

BEVERLY ENTERPRISES INC

Form 10-Q

November 07, 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 September 30, 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 the Registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that 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 whether the Registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act). Yes No

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

Shares of Registrant's Common Stock, \$.10 par value, outstanding, exclusive of treasury shares, at October 31, 2005 109,532,108

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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 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 the 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.

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Certificate of Designation

Acknowledgement Letter

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)

| | September 30, 2005 | December 31, 2004 |
|-------------------------------------------------------------------------------------------|-----------------------|----------------------|
| | (Unaudited) | (Note) |
| ASSETS | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 217,843 | \$ 215,665 |
| Accounts receivable less allowance for doubtful accounts: 2005 \$24,119; 2004 \$26,320 | 270,396 | 235,477 |
| Notes receivable, less allowance for doubtful notes: 2005 \$2,717; 2004 \$1,686 | 4,729 | 2,786 |
| Operating supplies | 9,308 | 9,660 |
| Assets held for sale | | 3,542 |
| Prepaid expenses and other | 44,984 | 37,266 |
| Total current assets | 547,260 | 504,396 |
| Property and equipment, net | 672,583 | 664,311 |
| Other assets: | | |
| Goodwill, net | 122,090 | 124,066 |
| Other, less allowance for doubtful accounts and notes: 2005 \$1,027; 2004 \$1,538 | 69,614 | 68,612 |
| Total other assets | 191,704 | 192,678 |
| | \$ 1,411,547 | \$ 1,361,385 |
| LIABILITIES AND STOCKHOLDERS EQUITY | | |
| Current liabilities: | | |
| Accounts payable | \$ 66,541 | \$ 67,778 |
| Accrued wages and related liabilities | 93,617 | 104,037 |
| Accrued interest | 8,787 | 3,602 |
| General and professional liabilities | 58,187 | 54,216 |
| Federal government settlement obligations | 15,386 | 14,359 |
| Liabilities held for sale | | 676 |
| Other accrued liabilities | 105,341 | 83,097 |
| Current portion of long-term debt | 8,158 | 12,240 |
| Total current liabilities | 356,017 | 340,005 |
| Long-term debt | 536,544 | 545,943 |
| Other liabilities and deferred items | 153,366 | 203,024 |
| Commitments and contingencies | | |
| Stockholders' equity: | | |

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Preferred stock, shares authorized: 25,000,000

Common stock, shares issued: 2005 117,812,924; 2004

| | | |
|-------------|--------|--------|
| 116,621,715 | 11,781 | 11,662 |
|-------------|--------|--------|

| | | |
|----------------------------|---------|---------|
| Additional paid-in capital | 912,400 | 902,053 |
|----------------------------|---------|---------|

| | | |
|---------------------|-----------|-----------|
| Accumulated deficit | (450,063) | (532,804) |
|---------------------|-----------|-----------|

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

| | | |
|---------------------------|---------|---------|
| Total stockholders equity | 365,620 | 272,413 |
|---------------------------|---------|---------|

| | | |
|--|--------------|--------------|
| | \$ 1,411,547 | \$ 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 September 30, | | Nine Months Ended September 30, | |
|----------------------------------------------------------------------------------------------------------------------------------------|---------------------------------------------|-------------|--------------------------------------------|--------------|
| | 2005 | 2004 | 2005 | 2004 |
| Revenues | \$ 583,942 | \$ 524,842 | \$ 1,761,555 | \$ 1,536,796 |
| Costs and expenses: | | | | |
| Wages and related | 331,126 | 311,850 | 971,216 | 889,193 |
| Provision for insurance and related items | 35,807 | 29,590 | 97,416 | 94,225 |
| Other operating and administrative | 156,527 | 134,962 | 495,506 | 402,036 |
| Depreciation and amortization | 19,355 | 15,624 | 53,621 | 45,863 |
| Asset impairments, workforce reductions and other unusual items | 504 | (473) | 479 | 1,122 |
| Total costs and expenses | 543,319 | 491,553 | 1,618,238 | 1,432,439 |
| Income before other income (expenses) | 40,623 | 33,289 | 143,317 | 104,357 |
| Other income (expenses): | | | | |
| Interest expense | (10,704) | (11,089) | (32,051) | (34,965) |
| Costs related to early extinguishment of debt | | (176) | | (40,430) |
| Costs related to the sales process of the Company | (11,514) | | (36,566) | |
| Interest income | 2,407 | 1,246 | 6,434 | 4,090 |
| Net gains on dispositions | 44 | 582 | 667 | 614 |
| Total other expenses, net | (19,767) | (9,437) | (61,516) | (70,691) |
| Income before provision for (benefit from) income taxes and discontinued operations | 20,856 | 23,852 | 81,801 | 33,666 |
| Provision for (benefit from) income taxes | (590) | 536 | 2,688 | 3,038 |
| Income before discontinued operations | 21,446 | 23,316 | 79,113 | 30,628 |
| Discontinued operations, net of taxes: for the quarters 2005 \$(80) and 2004 (\$59); for the nine months 2005 (\$1,438) and 2004 \$286 | 520 | 1,084 | 3,628 | (8,712) |
| Net income | \$ 21,966 | \$ 24,400 | \$ 82,741 | \$ 21,916 |
| Net income (loss) per share of common stock: | | | | |
| Basic: | | | | |
| Before discontinued operations | \$ 0.20 | \$ 0.22 | \$ 0.72 | \$ 0.28 |

