

BEVERLY ENTERPRISES INC

Form 10-Q

May 04, 2005

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**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, DC 20549
Form 10-Q**

(Mark One)

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

For the quarterly period ended March 31, 2005

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 1-9550
Beverly Enterprises, Inc.**

(Exact name of Registrant as specified in its charter)

Delaware

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

62-1691861

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

**One Thousand Beverly Way
Fort Smith, Arkansas 72919**

(Address of principal executive offices)

Registrant's telephone number, including area code:

(479) 201-2000

Registrant's website:

www.beverlycorp.com

Indicate by check mark whether 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 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 Registrant is an accelerated filer (as defined in Exchange Act Rule 12b-2). Yes No

Shares of Registrant's Common Stock, \$.10 par value, outstanding, exclusive of treasury shares, at April 29, 2005 109,488,273

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References throughout this document to the Company include Beverly Enterprises, Inc. and its wholly owned subsidiaries (BEI). In accordance with the Securities and Exchange Commission (SEC) Plain English guidelines, this Quarterly Report on Form 10-Q has been written in the first person. In this document, the words we, our, ours and us refer only to BEI and its wholly owned subsidiaries and not to any other person.

This document contains forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. Forward-looking statements may be identified by words such as expects, anticipates, intends, plans, believes, seeks, estimates or words of similar meaning and include, but are not limited to, statements about our expected future business and financial performance. Forward-looking statements are based on management's current expectations and assumptions, which are inherently subject to uncertainties, risks and changes in circumstances that are difficult to predict. Actual outcomes and results may differ materially from these expectations and assumptions due to changes in, among other things, political, economic, business, competitive, market, regulatory, demographic and other factors. In addition, our results of operations and financial condition, cash flows and liquidity may be adversely impacted by the ongoing sales process (see Item 1. Note 4). The sales process may impact our ability to attract and retain customers, management and employees and will result in the incurrence of significant advisory fees, legal fees and other expenses. We undertake no obligation to publicly update or revise any forward-looking information, whether as a result of new information, future developments or otherwise.

You should also refer to Item 1. Business in our Annual Report on Form 10-K for the fiscal year ended December 31, 2004 for a discussion of various governmental regulations and other operating factors relating to the healthcare industry and the risks inherent in them. You should carefully consider the risks described and referred to in the annual report before making any investment decisions regarding our securities. There may be additional risks that we do not presently know of or that we currently deem immaterial. If any of these risks actually occur, our business, financial condition, results of operations or cash flows could be materially and adversely affected. In that case, the trading price of our common stock and value of our other outstanding securities could decline, and you may lose all or part of your investment. Given these risks and uncertainties, we can give no assurances that any forward-looking statements, which speak only as of the date of this report will, in fact, transpire, and, therefore, we caution you not to place undue reliance on them.

BEVERLY ENTERPRISES, INC.
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Rule 13a-14(a)/15d-14(a) Certification of CEO

Rule 13a-14(a)/15d-14(a) Certification of CFO

Section 1350 Certification of CEO & CFO

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PART I
ITEM 1. FINANCIAL STATEMENTS.
BEVERLY ENTERPRISES, INC.
CONDENSED CONSOLIDATED BALANCE SHEETS
(Dollars in thousands)

| | March 31, 2005 | December 31, 2004 |
|---|---------------------|----------------------|
| | (Unaudited) | (Note) |
| ASSETS | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 233,810 | \$ 215,665 |
| Accounts receivable less allowance for doubtful accounts: 2005 \$25,715; 2004 \$26,320 | 276,269 | 235,477 |
| Notes receivable, less allowance for doubtful notes: 2005 \$1,999; 2004 \$1,686 | 5,012 | 2,786 |
| Operating supplies | 9,145 | 9,181 |
| Assets held for sale | 11,443 | 14,898 |
| Prepaid expenses and other | 31,511 | 37,266 |
| Total current assets | 567,190 | 515,273 |
| Property and equipment, net | 657,368 | 653,656 |
| Other assets: | | |
| Goodwill, net | 122,863 | 124,066 |
| Other, less allowance for doubtful accounts and notes: 2005 \$1,654; 2004 \$1,538 | 69,746 | 68,390 |
| Total other assets | 192,609 | 192,456 |
| | \$ 1,417,167 | \$ 1,361,385 |

| LIABILITIES AND STOCKHOLDERS EQUITY | | |
|--|----------------|----------------|
| Current liabilities: | | |
| Accounts payable | \$ 75,440 | \$ 67,778 |
| Accrued wages and related liabilities | 84,623 | 104,037 |
| Accrued interest | 8,865 | 3,602 |
| General and professional liabilities | 57,099 | 54,216 |
| Federal government settlement obligations | 14,711 | 14,359 |
| Liabilities held for sale | | 676 |
| Other accrued liabilities | 126,310 | 83,097 |
| Current portion of long-term debt | 12,167 | 12,240 |
| Total current liabilities | 379,215 | 340,005 |
| Long-term debt | 543,931 | 545,943 |
| Other liabilities and deferred items | 200,692 | 203,024 |
| Commitments and contingencies | | |
| Stockholders equity: | | |

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Preferred stock, shares authorized: 25,000,000

Common stock, shares issued: 2005 117,956,353; 2004

| | | |
|-------------|--------|--------|
| 116,621,715 | 11,796 | 11,662 |
|-------------|--------|--------|

| | | |
|----------------------------|---------|---------|
| Additional paid-in capital | 908,179 | 902,053 |
|----------------------------|---------|---------|

| | | |
|---------------------|-----------|-----------|
| Accumulated deficit | (518,148) | (532,804) |
|---------------------|-----------|-----------|

| | | |
|------------------------------------|-----------|-----------|
| Treasury stock, at cost: 8,283,316 | (108,498) | (108,498) |
|------------------------------------|-----------|-----------|

| | | |
|---------------------------|---------|---------|
| Total stockholders equity | 293,329 | 272,413 |
|---------------------------|---------|---------|

| | | | |
|----|-----------|----|-----------|
| \$ | 1,417,167 | \$ | 1,361,385 |
|----|-----------|----|-----------|

Note: The balance sheet at December 31, 2004 has been derived from the audited consolidated financial statements at that date but does not include all of the information and footnotes required by accounting principles generally accepted in the United States for complete financial statements.

See accompanying notes.

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BEVERLY ENTERPRISES, INC.
CONDENSED CONSOLIDATED STATEMENTS OF INCOME
(Unaudited)
(In thousands, except per share amounts)

| | Three Months Ended March 31, | |
|--|---|-------------|
| | 2005 | 2004 |
| Revenues | \$ 562,480 | \$ 480,618 |
| Costs and expenses: | | |
| Wages and related | 304,599 | 274,303 |
| Provision for insurance and related items | 29,920 | 28,356 |
| Other operating and administrative | 169,325 | 127,409 |
| Depreciation and amortization | 16,784 | 14,907 |
| Asset impairments, workforce reductions and other unusual items | (116) | 2,824 |
| Total costs and expenses | 520,512 | 447,799 |
| Income before other income (expenses) | 41,968 | 32,819 |
| Other income (expenses): | | |
| Interest expense | (10,597) | (11,804) |
| Interest income | 2,063 | 1,523 |
| Costs related to the sales process of the Company | (18,721) | |
| Net gains on dispositions | 84 | 37 |
| Total other expenses, net | (27,171) | (10,244) |
| Income before provision for income taxes and discontinued operations | 14,797 | 22,575 |
| Provision for income taxes | 1,547 | 1,442 |
| Income before discontinued operations | 13,250 | 21,133 |
| Discontinued operations, net of taxes: 2005 \$(1,495); 2004 \$423 | 1,406 | 2,306 |
| Net income | \$ 14,656 | \$ 23,439 |
| Net income per share of common stock: | | |
| Basic: | | |
| Before discontinued operations | \$ 0.12 | \$ 0.20 |
| Discontinued operations, net of taxes | 0.01 | 0.02 |
| Net income per share of common stock | \$ 0.13 | \$ 0.22 |
| Shares used to compute basic net income per share | 108,738 | 107,331 |
| Diluted: | | |
| Before discontinued operations | \$ 0.11 | \$ 0.18 |
| Discontinued operations, net of taxes | 0.01 | 0.02 |

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| | | | | |
|--------------------------------------|----|------|----|------|
| Net income per share of common stock | \$ | 0.12 | \$ | 0.20 |
|--------------------------------------|----|------|----|------|

| | | | | |
|---|--|---------|--|---------|
| Shares used to compute diluted net income per share | | 126,327 | | 123,888 |
|---|--|---------|--|---------|

See accompanying notes.

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BEVERLY ENTERPRISES, INC.
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited)
(Dollars in thousands)

| | Three Months Ended March 31, | |
|---|---|-------------|
| | 2005 | 2004 |
| Cash flows from operating activities: | | |
| Net income | \$ 14,656 | \$ 23,439 |
| Adjustments to reconcile net income to net cash provided by (used for) operating activities, including discontinued operations: | | |
| Depreciation and amortization | 17,061 | 15,766 |
| Provision for reserves on accounts, notes and other receivables, net | 1,711 | 6,194 |
| Amortization of deferred financing costs | 653 | 624 |
| Asset impairments, workforce reductions and other unusual items | (323) | 4,082 |
| Costs related to the sales process of the Company | 18,721 | |
| Losses (gains) on dispositions of facilities and other assets, net | 795 | (4,508) |
| Insurance related accounts | 704 | (572) |
| Changes in operating assets and liabilities, net of acquisitions and dispositions: | | |
| Accounts receivable | (43,227) | (59,324) |
| Operating supplies | 62 | 104 |
| Prepaid expenses and other receivables | 3,141 | 3,923 |
| Accounts payable and other accrued expenses | 20,277 | (21,602) |
| Income taxes payable | 2,178 | (585) |
| Other, net | (1,639) | (4,113) |
| Total adjustments | 20,114 | (60,011) |
| Net cash provided by (used for) operating activities | 34,770 | (36,572) |
| Cash flows from investing activities: | | |
| Capital expenditures | (20,479) | (9,777) |
| Proceeds from dispositions of facilities and other assets, net | 994 | 19,198 |
| Collections on notes receivable | 29 | 6,765 |
| Proceeds from (payments for) designated funds, net | 533 | (714) |
| Other, net | 703 | (3,746) |
| Net cash provided by (used for) investing activities | (18,220) | 11,726 |
| Cash flows from financing activities: | | |
| Repayments of long-term debt | (2,085) | (3,629) |
| Proceeds from exercise of stock options | 3,884 | 293 |
| Deferred financing costs paid | (204) | (406) |
| Net cash provided by (used for) financing activities | 1,595 | (3,742) |
| Net increase (decrease) in cash and cash equivalents | 18,145 | (28,588) |

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| | | |
|--|------------|------------|
| Cash and cash equivalents at beginning of period | 215,665 | 258,815 |
| Cash and cash equivalents at end of period | \$ 233,810 | \$ 230,227 |
| Supplemental schedule of cash flow information: | | |
| Cash paid (received) during the year for: | | |
| Interest, net of amounts capitalized | \$ 4,681 | \$ 5,218 |
| Income tax payments (refunds), net | (2,126) | 2,450 |

See accompanying notes.

