for the improvement of such controls or particular areas where new or more detailed controls or procedures are desirable. Particular emphasis should be given to the adequacy of internal controls to expose any payments, transactions, or procedures that might be deemed illegal or otherwise improper.
- Review disclosures made to the audit committee by the Company's Chief Executive Officer and Chief Financial Officer during their certification process for the Form 10-K and 10-Q about any significant deficiencies in the design or operation of internal controls or material weaknesses therein and any fraud involving management or other employees who have a significant role in the Company's internal controls.
- Discuss with management the Company's earnings press releases, including the use of "pro forma" or "adjusted" non-GAAP information, as well as financial information and earnings guidance provided to analysts and rating agencies. Such discussion may be done generally (consisting of discussing the types of information to be disclosed and the types of presentations to be made).
- Review and discuss the Company's quarterly financial statements and the disclosures under the heading "Management's Discussion and Analysis of Financial Condition and Results of Operations" with financial management and the independent auditors prior to the filing of the Company's Form 10-Qs and prior to the issuance of press release of results) to determine that the independent auditors do not take exception to the disclosure and content of the financial statements, and discuss any other matters required to be communicated to the committee by the auditors.
- Review and discuss the Company's annual audited financial statements and the disclosures under the heading "Management's Discussion and Analysis of Financial Condition and Results of Operations" contained in the annual report to shareholders with management and the independent auditors to determine that the independent auditors are satisfied with the disclosure and content of the financial statements to be presented to the shareholders, and discuss any other matters required to be communicated to the committee by the auditors.
- Review with financial management and the independent auditors the results of their timely analysis of significant financial reporting issues and practices, including changes in, or adoptions of, accounting principles and disclosure practices, and discuss any other matters required to be communicated to the committee by the auditors.

- Review reports received from regulators and other legal and regulatory matters, including the effect of regulatory and accounting initiatives, as well as off-balance sheet structures, that may have a material effect on the financial statements or related Company compliance policies.
- Review with financial management their judgments about the quality, not just acceptability, of accounting principles and the clarity of the financial disclosure practices used or proposed to be used, and particularly, the degree of aggressiveness or conservatism of the organization's accounting principles and underlying estimates, and other significant decisions made in preparing the financial statements.
- Report the results of the annual audit to the Board. If further requested by the Board, invite the independent auditors to attend the full board of directors meeting to assist in reporting the results of the annual audit or to answer other directors' questions (alternatively, the other directors, particularly the other independent directors, may be invited to attend the audit committee meeting during which the results of the annual audit are reviewed).
- Submit the minutes of all meetings of the audit committee to, or discuss the matters discussed at each committee meeting with, the Board.
- Prepare the audit committee report required by the rules of the SEC to be included in the Company's annual proxy statement.

#### B. Independent Auditors

- Have a clear understanding with the independent auditors that they are ultimately accountable to the audit committee, as the shareholders' representatives, who have the ultimate authority in deciding to engage, evaluate, and if appropriate, terminate their services.
- Review with the independent auditor any audit problems or difficulties and management's response, including any restrictions on the scope of the independent auditor's activities or on access to information and any disagreements with management. The audit committee may want to review with the independent auditor: any accounting adjustments that were noted or proposed by the auditor but were "passed" (as immaterial or otherwise); any communications between the audit team and the audit firm's national office respecting auditing or accounting issues presented by the engagement; and any "management" or "internal control" letter issued, or proposed to be issued, by the audit firm to the Company. This review should also include discussions of the responsibilities, budget and staffing of the Company's internal audit function.
- Inquire of management and the independent auditors about significant risks or exposures, assess the steps management has taken to minimize such risks to the Company and discuss policies with respect to risk assessment and risk management.
- Obtain and review a report from the independent auditor at least annually regarding (a) the independent auditor's internal quality-control procedures, (b) any material issues raised by the most recent internal quality-control review, or peer review, of the firm, or by any inquiry or investigation by governmental or professional authorities within the preceding five years respecting one or more independent audits carried out by the firm, and any steps taken to deal with any such issues, and (c) (in order to assess the firm's independence) all relationships between the independent auditor and the Company.
- Evaluate the qualifications, performance and independence of the independent auditor and the lead audit partner, including considering whether the auditor's quality controls are adequate and the provision of permitted non-audit services is compatible with maintaining the auditor's independence, taking into account the opinions of management and internal auditors. The audit committee shall present its conclusions with respect to the independent auditor to the Board.



- Provide sufficient opportunity for the independent auditors to meet with the members of the audit committee without members of management present. Among the items to be discussed in these meetings are the independent auditors' evaluation of the Company's financial, accounting, and auditing personnel, and the cooperation that the independent auditors received during the course of audit.
- On an annual basis, obtain from the independent auditors a written communication delineating all their relationships and professional services as required by Independence Standards Board Standard No. 1, Independence Discussions with Audit Committees. In addition, review with the independent auditors the nature and scope of any disclosed relationships or professional services and take, or recommend that the Board take, appropriate action to ensure the continuing independence of the auditors.
- Ensure rotation of the lead audit partner as required by law and consider further whether, to assure continuing auditor independence, there should be a regular rotation of the outside audit firm itself. The audit committee should present its conclusions with respect to the independent auditor to the Board.
- Set policies for the Company's hiring of employees or former employees of the independent auditor who participated in any capacity in the audit of the Company.

C. Ethical and Legal Compliance

- Investigate any matter brought to its attention within the scope of its duties, with the power to retain outside counsel and other advisors for this purpose if, in its judgment, that is appropriate.
- Establish procedures for the receipt, retention and treatment of complaints received by the Company regarding accounting, internal accounting controls or auditing matters, and for the confidential, anonymous submission by Company employees of concerns regarding questionable accounting or auditing matters.
- Obtain the full Board's approval of this Charter and perform a review and evaluation, at least annually, of the performance of the audit committee, including reviewing the compliance of the audit committee with this Charter. In addition, the audit committee shall review and reassess, at least annually, the adequacy of this Charter and recommend to the Board any improvements to this Charter that the committee considers necessary or valuable. The audit committee shall conduct such evaluations and reviews in such manner as it deems appropriate.

*Adopted by Resolution of the Board of  
Directors on March 6, 2006*