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BEVERLY ENTERPRISES, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
March 31, 2005
(Unaudited)

Note 1. General

Basis of Presentation

We have prepared these condensed consolidated financial statements without audit. In management's opinion, these condensed consolidated financial statements include all normal recurring adjustments necessary for a fair presentation of our results of operations and cash flows for the three months ended March 31, 2005 and 2004, and our financial condition at March 31, 2005 and December 31, 2004, in accordance with the rules and regulations of the SEC. Although certain information and footnote disclosures required by accounting principles generally accepted in the United States have been condensed or omitted, we believe that the disclosures in these condensed consolidated financial statements are adequate to make the information presented not misleading. These condensed consolidated financial statements should be read along with our Annual Report on Form 10-K for the fiscal year ended December 31, 2004, filed with the SEC. Our results of operations for the three months ended March 31, 2005 are not necessarily indicative of the results for a full year.

Use of Estimates

Generally accepted accounting principles in the United States require management to make estimates and assumptions when preparing financial statements that affect:

the reported amounts of assets and liabilities at the date of the financial statements; and

the reported amounts of revenues and expenses during the reporting period.

They also require management to make estimates and assumptions regarding contingent assets and liabilities at the date of the financial statements. Actual results could differ from those estimates.

Revenues

Our revenues are derived primarily from providing long-term healthcare services. Approximately 80% of our revenues for each of the three months ended March 31, 2005 and 2004, were derived from federal and state medical assistance programs (primarily Medicare and Medicaid). We record revenues when services are provided at standard charges adjusted to amounts estimated to be received under governmental programs and other third-party contractual arrangements based on contractual terms and historical experience. These revenues are reported at their estimated net realizable amounts and are subject to audit and retroactive adjustment.

All providers participating in the Medicare and Medicaid programs are required to meet certain financial cost reporting requirements. Federal and state regulations generally require the submission of annual cost reports covering revenues, costs and expenses associated with the services provided to Medicare beneficiaries and Medicaid recipients. Annual cost reports are subject to routine audits and retroactive adjustments. These audits often require several years to reach the final determination of amounts due to, or by, us under these programs.

Retroactive adjustments are estimated in the recording of revenues in accordance with the state plan provisions in effect during the period the related services are rendered. These amounts are adjusted in future periods as adjustments become known, as state plan provisions are retroactively changed or as cost reporting years are no longer subject to audits, reviews or investigations. Due to the complexity of the laws and regulations governing the Medicare and Medicaid programs, there is at least a possibility that recorded estimates will change by a material amount in the near term. During the three months ended March 31, 2005, we recorded the impact of an approved Medicaid plan change for the state of Pennsylvania, which resulted in

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BEVERLY ENTERPRISES, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)
March 31, 2005
(Unaudited)

Note 1. General (Continued)

an increase in revenues and Accounts receivable of \$35.7 million related to prior years and an increase in provider tax expense and Other accrued liabilities of \$28.3 million. This resulted in a net increase in pre-tax income of \$7.4 million. All other changes in estimates related to third party receivables resulted in an increase in revenues from continuing operations of \$739,000 and \$1.8 million for the three months ended March 31, 2005 and 2004, respectively. We believe adequate provision has been made to reflect any adjustments that could result from subsequent audits or reviews.

Compliance with laws and regulations governing the Medicare and Medicaid programs is subject to government review and interpretation, as well as significant regulatory action including fines, penalties, and possible exclusion from the Medicare and Medicaid programs. In addition, under the Medicare program, if the federal government makes a formal demand for reimbursement, even related to contested items, payment must be made for those items before the provider is given an opportunity to appeal and resolve the issue.

Earnings Per Share

The following table sets forth the calculation of basic and diluted earnings per share from continuing operations for the three months ended March 31 (in thousands, except per share amounts):

| | 2005 | 2004 |
|--|-----------|-----------|
| Numerator: | | |
| Numerator for basic net income per share from continuing operations | \$ 13,250 | \$ 21,133 |
| Effect of dilutive securities: | | |
| Interest on 2.75% convertible subordinated notes, net of income taxes of \$0 | 827 | 824 |
| Numerator for diluted net income per share from continuing operations | \$ 14,077 | \$ 21,957 |
| Denominator: | | |
| Denominator for basic net income per share from continuing operations weighted average shares | 108,738 | 107,331 |
| Effect of dilutive securities: | | |
| Employee stock options | 2,157 | 1,125 |
| 2.75% convertible subordinated notes | 15,432 | 15,432 |
| Denominator for diluted net income per share from continuing operations adjusted weighted average shares and assumed conversions | 126,327 | 123,888 |
| Basic net income per share from continuing operations | \$ 0.12 | \$ 0.20 |
| Diluted net income per share from continuing operations | \$ 0.11 | \$ 0.18 |

Diluted net income per share from continuing operations does not include the impact of 345,000 and 1.8 million of employee stock options outstanding for the three months ended March 31, 2005 and 2004, respectively, because their effect would have been antidilutive. In accordance with Emerging Issues Task Force 04-8, *The Effect of Contingently*

Convertible Debt on Diluted Earnings Per Share, we have included the dilutive effect of our 2.75% convertible subordinated notes, on an if-converted basis, in our calculation of diluted net income per share from continuing operations.

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BEVERLY ENTERPRISES, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)
March 31, 2005
(Unaudited)

Note 2. Insurance

We believe that adequate provision has been made in the financial statements for liabilities that may arise out of patient care and related services provided to date. These provisions are based primarily upon the results of independent actuarial valuations, prepared by experienced actuaries. These independent valuations are formally prepared twice each year using the most recent trends of claims, settlements and other relevant data. In addition to the estimate of retained losses, our provision for insurance includes accruals for insurance premiums and related costs for the coverage period and our estimate of any experience adjustments to premiums.

The following table summarizes our provision for insurance and related items for the three months ended March 31 (in thousands):

| | 2005 | 2004 |
|---|-----------|-----------|
| General and professional liability: | | |
| Continuing operations | \$ 19,076 | \$ 17,433 |
| Discontinued operations | 1,790 | 4,284 |
| | \$ 20,866 | \$ 21,717 |
| Workers compensation: | | |
| Continuing operations | \$ 8,561 | \$ 7,689 |
| Discontinued operations | 1,427 | 1,135 |
| | \$ 9,988 | \$ 8,824 |
| Other insurance: | | |
| Continuing operations | \$ 2,283 | \$ 3,234 |
| Discontinued operations | 65 | 108 |
| | \$ 2,348 | \$ 3,342 |
| Total provision for insurance and related items: | | |
| Continuing operations | \$ 29,920 | \$ 28,356 |
| Discontinued operations | 3,282 | 5,527 |
| | \$ 33,202 | \$ 33,883 |

Our insurance liabilities are included in the consolidated balance sheet captions as follows (in thousands):

| | March 31, 2005 | December 31, 2004 |
|---------------------------------------|-------------------|----------------------|
| Accrued wages and related liabilities | \$ 488 | \$ 488 |
| General and professional liabilities | 57,099 | 54,216 |

| | | |
|--------------------------------------|------------|------------|
| Other liabilities and deferred items | 115,755 | 117,962 |
| | \$ 173,342 | \$ 172,666 |

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BEVERLY ENTERPRISES, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)
March 31, 2005
(Unaudited)

Note 3. Asset Impairments, Workforce Reductions and Other Unusual Items

We recorded pre-tax charges (credits) for asset impairments, workforce reductions and other unusual items as follows for the three months ended March 31 (in thousands):

| | 2005 | 2004 |
|---|----------|----------|
| Asset impairments | \$ (112) | \$ 2,885 |
| Workforce reductions | | (132) |
| Other unusual items, including exit costs | (4) | 71 |
| | \$ (116) | \$ 2,824 |

Asset Impairments

During 2005, we recorded a credit of \$112,000, primarily related to the sale of a previously impaired asset at an amount above its carrying value. During March 2004, we recorded asset impairments of \$2.9 million, primarily related to the write-down of property and equipment on two nursing facilities included in the Nursing Facilities segment. During the first quarter of 2004, management made a determination to close these nursing facilities, which led to an impairment assessment. We estimated the fair market values of these facilities based on sales values for the land and buildings.

Workforce Reductions

During the three months ended March 31, 2004, we recorded \$214,000 for workforce reductions, less \$346,000 in related credits primarily due to the cancellation of restricted stock. The \$214,000 for workforce reductions primarily related to six associates who were notified in the first quarter of 2004 that their positions would be eliminated and included \$196,000 of cash expenses, which was paid during the year ended December 31, 2004.

Other Unusual Items

During the three months ended March 31, 2005 and 2004, we recorded special pre-tax credits of \$4,000 and special pre-tax charges of \$71,000, respectively, for certain exit costs under retention and severance agreements with employees associated with facilities affected by our divestiture strategy. The following table summarizes activity in our accruals for estimated workforce reductions and exit costs for the three months ended March 31 (in thousands):

| | 2005 | | 2004 | |
|------------------------------------|-------------------------|---------------|-------------------------|---------------|
| | Workforce Reductions | Exit Costs | Workforce Reductions | Exit Costs |
| Balance beginning of quarter | \$ 1,166 | \$ 4,572 | \$ 3,029 | \$ 7,270 |
| Charged to continuing operations | | (4) | 196 | 71 |
| Charged to discontinued operations | | 1,331 | | 1,596 |
| Cash payments | (654) | (900) | (1,114) | (1,194) |
| Reversals | (19) | (84) | 18 | |
| Balance end of quarter | \$ 493 | \$ 4,915 | \$ 2,129 | \$ 7,743 |

Workforce reduction and exit cost accruals are included in Accrued wages and related liabilities and Other accrued liabilities on our condensed consolidated balance sheets.

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BEVERLY ENTERPRISES, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)
March 31, 2005
(Unaudited)

Note 4. Sale of the Company and Related Items

In January 2005, a group including Formation Capital, LLC, Appaloosa Management, LP, Franklin Mutual Advisers LLC and Northbrook NBV LLC (the Formation Capital Consortium), publicly announced an unsolicited indication of interest in acquiring all of our outstanding common stock. Arnold M. Whitman, the Chief Executive Officer of Formation Capital, also nominated a slate of six individuals for election to our Board of Directors.

On February 3, 2005, our Board of Directors unanimously rejected the Formation Capital Consortium's proposal. On March 22, 2005, we announced that our Board of Directors had unanimously voted to conduct an auction process to maximize value for all of our stockholders as soon as practicable through a sale of BEI. The Board also adopted procedures to enable the beneficial owners of not less than 20% of our outstanding common stock to cause us to call a special meeting of stockholders to be held on October 21, 2005 to remove and replace the Board and for the nomination of individuals for election as directors at the special meeting, if held.

On April 11, 2005, we entered into a Settlement Agreement with the Formation Capital Consortium and Mr. Whitman under which the Formation Capital Consortium and Mr. Whitman agreed to discontinue the solicitation of proxies in connection with the Company's April 21, 2005 Annual Meeting of Stockholders and Mr. Whitman withdrew his nominees for election to our Board of Directors and other proposals for consideration at the 2005 Annual Meeting. In addition, we agreed to reimburse the Formation Capital Consortium for up to \$600,000 of out-of-pocket fees and expenses incurred by them and Mr. Whitman in connection with their proxy solicitation. We have also entered into a Confidentiality Agreement with the members of the Formation Capital Consortium under which the Formation Capital Consortium and its representatives may examine our confidential information for the purpose of evaluating a possible transaction with us pursuant to the same restrictions imposed on other bidders involved in the sales process. We committed in the Confidentiality Agreement to allow the Formation Capital Consortium to participate in our on-going sales process on the same basis as all other potential buyers.

Our results of operations, financial condition and cash flows may be adversely impacted by the ongoing sales process. To date, we have incurred various costs as a result of the expression of interest, the proxy contest and the sales process including legal, investment banking advisory fees and other related costs. During the three months ended March 31, 2005, we engaged two investment banking firms to assist us in evaluating proposals, both solicited and unsolicited, to acquire the Company or any of its assets or businesses. Under the terms of the engagement we are required to pay a fee to these two firms equal to a percentage of any consideration received in connection with a sale of the Company, with their percentage compensation increasing with an increase in the sales value, or a flat fee if no sale was to occur. As a result, we recorded a liability of \$16.5 million at March 31, 2005. In addition, we have incurred other costs related to the proxy contest and have recorded a liability of \$2.2 million of which \$807,000 was paid and \$1.4 million remains accrued at March 31, 2005. In addition, the sales process may impact our ability to attract and retain customers, management and employees and may result in the incurrence of significant additional advisory fees, legal fees and other expenses; however the amount and impact of these potential additional expenses cannot be reasonably estimated at this time.

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BEVERLY ENTERPRISES, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)
March 31, 2005
(Unaudited)

Note 5. Discontinued Operations

During the three months ended March 31, 2005, we recognized net pre-tax losses of \$878,000 relating to the following 2005 disposal activities:

five nursing facilities (456 beds) for cash proceeds totaling \$134,000. These assets were part of our Nursing Facilities segment and were held for sale as of December 31, 2004; and

10 outpatient clinics for \$4.6 million, including \$710,000 in cash and \$3.9 million of notes receivable. These assets and related liabilities were part of our former Matrix segment and were held for sale as of December 31, 2004.

We have included the remaining assets of 22 facilities (2,116 beds) of our Nursing Facilities segment as held for sale in the accompanying condensed consolidated balance sheet as of March 31, 2005. We expect to dispose of these facilities in the next three to six months. The remaining assets and liabilities of our former Matrix segment and the assets of 27 nursing facilities were included in assets and liabilities held for sale as of December 31, 2004.

A summary of the asset and liability line items from which the reclassifications have been made at March 31, 2005 and December 31, 2004 is as follows (in thousands):

| | 2005 | | 2004 | |
|-----------------------------------|-------------------------------|-------------------------------|-----------------|------------------|
| | Nursing Facilities | Nursing Facilities | Matrix | Total |
| Current assets | \$ 453 | \$ 479 | \$ 1,970 | \$ 2,449 |
| Property and equipment, net | 10,785 | 10,655 | 1,212 | 11,867 |
| Goodwill | | | 332 | 332 |
| Other assets | 205 | 222 | 28 | 250 |
| Total assets held for sale | \$ 11,443 | \$ 11,356 | \$ 3,542 | \$ 14,898 |
| Current liabilities held for sale | \$ | \$ | \$ 676 | \$ 676 |

The results of operations of disposed facilities and other assets in the three months ended March 31, 2005, as well as the results of operations of held-for-sale assets, have been reported as discontinued operations for all periods presented in the accompanying condensed consolidated statements of income. Also included in discontinued operations are the gains and losses on sales and exit costs relative to these transactions. Discontinued operations for the three months ended March 31, 2004 also include the results of operations for all facilities, clinics and businesses disposed of during 2004.

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BEVERLY ENTERPRISES, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)
March 31, 2005
(Unaudited)

Note 5. Discontinued Operations (Continued)

A summary of discontinued operations by operating segment for the three months ended March 31 is as follows (in thousands):

| | 2005 | | | | 2004 | | | |
|--|-----------------------|----------|--------------|-----------|-----------------------|----------|--------------|-----------|
| | Nursing Facilities | Matrix | Home Care | Total | Nursing Facilities | Matrix | Home Care | Total |
| Revenues | \$ 30,159 | \$ 2,546 | \$ | \$ 32,705 | \$ 49,131 | \$ 3,301 | \$ 148 | \$ 52,580 |
| Operating income (loss)(1) | \$ 274 | \$ 405 | \$ (97) | \$ 582 | \$ (630) | \$ 153 | \$ (7) | \$ (484) |
| Gain (loss) on sales and exit costs | (878) | | | (878) | 4,488 | | (17) | 4,471 |
| Impairments and other unusual items | 207 | | | 207 | (1,258) | | | (1,258) |
| Pre-tax income (loss) | \$ (397) | \$ 405 | \$ (97) | (89) | \$ 2,600 | \$ 153 | \$ (24) | 2,729 |
| Provision for (benefit from) state income taxes | | | | (1,495) | | | | 423 |
| Discontinued operations, net of taxes | | | | \$ 1,406 | | | | \$ 2,306 |

(1) Includes net interest income of \$3,000 for 2005 and net interest expense of \$44,000 for 2004, as well as depreciation and amortization expense of \$277,000 and \$859,000 for 2005 and 2004, respectively.

Note 6. Long-Term Debt

As of April 1, 2005, our 2.75% convertible subordinated notes became eligible for conversion into common stock. Under the indenture governing the notes, a holder may convert any of their notes into our common stock during any fiscal quarter if the sale price of our common stock for at least 20 consecutive trading days in the 30 trading days ending on the last trading day of the immediately preceding fiscal quarter exceeds 120 percent of the conversion price on that 30th trading day.

Our 7⁷/₈% senior subordinated notes are jointly and severally, fully and unconditionally guaranteed by most of our subsidiaries (the Guarantor Subsidiaries). As of March 31, 2005, the non-guarantor subsidiaries included Beverly Indemnity, Ltd., our captive insurance subsidiary, and Beverly Funding Corporation, our receivables-backed financing subsidiary (the Non-Guarantor Subsidiaries). Since the carrying value of the assets of the non-guarantor subsidiaries exceeds three percent of the consolidated assets of Beverly Enterprises, Inc., we are required to disclose consolidating financial statements in our periodic filings with the SEC.

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BEVERLY ENTERPRISES, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)
March 31, 2005
(Unaudited)

Note 6. Long-Term Debt (Continued)

Condensed consolidating balance sheets as of March 31, 2005 for Beverly Enterprises, Inc. (parent only), the combined Guarantor Subsidiaries and the combined Non-Guarantor Subsidiaries are as follows (in thousands):

| | Parent | Guarantor Subsidiaries | Non- Guarantor Subsidiaries | Eliminations | Total |
|---|-------------------|---------------------------|-----------------------------------|---------------------|---------------------|
| ASSETS | | | | | |
| Current assets: | | | | | |
| Cash and cash equivalents | \$ 151,563 | \$ 6,476 | \$ 75,771 | \$ | \$ 233,810 |
| Accounts receivable, less allowance for doubtful accounts | 4,887 | 229,450 | 42,108 | (176) | 276,269 |
| Notes receivable, less allowance for doubtful notes | 2,206 | 2,772 | 34 | | 5,012 |
| Operating supplies | 124 | 9,021 | | | 9,145 |
| Assets held for sale | | 11,443 | | | 11,443 |
| Prepaid expenses and other | 7,552 | 7,966 | 15,993 | | 31,511 |
| Total current assets | 166,332 | 267,128 | 133,906 | (176) | 567,190 |
| Property and equipment, net | 6,370 | 650,998 | | | 657,368 |
| Other assets: | | | | | |
| Goodwill, net | | 122,863 | | | 122,863 |
| Other, less allowance for doubtful accounts and notes | 302,887 | 30,659 | 701 | (264,501) | 69,746 |
| Due from affiliates | 442,742 | | 109,760 | (552,502) | |
| Total other assets | 745,629 | 153,522 | 110,461 | (817,003) | 192,609 |
| | \$ 918,331 | \$ 1,071,648 | \$ 244,367 | \$ (817,179) | \$ 1,417,167 |
| LIABILITIES AND STOCKHOLDERS EQUITY | | | | | |
| Current liabilities: | | | | | |
| Accounts payable | \$ 10,303 | \$ 65,137 | \$ | \$ | \$ 75,440 |
| Accrued wages and related liabilities | 20,137 | 64,486 | | | 84,623 |
| Accrued interest | 7,458 | 1,100 | 307 | | 8,865 |
| General and professional liabilities | 18,903 | | 38,196 | | 57,099 |
| Federal government settlement obligations | | 14,711 | | | 14,711 |
| Liabilities held for sale | | | | | |

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| | | | | | |
|---|------------|--------------|------------|--------------|--------------|
| Other accrued liabilities | 30,905 | 95,581 | | (176) | 126,310 |
| Current portion of long-term debt | 1,350 | 10,817 | | | 12,167 |
| Total current liabilities | 89,056 | 251,832 | 38,503 | (176) | 379,215 |
| Long-term debt | 467,583 | 76,348 | | | 543,931 |
| Other liabilities and deferred items | 68,363 | 54,779 | 77,550 | | 200,692 |
| Due to affiliates | | 552,502 | | (552,502) | |
| Commitments and contingencies | | | | | |
| Stockholders' equity: | | | | | |
| Preferred stock | | | | | |
| Common stock | 11,796 | 5,908 | 121 | (6,029) | 11,796 |
| Additional paid-in capital | 908,179 | 414,340 | 44,434 | (458,774) | 908,179 |
| Retained earnings (accumulated deficit) | (518,148) | (284,061) | 83,759 | 200,302 | (518,148) |
| Treasury stock, at cost | (108,498) | | | | (108,498) |
| Total stockholders' equity | 293,329 | 136,187 | 128,314 | (264,501) | 293,329 |
| | \$ 918,331 | \$ 1,071,648 | \$ 244,367 | \$ (817,179) | \$ 1,417,167 |

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BEVERLY ENTERPRISES, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)
March 31, 2005
(Unaudited)

Note 6. Long-Term Debt (Continued)

Condensed consolidating balance sheets as of December 31, 2004 for Beverly Enterprises, Inc. (parent only), the combined Guarantor Subsidiaries and the combined Non-Guarantor Subsidiaries are as follows (in thousands):

| | Parent | Guarantor Subsidiaries | Non- Guarantor Subsidiaries | Eliminations | Total |
|---|-------------------|---------------------------|-----------------------------------|---------------------|---------------------|
| ASSETS | | | | | |
| Current assets: | | | | | |
| Cash and cash equivalents | \$ 142,515 | \$ 5,237 | \$ 67,913 | \$ | \$ 215,665 |
| Accounts receivable, less allowance for doubtful accounts | 8,160 | 183,920 | 43,397 | | 235,477 |
| Notes receivable, less allowance for doubtful notes | 18 | 2,768 | | | 2,786 |
| Operating supplies | 101 | 9,080 | | | 9,181 |
| Assets held for sale | | 14,898 | | | 14,898 |
| Prepaid expenses and other | 10,952 | 10,285 | 16,029 | | 37,266 |
| Total current assets | 161,746 | 226,188 | 127,339 | | 515,273 |
| Property and equipment, net | 6,392 | 647,264 | | | 653,656 |
| Other assets: | | | | | |
| Goodwill, net | | 124,066 | | | 124,066 |
| Other, less allowance for doubtful accounts and notes | 255,350 | 32,385 | 709 | (220,054) | 68,390 |
| Due from affiliates | 453,483 | | 132,141 | (585,624) | |
| Total other assets | 708,833 | 156,451 | 132,850 | (805,678) | 192,456 |
| | \$ 876,971 | \$ 1,029,903 | \$ 260,189 | \$ (805,678) | \$ 1,361,385 |
| LIABILITIES AND STOCKHOLDERS EQUITY | | | | | |
| Current liabilities: | | | | | |
| Accounts payable | \$ 2,696 | \$ 65,082 | \$ | \$ | \$ 67,778 |
| Accrued wages and related liabilities | 28,240 | 75,797 | | | 104,037 |
| Accrued interest | 2,618 | 875 | 109 | | 3,602 |
| General and professional liabilities | 23,323 | | 45,934 | (15,041) | 54,216 |
| Federal government settlement obligations | | 14,359 | | | 14,359 |
| Liabilities held for sale | | 676 | | | 676 |

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| | | | | | |
|---|------------|--------------|------------|--------------|--------------|
| Other accrued liabilities | 18,694 | 64,403 | | | 83,097 |
| Current portion of long-term debt | 1,350 | 10,890 | | | 12,240 |
| Total current liabilities | 76,921 | 232,082 | 46,043 | (15,041) | 340,005 |
| Long-term debt | 467,858 | 78,085 | | | 545,943 |
| Other liabilities and deferred items | 59,779 | 56,269 | 86,976 | | 203,024 |
| Due to affiliates | | 585,624 | | (585,624) | |
| Commitments and contingencies | | | | | |
| Stockholders' equity: | | | | | |
| Preferred stock | | | | | |
| Common stock | 11,662 | 5,908 | 121 | (6,029) | 11,662 |
| Additional paid-in capital | 902,053 | 414,340 | 44,434 | (458,774) | 902,053 |
| Retained earnings (accumulated deficit) | (532,804) | (342,405) | 82,615 | 259,790 | (532,804) |
| Treasury stock, at cost | (108,498) | | | | (108,498) |
| Total stockholders' equity | 272,413 | 77,843 | 127,170 | (205,013) | 272,413 |
| | \$ 876,971 | \$ 1,029,903 | \$ 260,189 | \$ (805,678) | \$ 1,361,385 |

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BEVERLY ENTERPRISES, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)
March 31, 2005
(Unaudited)

Note 6. Long-Term Debt (Continued)

Condensed consolidating statements of income for the three months ended March 31, 2005 for Beverly Enterprises, Inc. (parent only), the combined Guarantor Subsidiaries and the combined Non-Guarantor Subsidiaries are as follows (in thousands):

| | Parent | Guarantor Subsidiaries | Non- Guarantor Subsidiaries | Eliminations | Total |
|--|----------|---------------------------|-----------------------------------|--------------|------------|
| Revenues | \$ 191 | \$ 562,289 | \$ 14,185 | \$ (14,185) | \$ 562,480 |
| Costs and expenses: | | | | | |
| Wages and related | 17,477 | 287,122 | | | 304,599 |
| Provision for insurance and related items | 1,407 | 28,513 | 14,364 | (14,364) | 29,920 |
| Other operating and administrative | 26,577 | 142,902 | 155 | (309) | 169,325 |
| Overhead allocation | (20,401) | 20,401 | | | |
| Depreciation and amortization | 1,570 | 15,214 | | | 16,784 |
| Asset impairments, workforce reductions and other unusual items | | (116) | | | (116) |
| Total costs and expenses | 26,630 | 494,036 | 14,519 | (14,673) | 520,512 |
| Income (loss) before other income (expenses) | (26,439) | 68,253 | (334) | 488 | 41,968 |
| Other income (expenses): | | | | | |
| Interest expense | | (11,613) | (176) | 1,192 | (10,597) |
| Interest income | 1,387 | 214 | 1,654 | (1,192) | 2,063 |
| Costs related to the sales process of the Company | (18,721) | | | | (18,721) |
| Net gains on dispositions | | 84 | | | 84 |
| Equity in income of affiliates | 59,976 | | | (59,976) | |
| Total other income (expenses), net | 42,642 | (11,315) | 1,478 | (59,976) | (27,171) |
| Income before provision for income taxes and discontinued operations | 16,203 | 56,938 | 1,144 | (59,488) | 14,797 |
| Provision for income taxes | 1,547 | | | | 1,547 |
| | 14,656 | 56,938 | 1,144 | (59,488) | 13,250 |

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Income before discontinued
operations

| | | | | |
|---|--|-------|--|-------|
| Discontinued operations, net of taxes of \$(1,495) | | 1,406 | | 1,406 |
|---|--|-------|--|-------|

| | | | | | |
|------------|-----------|-----------|----------|-------------|-----------|
| Net income | \$ 14,656 | \$ 58,344 | \$ 1,144 | \$ (59,488) | \$ 14,656 |
|------------|-----------|-----------|----------|-------------|-----------|

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BEVERLY ENTERPRISES, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)
March 31, 2005
(Unaudited)

Note 6. Long-Term Debt (Continued)

Condensed consolidating statements of income for the three months ended March 31, 2004 for Beverly Enterprises, Inc. (parent only), the combined Guarantor Subsidiaries and the combined Non-Guarantor Subsidiaries are as follows (in thousands):

| | Parent | Guarantor Subsidiaries | Non- Guarantor Subsidiaries | Eliminations | Total |
|--|----------|---------------------------|-----------------------------------|--------------|------------|
| Revenues | \$ 1,039 | \$ 479,579 | \$ 12,847 | \$ (12,847) | \$ 480,618 |
| Costs and expenses: | | | | | |
| Wages and related | 11,724 | 262,579 | | | 274,303 |
| Provision for insurance and related items | 2,389 | 25,967 | 11,665 | (11,665) | 28,356 |
| Other operating and administrative | 5,732 | 121,677 | | | 127,409 |
| Overhead allocation | (20,282) | 20,282 | | | |
| Depreciation and amortization | 1,542 | 13,365 | | | 14,907 |
| Asset impairments, workforce reductions and other unusual items | (225) | 3,049 | | | 2,824 |
| Total costs and expenses | 880 | 446,919 | 11,665 | (11,665) | 447,799 |
| Income (loss) before other income (expenses) | 159 | 32,660 | 1,182 | (1,182) | 32,819 |
| Other income (expenses): | | | | | |
| Interest expense | | (13,139) | | 1,335 | (11,804) |
| Interest income | 743 | 628 | 1,487 | (1,335) | 1,523 |
| Net gains on dispositions | | 37 | | | 37 |
| Equity in income of affiliates | 23,979 | | | (23,979) | |
| Total other income (expenses), net | 24,722 | (12,474) | 1,487 | (23,979) | (10,244) |
| Income before provision for income taxes and discontinued operations | 24,881 | 20,186 | 2,669 | (25,161) | 22,575 |
| Provision for income taxes | 1,442 | | | | 1,442 |
| Income before discontinued operations | 23,439 | 20,186 | 2,669 | (25,161) | 21,133 |
| | | 2,306 | | | 2,306 |

Discontinued operations, net of
taxes of \$423

| | | | | | |
|------------|-----------|-----------|----------|-------------|-----------|
| Net income | \$ 23,439 | \$ 22,492 | \$ 2,669 | \$ (25,161) | \$ 23,439 |
|------------|-----------|-----------|----------|-------------|-----------|

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BEVERLY ENTERPRISES, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)
March 31, 2005
(Unaudited)

Note 6. Long-Term Debt (Continued)

Condensed consolidating statements of cash flows for the three months ended March 31, 2005 for Beverly Enterprises, Inc. (parent only), the combined Guarantor Subsidiaries and the combined Non-Guarantor Subsidiaries are as follows (in thousands):

| | Parent | Guarantor Subsidiaries | Non- Guarantor Subsidiaries | Total |
|--|------------|---------------------------|-----------------------------------|------------|
| Cash flows provided by (used for) operating activities: | \$ 5,868 | \$ 20,968 | \$ 7,934 | \$ 34,770 |
| Cash flows from investing activities: | | | | |
| Capital expenditures | (2,233) | (18,246) | | (20,479) |
| Proceeds from dispositions of facilities and other assets, net | | 994 | | 994 |
| Collections on notes receivable | | 29 | | 29 |
| Proceeds from (payments for) designated funds, net | (35) | 568 | | 533 |
| Other, net | 2,064 | (1,327) | (34) | 703 |
| Net cash used for investing activities | (204) | (17,982) | (34) | (18,220) |
| Cash flows from financing activities: | | | | |
| Repayments of long-term debt | (338) | (1,747) | | (2,085) |
| Proceeds from exercise of stock options | 3,884 | | | 3,884 |
| Deferred financing costs paid | (162) | | (42) | (204) |
| Net cash provided by (used for) financing activities | 3,384 | (1,747) | (42) | 1,595 |
| Net increase (decrease) in cash and cash equivalents | 9,048 | 1,239 | 7,858 | 18,145 |
| Cash and cash equivalents at beginning of period | 142,515 | 5,237 | 67,913 | 215,665 |
| Cash and cash equivalents at end of period | \$ 151,563 | \$ 6,476 | \$ 75,771 | \$ 233,810 |

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BEVERLY ENTERPRISES, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)
March 31, 2005
(Unaudited)

Note 6. Long-Term Debt (Continued)

Condensed consolidating statements of cash flows for the three months ended March 31, 2004 for Beverly Enterprises, Inc. (parent only), the combined Guarantor Subsidiaries and the combined Non-Guarantor Subsidiaries are as follows (in thousands):

| | Parent | Guarantor Subsidiaries | Non- Guarantor Subsidiaries | Total |
|--|-------------|---------------------------|-----------------------------------|-------------|
| Cash flows provided by (used for) operating activities: | \$ (41,051) | \$ (8,691) | \$ 13,170 | \$ (36,572) |
| Cash flows from investing activities: | | | | |
| Capital expenditures | (987) | (8,790) | | (9,777) |
| Proceeds from dispositions of facilities and other assets, net | | 19,198 | | 19,198 |
| Collections on notes receivable | | 6,765 | | 6,765 |
| Payments for designated funds, net | (3) | (711) | | (714) |
| Other, net | (881) | (2,865) | | (3,746) |
| Net cash used for investing activities | (1,871) | 13,597 | | 11,726 |
| Cash flows from financing activities: | | | | |
| Repayments of long-term debt | (338) | (3,291) | | (3,629) |
| Proceeds from exercise of stock options | 293 | | | 293 |
| Deferred financing costs paid | (406) | | | (406) |
| Net cash provided by (used for) financing activities | (451) | (3,291) | | (3,742) |
| Net increase (decrease) in cash and cash equivalents | (43,373) | 1,615 | 13,170 | (28,588) |
| Cash and cash equivalents at beginning of period | 223,575 | 5,351 | 29,889 | 258,815 |
| Cash and cash equivalents at end of period | \$ 180,202 | \$ 6,966 | \$ 43,059 | \$ 230,227 |

Note 7. Income Taxes

The provisions for income taxes from continuing operations of \$1.5 million and \$1.4 million for the three months ended March 31, 2005 and 2004, respectively, primarily relate to state income taxes estimated to be due in separate return filing states where we conduct business and to federal alternative minimum tax (AMT). We recorded a tax benefit in discontinued operations of \$1.5 million for the three months ended March 31, 2005, related to state tax refunds in a state where we have ceased operations.

The provisions differ from those calculated using the federal statutory rate due to changes in the valuation allowance, established at December 31, 2001, for net deferred tax assets. In 2005, the valuation allowance decreased

\$36.5 million primarily due to the reversal of temporary differences and the utilization of net operating loss carryforwards, general business credits and AMT credits to offset taxable income during the quarter. In 2004, the valuation allowance decreased primarily due to the reversal of temporary differences and the utilization of net operating loss carryforwards to offset taxable income during the quarter, partially offset by an increase in AMT credits generated during the quarter.

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BEVERLY ENTERPRISES, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)
March 31, 2005
(Unaudited)

Note 8. Stockholders Equity

During March 2005, we issued approximately 722,000 shares of restricted stock to certain officers and other employees, all of which vest on the third anniversary of the grant date. If these additional shares had been issued prior to January 1, 2005, there would have been no material impact on our diluted net income per share for the three months ended March 31, 2005.

Statement of Financial Accounting Standards (SFAS) No. 148, *Accounting for Stock-Based Compensation Transition and Disclosure* (SFAS No. 148), issued on December 31, 2002, provides companies alternative methods of transitioning to the fair value method of accounting for stock-based compensation, and amends certain disclosure requirements. SFAS No. 148 does not mandate fair value accounting for stock-based compensation. We currently do not recognize compensation expense for our stock option grants, which are issued at fair market value on the date of grant and are accounted for under the intrinsic value method. We are in compliance with the current accounting rules regarding stock-based compensation (see discussion of SFAS No. 123R below).

For purposes of pro forma disclosures, the estimated fair market value of all outstanding stock options is amortized to expense over the respective vesting periods. The fair market value has been estimated at the date of grant using a Black-Scholes option pricing model. The pro forma effects are not necessarily indicative of the effects on future quarters or future years. The following table summarizes our pro forma net income and diluted net income per share for the three months ended March 31 assuming we accounted for our stock option grants using the fair value method, (in thousands, except per share amounts):

| | 2005 | 2004 |
|--|-----------|-----------|
| Reported net income(a) | \$ 14,656 | \$ 23,439 |
| Stock option compensation expense | 1,148 | 1,790 |
| Pro forma net income | \$ 13,508 | \$ 21,649 |
| Reported basic net income per share | \$ 0.13 | \$ 0.22 |
| Pro forma basic net income per share | \$ 0.12 | \$ 0.20 |
| Reported diluted net income per share | \$ 0.12 | \$ 0.20 |
| Pro forma diluted net income per share | \$ 0.11 | \$ 0.18 |

(a) Includes total charges to our condensed consolidated statements of income related to restricted stock grants for the three months ended March 31, 2005 and 2004 of approximately \$1.4 million and \$620,000, respectively.

In December 2004, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards No. 123 (revised), *Share-Based Payment* (SFAS No. 123R), which eliminates the intrinsic value method as an alternative method of accounting for stock-based awards. SFAS No. 123R also revises the fair value-based method of accounting for share-based payment liabilities, forfeitures and modifications of stock-based awards and clarifies guidance surrounding measuring fair value, classifying an award as equity or as a liability and attributing compensation cost to reporting periods. In addition, SFAS No. 123R amends SFAS No. 95 to require that excess tax

benefits be reported as a financing cash inflow rather than as a reduction of taxes paid, which is included within operating cash flows.

In the first quarter of 2005, the SEC issued Staff Accounting Bulletin No. 107, which provided further clarification on the implementation of SFAS No. 123R and provided alternative phase-in methods. The SEC

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BEVERLY ENTERPRISES, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)
March 31, 2005
(Unaudited)

Note 8. Stockholders Equity (Continued)

announced in the second quarter of 2005 that it is extending the phase-in period, which will extend our effective date for implementation of SFAS No. 123R to January 1, 2006. We expect to use the modified version of prospective application when we implement SFAS No. 123R. Based on the estimated value of unvested stock options, we expect wages and related expenses to increase \$469,000 in 2006.

Note 9. Contingencies and Legal Proceedings

We are contingently liable for approximately \$11.8 million of long-term debt maturing on various dates through 2019, as well as annual interest on that debt. These contingent liabilities principally arose from previous sales of nursing facilities. We also guarantee certain third-party operating leases. Those guarantees arose from our dispositions of leased facilities and the underlying leases have \$56.0 million of minimum rental commitments remaining through the initial lease terms. In accordance with the FASB's Interpretation No. 45, *Guarantors Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others*, we have recorded approximately \$685,000, included in Other accrued liabilities on the condensed consolidated balance sheets, as the estimated fair value of guarantees.

We are a party to various legal matters relating to patient care, including claims that our services have resulted in injury or death to residents of our facilities. Over the past few years, we have experienced an increasing trend in the number and severity of the claims asserted against us. We believe that there has been, and will continue to be, an increase in governmental investigations of long-term care providers. Adverse determinations in legal proceedings or governmental investigations, whether currently asserted or arising in the future, could have a material adverse effect on us.

There are various other lawsuits and regulatory actions pending against us arising in the normal course of business, some of which seek punitive damages that are generally not covered by insurance. We do not believe that the ultimate resolution of such other matters will have a material adverse effect on our consolidated financial position, results of operations or cash flows.

Note 10. Segment Information

Statement of Financial Accounting Standards No. 131, *Disclosures about Segments of an Enterprise and Related Information*, provides disclosure guidelines for segments of a company based on a management approach to defining operating segments. Our operations are organized into three primary segments:

Nursing Facilities, which provide long-term healthcare through the operation of skilled nursing homes and assisted living centers;

Aegis, which provides rehabilitation therapy services under contract to our nursing facilities and third-party nursing facilities; and

AseraCare, which primarily provides hospice services.

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BEVERLY ENTERPRISES, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)
March 31, 2005
(Unaudited)

Note 10. Segment Information (Continued)

The following table summarizes certain information for each of our operating segments (in thousands):

| | Nursing Facilities | Aegis(1) | AseraCare | All Other(2) | Total | Discontinued Operations(3) |
|----------------------------------|-----------------------|-----------|-----------|-----------------|------------|-------------------------------|
| <i>Three months ended</i> | | | | | | |
| <i>March 31, 2005</i> | | | | | | |
| Revenues from external customers | \$ 500,872 | \$ 36,204 | \$ 24,043 | \$ 1,361 | \$ 562,480 | \$ 32,705 |
| Intercompany revenues | 87 | 40,462 | | 708 | 41,257 | |
| Interest income | 86 | 5 | 57 | 1,915 | 2,063 | 3 |
| Interest expense | 1,500 | | | 9,097 | 10,597 | |
| Depreciation and amortization | 14,419 | 250 | 197 | 1,918 | 16,784 | 277 |
| Pre-tax income (loss) | 34,185 | 15,141 | 1,963 | (36,492) | 14,797 | (89) |
| Goodwill | 44,758 | | 78,104 | 1 | 122,863 | |
| Total assets | 891,343 | 32,699 | 105,126 | 362,514 | 1,391,682 | 25,485 |
| Capital expenditures | 16,987 | 246 | 348 | 2,345 | 19,926 | 553 |
| <i>Three months ended</i> | | | | | | |
| <i>March 31, 2004</i> | | | | | | |
| Revenues from external customers | \$ 439,988 | \$ 27,180 | \$ 10,970 | \$ 2,480 | \$ 480,618 | \$ 52,580 |
| Intercompany revenues | | 37,527 | | 453 | 37,980 | |
| Interest income | 623 | | | 900 | 1,523 | 45 |
| Interest expense | 1,989 | | | 9,815 | 11,804 | 89 |
| Depreciation and amortization | 12,725 | 205 | 108 | 1,869 | 14,907 | 859 |
| Pre-tax income (loss) | 24,279 | 12,380 | 1,317 | (15,401) | 22,575 | 2,729 |
| Goodwill | 44,747 | | 11,723 | | 56,470 | 365 |
| Total assets | 865,502 | 25,912 | 21,444 | 363,750 | 1,276,608 | 64,942 |
| Capital expenditures | 8,141 | 222 | 36 | 1,009 | 9,408 | 369 |

(1) Pre-tax income includes profit on intercompany revenues, which is eliminated in All Other.

(2) Consists of the operations of our corporate headquarters and related overhead, as well as certain non-operating revenues and expenses. Such amounts also include special pre-tax credits totaling \$116,000 and pre-tax charges totaling \$2.8 million for the three months ended March 31, 2005 and 2004, respectively, for asset impairments, workforce reductions and other unusual items, as well as \$18.7 million of costs related to the sales process.

- (3) In accordance with the provisions of SFAS No. 144, the results of operations of certain nursing facilities, clinics and other assets have been reclassified, for all periods presented, as discontinued operations. Pre-tax income (loss) for discontinued operations includes net gains (losses) on sales, exit costs, asset impairments and other unusual items of \$671,000 and \$3.2 million for the three months ended March 2005 and 2004, respectively. The remaining assets of 22 nursing facilities are classified as held for sale at March 31, 2005. (See Note 5.)

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**REPORT OF ERNST & YOUNG LLP,
INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

The Board of Directors
Beverly Enterprises, Inc.

We have reviewed the accompanying condensed consolidated balance sheet of Beverly Enterprises, Inc. as of March 31, 2005, and the related condensed consolidated statements of income and cash flows for the three months ended March 31, 2005 and 2004 (Form 10-Q). These financial statements are the responsibility of the Company s management.

We conducted our reviews in accordance with standards of the Public Company Accounting Oversight Board (United States). A review of interim financial information consists principally of applying analytical procedures and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with standards of the Public Company Accounting Oversight Board, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.

Based on our reviews, we are not aware of any material modifications that should be made to the accompanying condensed consolidated financial statements referred to above for them to be in conformity with U.S. generally accepted accounting principles.

We have previously audited, in accordance with standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheet of Beverly Enterprises, Inc. as of December 31, 2004 and the related consolidated statements of income, stockholders equity, and cash flows for the year then ended, not presented in the Company s Form 10-Q, and in our report dated March 8, 2005, we expressed an unqualified opinion on those consolidated financial statements. In our opinion, the information set forth in the accompanying condensed consolidated balance sheet as of December 31, 2004, is fairly stated, in all material respects, in relation to the consolidated balance sheet from which it has been derived.

Fort Smith, Arkansas
April 29, 2005

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BEVERLY ENTERPRISES, INC.
ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS
OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Forward-Looking Statements

This document contains forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. Forward-looking statements may be identified by words such as expects, anticipates, intends, plans, believes, seeks, estimates or words of similar meaning and include, but are not limited to, statements about expected future business and financial performance. Forward-looking statements are based on management's current expectations and assumptions, which are inherently subject to uncertainties, risks and changes in circumstances that are difficult to predict. Actual outcomes and results may differ materially from these expectations and assumptions due to changes in, among other things, political, economic, business, competitive, market, regulatory, demographic and other factors. In addition, our results of operations and financial condition, cash flows and liquidity may be adversely impacted by the ongoing sales process (see Item 1. Note 4). The sales process may impact our ability to attract and retain customers, management and employees and will result in the incurrence of significant advisory fees, legal fees and other expenses. We undertake no obligation to publicly update or revise any forward-looking information, whether as a result of new information, future developments or otherwise.

Overview

Sales Process and Related Items

In January 2005, a group including Formation Capital, LLC, Appaloosa Management, LP, Franklin Mutual Advisers LLC and Northbrook NBV LLC (the Formation Capital Consortium), publicly announced an unsolicited indication of interest in acquiring all of our outstanding common stock. Arnold M. Whitman, the Chief Executive Officer of Formation Capital also nominated a slate of six individuals for election to our Board of Directors.

On February 3, 2005, our Board of Directors unanimously rejected the Formation Capital Consortium's proposal. On March 22, 2005, we announced that our Board of Directors had unanimously voted to conduct an auction process to maximize value for all of our stockholders as soon as practicable through a sale of BEI. The Board also adopted procedures to enable the beneficial owners of not less than 20% of our outstanding common stock to cause us to call a special meeting of stockholders to be held on October 21, 2005 to remove and replace the Board and for the nomination of individuals for election as directors at the special meeting, if held.

On April 11, 2005, we entered into a Settlement Agreement with the Formation Capital Consortium and Mr. Whitman under which the Formation Capital Consortium and Mr. Whitman agreed to discontinue the solicitation of proxies in connection with the Company's April 21, 2005 Annual Meeting of Stockholders and Mr. Whitman withdrew his nominees for election to our Board of Directors and other proposals for consideration at the 2005 Annual Meeting. In addition, we agreed to reimburse the Formation Capital Consortium for up to \$600,000 of out-of-pocket fees and expenses incurred by them and Mr. Whitman in connection with their proxy solicitation. We have also entered into a Confidentiality Agreement with the members of the Formation Capital Consortium under which the Formation Capital Consortium and its representatives may examine our confidential information for the purpose of evaluating a possible transaction with us pursuant to the same restrictions imposed on other bidders involved in the sales process. We committed in the Confidentiality Agreement to allow the Formation Capital Consortium to participate in our on-going sales process on the same basis with all other potential buyers.

The sales process is being overseen by independent members of our Board of Directors. We have established a due diligence process to assist potential bidders in evaluating their level of interest in acquiring us and in developing bids. Multiple potential bidders or bidding groups already have signed confidentiality agreements and obtained access to information about BEI contained in an online data room we established.

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**BEVERLY ENTERPRISES, INC.
MANAGEMENT'S DISCUSSION AND ANALYSIS
OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)**

All interested parties have been requested to submit initial proposals that would include information on price, financing plans, and potential financial and operating partners. The independent board members plan to evaluate these proposals when received, and then select a smaller number of interested parties to participate in a second round of more detailed due diligence and bidding.

Our results of operations, financial condition and cash flows may be adversely impacted by the ongoing sales process. To date we have incurred various costs as a result of the expression of interest, the proxy contest and the sales process including legal, investment banking advisory fees and other related costs. During the three months ended March 31, 2005, we engaged two investment banking firms to assist us in evaluating proposals, both solicited and unsolicited, to acquire the Company or any of its assets or businesses. Under the terms of the engagement we are required to pay a fee to these two firms equal to a percentage of any consideration received in connection with a sale of the Company, with their percentage compensation increasing with an increase in the sales value, or a flat fee if no sale was to occur. As a result, we recorded a liability of \$16.5 million at March 31, 2005. In addition, we have incurred other costs related to the proxy contest and have recorded a liability of \$2.2 million of which \$807,000 was paid and \$1.4 million remains accrued at March 31, 2005. In addition, the sales process may impact our ability to attract and retain customers, management and employees and will result in the incurrence of significant additional advisory fees, legal fees and other expenses; however the amount and impact of these potential additional expenses cannot be reasonably estimated at this time.

General

Despite the expression of interest and subsequent sales process, our business unit operating and financial trends continue to be positive. Our first quarter included revenue growth of nearly 17% with improvements in operating margins, compared to the year-earlier period. We are dedicated to providing quality of care and executing the specific initiatives we have developed to achieve profitable growth in our business segments and to increase our financial position.

Our three principal business segments performed well ahead of 2004 first-quarter results. On a continuing operations basis, our Nursing Facility revenues increased 13.8% and pre-tax income increased \$13.0 million primarily due to favorable rate increases in Pennsylvania. Aegis revenues from third-party customers rose 33%, compared with the 2004 first quarter, reflecting increased business with existing clients and the net addition of 13 customers. AseraCare revenues from core operations were up 38%, primarily due to an increase in average daily census of 35%. The balance of the revenue growth from AseraCare is related to our July 2004 acquisition of Hospice USA, LLC and the openings of 15 new hospice locations.

Based on the growth trends we are seeing in our principal business units, improved operating metrics and a generally positive reimbursement environment at both federal and state levels, our pre-tax income from continuing operations, excluding \$18.7 million of costs related to the sales process discussed above, would have increased 48% to \$33.5 million for the 2005 first quarter compared to \$22.6 million for the same period in 2004.

Operating Results

Reclassification

Results of operations for the three months ended March 31, 2005, and 2004, reflect asset dispositions during 2005 and 2004, and assets classified as held for sale, as discontinued operations. The following discussions reflect this reclassification.

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BEVERLY ENTERPRISES, INC.
MANAGEMENT'S DISCUSSION AND ANALYSIS
OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)

First Quarter 2005 Compared to First Quarter 2004**Results of Operations – Continuing Operations**

We reported a 34% decrease in pre-tax income from continuing operations to \$14.8 million for the three months ended March 31, 2005, compared to \$22.6 million for the same period in 2004. The quarter-over-quarter comparisons of our financial results are affected by material special pre-tax charges discussed below. Excluding these special pre-tax charges, our pre-tax income from continuing operations would have increased 32% for the three months ended March 31, 2005, compared to the same period in 2004.

Pre-tax income from continuing operations for 2005 included a special pre-tax charge of \$18.7 million for costs related to the expression of interest, the proxy contest and the sales process, of which \$807,000 was paid and \$17.9 million remains accrued as of March 31, 2005 (see Item 1. Note 4). These costs include legal, investment banking advisory fees and other related costs.

Pre-tax income from continuing operations for 2004 included the following special pre-tax charges:
\$2.9 million for asset impairments, primarily related to two nursing facilities;

\$214,000 for workforce reduction charges, less \$346,000 in related credits primarily due to the cancellation of restricted stock. The \$214,000 for workforce reductions primarily related to six associates who were notified in the first quarter of 2004 that their positions would be eliminated and included \$196,000 of cash expenses paid during the year ended December 31, 2004 (see Item 1. Note 3).

Revenues

Revenues from external customers by operating segment for the three months ended March 31 (in thousands) are as follows:

| | 2005 | 2004 | Change | |
|-----------------------|-------------------|-------------------|------------------|--------------|
| | | | 2005 vs. 2004 | |
| | | | \$ | % |
| Nursing Facilities | \$ 500,872 | \$ 439,988 | \$ 60,884 | 13.8% |
| Aegis Therapies | 36,204 | 27,180 | 9,024 | 33.2% |
| AseraCare | 24,043 | 10,970 | 13,073 | 119.2% |
| Other | 1,361 | 2,480 | (1,119) | (45.1)% |
| Total revenues | \$ 562,480 | \$ 480,618 | \$ 81,862 | 17.0% |

Approximately 89% and 92% of our revenues for the three months ended March 31, 2005 and 2004, respectively, were derived from services provided by our Nursing Facilities segment. The increase in total revenues of \$81.9 million for the three months ended March 31, 2005, as compared to the same period in 2004, is primarily due to the following, by operating segment:

Nursing Facilities:

an increase of \$35.7 million primarily due to a retroactive Medicaid rate adjustment in Pennsylvania;

an increase of \$17.8 million, \$7.4 million and \$3.7 million due to increases in Medicaid, Medicare and private payment rates, respectively;

an increase of \$3.3 million in Medicare Part B revenues, primarily due to increased therapy-related services;

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BEVERLY ENTERPRISES, INC.
MANAGEMENT'S DISCUSSION AND ANALYSIS
OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)

an increase of \$1.7 million due to a positive shift in our patient mix; partially offset by

a decrease of \$4.6 million due to one less calendar day during the first quarter of 2005, as compared to the same period in 2004;

a decrease of \$3.0 million due to a decline in census;

Aegis:

an increase of \$9.0 million from growth in Aegis external therapy business, including a 9.3% increase in the number of contracts and a 5% growth in average revenue per contract;

AseraCare:

an increase of \$8.8 million due to the Hospice USA acquisition; and

an increase of \$4.3 million, primarily due to openings of new hospice locations and a 35% increase in average daily census in our AseraCare business.

Costs and Expenses

The following table details costs and expenses, excluding special pre-tax charges, for the three months ended March 31 (in thousands):

| | 2005 | 2004 | Change | |
|---|-------------------|-------------------|------------------|--------------|
| | | | 2005 vs. 2004 | |
| | | | \$ | % |
| Wages and related | \$ 304,599 | \$ 274,303 | \$ 30,296 | 11.0% |
| Provision for insurance and related items | 29,920 | 28,356 | 1,564 | 5.5% |
| Other operating and administrative | 169,325 | 127,409 | 41,916 | 32.9% |
| Depreciation and amortization | 16,784 | 14,907 | 1,877 | 12.6% |
| Total costs and expenses excluding special pre-tax charges (adjustments) | \$ 520,628 | \$ 444,975 | \$ 75,653 | 17.0% |

Excluding special pre-tax charges discussed above, our total costs and expenses increased \$75.7 million, primarily due to the following:

an increase of \$35.4 million in state-imposed provider taxes, primarily associated with the retroactive Medicaid rate adjustment in Pennsylvania, included in our Nursing Facilities segment; and

an increase of \$10.2 million in Aegis wages and related expenses due to increased staffing related to the increased volume of new contracts. This increase also includes a \$2.2 million, or 65%, increase in Aegis contract therapy cost;

an increase of \$9.5 million in our Nursing Facilities wages and related expenses, primarily due to a 4.5% increase in our weighted average wage rate and an increase in nursing hours per patient day;

an increase of \$9.3 million due to the Hospice USA acquisition and the opening of 15 new hospice locations;

an increase of \$2.6 million in contracted services, primarily due to outsourcing certain housekeeping, laundry and dietary services in our Nursing Facilities segment;

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BEVERLY ENTERPRISES, INC.
MANAGEMENT'S DISCUSSION AND ANALYSIS
OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)

an increase in depreciation and amortization expense, primarily due to an increase in capital expenditures in our Nursing Facilities segment.

Other Income and Expenses, Net

Other income and expenses for the three months ended March 31 (in thousands) are as follows:

| | 2005 | 2004 | Change | |
|--|-------------|-------------|---------------|---------|
| | | | 2005 vs. 2004 | |
| | | | \$ | % |
| Other income (expenses): | | | | |
| Interest expense | \$ (10,597) | \$ (11,804) | \$ 1,207 | (10.2)% |
| Interest income | 2,063 | 1,523 | 540 | 35.5% |
| Costs related to the sales process of the Company ⁽¹⁾ | (18,721) | | (18,721) | |
| Net gains on dispositions | 84 | 37 | 47 | 127.0% |

(1) See *Results of Operations - Continuing Operations* for a discussion of this special pre-tax charge.

Interest Expense

Interest expense decreased 10% in the 2005 first quarter, as compared to the same period in 2004, primarily due to the June 2004 refinancing of our 9 5/8% senior notes and the reduction of debt using proceeds from sales of facilities in 2004.

Results of Operations - Discontinued Operations

The results of operations of facilities, clinics and other assets disposed of in the three-month period ended March 31, 2005, as well as the results of operations of held-for-sale assets, have been reported as discontinued operations for all periods presented in the accompanying condensed consolidated statements of income. Also included in discontinued operations are gains and losses on sales, additional impairments and exit costs related

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BEVERLY ENTERPRISES, INC.
MANAGEMENT'S DISCUSSION AND ANALYSIS
OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)

to these transactions. A summary of discontinued operations by operating segment for the three months ended March 31, 2005, is as follows (in thousands):

| | 2005 | | | | 2004 | | | |
|---|-----------------------|----------|--------------|-----------|-----------------------|----------|--------------|-----------|
| | Nursing Facilities | Matrix | Home Care | Total | Nursing Facilities | Matrix | Home Care | Total |
| Revenues | \$ 30,159 | \$ 2,546 | \$ | \$ 32,705 | \$ 49,131 | \$ 3,301 | \$ 148 | \$ 52,580 |
| Operating income (loss)(1) | \$ 274 | \$ 405 | \$ (97) | \$ 582 | \$ (630) | \$ 153 | \$ (7) | \$ (484) |
| Gain (loss) on sales and exit costs | (878) | | | (878) | 4,488 | | (17) | 4,471 |
| Impairments and other unusual items | 207 | | | 207 | (1,258) | | | (1,258) |
| Pre-tax income (loss) | \$ (397) | \$ 405 | \$ (97) | (89) | \$ 2,600 | \$ 153 | \$ (24) | 2,729 |
| Provision for (benefit from) state income taxes | | | | (1,495) | | | | 423 |
| Discontinued operations, net of taxes | | | | \$ 1,406 | | | | \$ 2,306 |

(1) Includes net interest income of \$3,000 for 2005 and net interest expense of \$44,000 for 2004, as well as depreciation and amortization expense of \$277,000, and \$859,000 for 2005, and 2004, respectively.

Income Taxes

Our provision for income taxes from continuing operations of \$1.5 million for the three months ended March 31, 2005, primarily relates to state income taxes estimated to be due in separate return states where we conduct business and to federal alternative minimum tax. We recorded a tax benefit in discontinued operations of \$1.5 million for the three months ended March 31, 2005, relating to state tax refunds in a state where we have ceased operations. We decreased the valuation allowance on our deferred tax assets by \$36.5 million during the three months ended March 31, 2005 to \$121.8 million, primarily due to the reversal of temporary differences and the utilization of net operating loss carryforwards, general business tax credits, and alternative minimum tax credits to offset taxable income for the quarter (see *Tax Valuation Allowance* in our Critical Accounting Policies Update above).

New Accounting Standard

In December 2004, the FASB issued SFAS No. 123R which eliminates the intrinsic value method as an alternative method of accounting for stock-based awards. SFAS No. 123R also revises the fair value-based method of accounting for share-based payment liabilities, forfeitures and modifications of stock-based awards and clarifies guidance surrounding measuring fair value, classifying an award as equity or as a liability and attributing compensation cost to reporting periods. In addition, SFAS No. 123R amends SFAS No. 95 to require that excess tax benefits be reported as

a financing cash inflow rather than as a reduction of taxes paid, which is included within operating cash flows.

In the first quarter of 2005, the SEC issued Staff Accounting Bulletin No. 107, which provided further clarification on the implementation of SFAS No. 123R and provided alternative phase-in methods. The SEC announced in the second quarter of 2005 that it is extending the phase-in period, which will extend our effective date for implementation of SFAS No. 123R to January 1, 2006. We expect to use the modified

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BEVERLY ENTERPRISES, INC.
MANAGEMENT'S DISCUSSION AND ANALYSIS
OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)

version of prospective application when we implement SFAS No. 123R. Based on the estimated value of unvested stock options, we expect wages and related expenses to increase \$469,000 in 2006.

Liquidity and Capital Resources

At March 31, 2005, we had \$233.8 million in cash and cash equivalents and \$3.0 million of investments with maturities between three and six months. We anticipate that \$74.3 million of this cash balance, while not legally restricted, will be utilized primarily to fund certain general and professional liabilities and workers' compensation claims and expenses. In addition, at March 31, 2005, we had approximately \$16.0 million in funds that are restricted for the payment of insured claims and are included in Prepaid expenses and other on our condensed consolidated balance sheet. At March 31, 2005, we had positive working capital of \$188.0 million reflected on our condensed consolidated balance sheet, an increase of 7% from year-end 2004. At March 31, 2005, we had \$90.0 million of unused commitments under our revolving credit facility and \$15.7 million of unused commitments under our letter of credit facility.

Cash Flows. Our cash flows consisted of the following for the three months ended March 31 (in thousands):

| | 2005 | 2004 |
|--|-----------|-------------|
| Net cash provided by (used for): | | |
| Operating activities | \$ 34,770 | \$ (36,572) |
| Investing activities | (18,220) | 11,726 |
| Financing activities | 1,595 | (3,742) |
| Net increase (decrease) in cash and cash equivalents | \$ 18,145 | \$ (28,588) |

Net cash provided by (used for) operating activities, under the direct method, for the three months ended March 31, consists of the following (in thousands):

| | 2005 | 2004 |
|--|------------|-------------|
| Cash received from patients and third-party payors | \$ 551,958 | \$ 473,874 |
| Interest received | 2,066 | 1,568 |
| Cash paid to suppliers and employees | (516,699) | (504,346) |
| Interest paid | (4,681) | (5,218) |
| Income tax (paid) refunds received | 2,126 | (2,450) |
| Net cash provided (used for) by operating activities | \$ 34,770 | \$ (36,572) |

The \$34.8 million of net cash provided by operating activities was primarily used to fund capital expenditures of \$20.7 million for the three months ended March 31, 2005. For the three months ended March 31, 2004, the \$36.6 million net cash used for operating activities was not caused by operational issues, but was primarily due to a \$55.9 million increase in accounts receivable resulting from the termination of daily purchases of receivables by Beverly Funding Corporation (BFC) from Beverly Health and Rehabilitation Services (BHRS) on March 1, 2004. With the termination of daily purchases of receivables by BFC from BHRS, our accounts receivable increased and resulted in a use of cash from operating activities on our condensed consolidated statement of cash flows for the first quarter of 2004.

Divestitures. During February 2005, we sold 10 outpatient clinics for \$4.6 million consisting of \$710,000 cash and \$3.9 million of notes receivable. The purchase price is subject to adjustment based on a working capital settlement, which is expected to be finalized by the third quarter of 2005. As of March 31, 2005, we

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**BEVERLY ENTERPRISES, INC.
MANAGEMENT'S DISCUSSION AND ANALYSIS
OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)**

had 22 nursing facilities classified as held for sale that met the appropriate criteria set forth in SFAS No. 144 and we expect to dispose of them within the next three to six months.

Sale of the Company. Our results of operations, financial condition, cash flows and liquidity may be adversely impacted by the ongoing sales process. To date we have incurred various costs as a result of the expression of interest, the proxy contest and the sales process including legal, investment banking advisory fees and other related costs. During the three months ended March 31, 2005, we recorded \$18.7 million of these costs of which \$807,000 was paid and \$17.9 million remains accrued as of March 31, 2005. In addition, the sale process may impact our ability to attract and retain customers, management and employees and will result in the incurrence of significant additional advisory fees, legal fees and other expenses; however the amount and impact of these potential additional expenses cannot be reasonably estimated at this time.

Summary. We currently anticipate that cash on hand, cash flows from operations and availability under our banking arrangements will be adequate to repay our debts due within one year of \$12.2 million, to make capital additions and improvements of approximately \$100.0 million, to make operating lease and other contractual obligation payments, to make selective acquisitions, including the purchase of previously leased facilities and to meet working capital requirements for the twelve months ending March 31, 2006.

Our ability to make payments on, and to refinance, our indebtedness, as well as to fund planned capital expenditures, including strategic acquisitions, and research and development efforts, will depend on our ability to generate cash in the future. This, to a certain extent, is subject to general economic, financial, competitive, legislative, regulatory and other factors that are beyond our control. However, based on our current level of operations and anticipated cost savings and operating improvements, we believe our cash flows from operations, current cash and cash equivalents and available borrowings will be adequate to meet our future liquidity needs.

We cannot assure you, however, that our business will generate sufficient cash flows from operations, that currently anticipated cost savings and operating improvements will be realized on schedule or that future borrowings will be available to us in an amount sufficient to enable us to pay our indebtedness or to fund our other liquidity needs. We also cannot assure you as to what the potential impact of the sales process will ultimately be on our business and our operations. We may need to refinance all or a portion of our indebtedness on or before maturity. We cannot assure you that we will be able to refinance any of our indebtedness on commercially reasonable terms or at all. If cash flows from operations or availability under our existing banking arrangements fall below expectations, we may be required to utilize cash on hand, delay capital expenditures, dispose of certain assets, issue additional debt securities, or consider other alternatives to improve liquidity.

Obligations and Commitments

There have been no material changes in the information related to obligations and commitments provided in our Annual Report on Form 10-K for the fiscal year ended December 31, 2004 under Item 7.

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ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK.

There have been no material changes in the information provided in our Annual Report on Form 10-K for the fiscal year ended December 31, 2004 under Item 7A.

ITEM 4. CONTROLS AND PROCEDURES.

Evaluation of Disclosure Controls and Procedures

We maintain disclosure controls and procedures, which are designed to ensure that information required to be disclosed in our Exchange Act reports is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms. Such information is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure. In designing and evaluating the disclosure controls and procedures, management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives, and management is required to apply its judgment in evaluating the cost-benefit relationship of possible controls and procedures.

As required by SEC Rule 13a-15(b), we have carried out an evaluation as of March 31, 2005, the end of the period covered by this report, under the supervision and with the participation of management, including our Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures. Based upon their evaluation and subject to the foregoing, the Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures were effective at the reasonable assurance level.

Changes in Internal Control Over Financial Reporting

There has been no change in our internal controls over financial reporting during our most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, our internal controls over financial reporting.

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PART II
BEVERLY ENTERPRISES, INC.
OTHER INFORMATION
March 31, 2005
(Unaudited)

ITEM 1. LEGAL PROCEEDINGS.

There have been no material developments to the information presented under Item 3. Legal Proceedings in our Annual Report on Form 10-K for the fiscal year ended December 31, 2004.

ITEM 5. OTHER INFORMATION.

(b) The information contained in Item 8.01 of our Current Report on Form 8-K filed March 23, 2005, and Item 8.01 of our Current Report on Form 8-K filed April 7, 2005, is hereby incorporated by reference. These items pertain to the procedures adopted by our Board of Directors to enable the beneficial owners of not less than 20 percent of our outstanding common stock to cause us to call a special meeting of stockholders to remove and replace the Board and the nomination of individuals for election as directors at the special meeting, if held.

ITEM 6. EXHIBITS.

**Exhibit
Number**

- | | |
|------|---|
| 3.1 | Form of Restated Certificate of Incorporation of New Beverly Holdings, Inc. (incorporated by reference to Exhibit 3.1 to Beverly Enterprises, Inc.'s Annual Report on Form 10-K for the year ended December 31, 1997) |
| 3.2 | Form of Certificate of Amendment of Certificate of Incorporation of New Beverly Holdings, Inc., changing its name to Beverly Enterprises, Inc. (incorporated by reference to Exhibit 3.2 to Beverly Enterprises, Inc.'s Annual Report on Form 10-K for the year ended December 31, 1997) |
| 3.3 | By-Laws of Beverly Enterprises, Inc. (incorporated by reference to Exhibit 3.4 to Beverly Enterprises, Inc.'s Registration Statement on Form S-1 filed on June 4, 1997 (File No. 333-28521)) |
| 4.1 | Rights agreement, dated as of January 26, 2005, between Beverly Enterprises, Inc. and the Bank of New York, as Rights Agent, which includes the form of Certificate of Designations of the Series A Junior Participating Preferred Stock of Beverly Enterprises, Inc. as Exhibit A, the form of Right Certificate as Exhibit B and the Summary of Rights to Purchase Preferred Shares as Exhibit C (incorporated by reference to Exhibit 4.1 to Beverly Enterprises, Inc.'s Current Report on Form 10-K filed January 28, 2005) |
| 4.2 | Amendment to Rights Agreement, dated April 7, 2005, between Beverly Enterprises, Inc. and the Bank of New York, as Rights Agent (incorporated by reference to Exhibit 4.1 to Beverly Enterprises, Inc.'s Current Report on Form 8-K filed April 7, 2005) |
| 10.1 | Settlement Agreement, dated April 11, 2005, between Beverly Enterprises, Inc. and Arnold Whitman, Appaloosa Management L.P., Formation Capital LLC, Franklin Mutual Advisers, LLC and Northbrook NBV, LLC (incorporated by reference to Exhibit 10.1 to Beverly Enterprises, Inc.'s Current Report on Form 8-K filed April 13, 2005) |

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**BEVERLY ENTERPRISES, INC.
OTHER INFORMATION (Continued)
March 31, 2005
(Unaudited)**

**Exhibit
Number**

| | |
|------|---|
| 10.2 | Summary of Executive Compensation for 2005. |
| 15 | Acknowledgement Letter of Ernst & Young LLP re: Unaudited Condensed Consolidated Interim Financial Statements |
| 31.1 | Rule 13a-14(a)/15d-14(a) Certification of Chief Executive Officer |
| 31.2 | Rule 13a-14(a)/15d-14(a) Certification of Chief Financial Officer |
| 32.1 | Section 1350 Certification of Chief Executive Officer and Chief Financial Officer |
| 99.1 | Resolution of the Beverly Enterprises, Inc. Board of Directors (incorporated by reference to Exhibit 99.1 to Beverly Enterprises, Inc. s Current Report on Form 8-K filed March 23, 2005) |
| 99.2 | Resolution of the Beverly Enterprises, Inc. Board of Directors (incorporated by reference to Exhibit 99.1 to Beverly Enterprises, Inc. s Current Report on Form 8-K filed April 7, 2005) |

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SIGNATURE

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

Beverly Enterprises, Inc.
Registrant

By: /s/ Pamela H. Daniels

Pamela H. Daniels
*Senior Vice President, Controller
and Chief Accounting Officer*

Dated: May 4, 2005