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| | | | | | | | | |
|------------------------------------------------------------|----|---------|----|---------|----|---------|----|---------|
| Discontinued operations, net of taxes | | 0.01 | | 0.04 | | (0.08) | | |
| Net income per share of common stock | \$ | 0.20 | \$ | 0.23 | \$ | 0.76 | \$ | 0.20 |
| Shares used to compute basic net income (loss) per share | | 109,506 | | 108,039 | | 109,246 | | 107,613 |
| Diluted: | | | | | | | | |
| Before discontinued operations | \$ | 0.18 | \$ | 0.19 | \$ | 0.64 | \$ | 0.27 |
| Discontinued operations, net of taxes | | | | 0.01 | | 0.03 | | (0.07) |
| Net income per share of common stock | \$ | 0.18 | \$ | 0.20 | \$ | 0.67 | \$ | 0.20 |
| Shares used to compute diluted net income (loss) per share | | 127,184 | | 124,493 | | 126,862 | | 124,105 |

See accompanying notes.

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

| | Nine Months Ended September 30, | |
|---------------------------------------------------------------------------------------------------------------------------------|--------------------------------------------|-------------|
| | 2005 | 2004 |
| Cash flows from operating activities: | | |
| Net income | \$ 82,741 | \$ 21,916 |
| Adjustments to reconcile net income to net cash provided by (used for) operating activities, including discontinued operations: | | |
| Depreciation and amortization | 53,973 | 47,656 |
| Provision for reserves on accounts, notes and other receivables, net | 6,530 | 10,772 |
| Amortization of deferred financing costs | 2,072 | 2,107 |
| Asset impairments, workforce reductions and other unusual items | 479 | 3,799 |
| Costs related to early extinguishments of debt | | 40,430 |
| Costs related to the sales process of the Company | 36,566 | |
| Gains on dispositions of facilities and other assets, net | (2,493) | (455) |
| Insurance related accounts | (49,455) | (12,833) |
| Changes in operating assets and liabilities, net of acquisitions and dispositions: | | |
| Accounts receivable | (45,161) | (53,955) |
| Prepaid expenses and other receivables | 933 | 8,139 |
| Accounts payable and other accrued expenses | (20,034) | (23,140) |
| Income taxes payable | 3,081 | (2,497) |
| Other, net | 1,872 | (4,219) |
| Total adjustments | (11,637) | 15,804 |
| Net cash provided by operating activities | 71,104 | 37,720 |
| Cash flows from investing activities: | | |
| Capital expenditures | (68,194) | (37,964) |
| Payments for acquisitions, net of cash acquired | | (71,479) |
| Proceeds from dispositions of facilities and other assets, net | 14,158 | 22,346 |
| Collections on notes receivable | 63 | 32,268 |
| Payments for designated funds, net | (185) | (958) |
| Proceeds from Beverly Funding Corporation investment | | 28,956 |
| Other, net | (6,409) | (24,316) |
| Net cash used for investing activities | (60,567) | (51,147) |
| Cash flows from financing activities: | | |
| Proceeds from issuance of new debt | 5,200 | 211,384 |
| Repayments of long-term debt | (18,681) | (207,479) |
| Proceeds from exercise of stock options | 5,428 | 1,399 |
| Deferred financing costs paid | (306) | (43,332) |

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| | | |
|------------------------------------------------------|------------|------------|
| Net cash used for financing activities | (8,359) | (38,028) |
| Net increase (decrease) in cash and cash equivalents | 2,178 | (51,455) |
| Cash and cash equivalents at beginning of period | 215,665 | 258,815 |
| Cash and cash equivalents at end of period | \$ 217,843 | \$ 207,360 |
| Supplemental schedule of cash flow information: | | |
| Cash paid (received) during the year for: | | |
| Interest, net of amounts capitalized | \$ 24,834 | \$ 30,969 |
| Income tax payments (refunds), net | (1,831) | 5,821 |

See accompanying notes.

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BEVERLY ENTERPRISES, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
September 30, 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 for the three-month and nine-month periods ended September 30, 2005 and 2004, our cash flows for the nine months ended September 30, 2005 and 2004, and our financial condition at September 30, 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-month and nine-month periods ended September 30, 2005 are not necessarily indicative of the results for a full year.

Reclassification

The accompanying condensed consolidated financial statements have been restated for all periods presented to reflect the reclassification of our California nursing facilities as held and used (see Note 5).

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-month and nine-month periods ended September 30, 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.

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BEVERLY ENTERPRISES, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)
September 30, 2005
(Unaudited)

Note 1. General (Continued)

Retroactive adjustments are estimated in the recording of revenues in accordance with Medicare and Medicaid 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 September 30, 2005, we recorded the impact of an approved retroactive Medicaid plan change for the state of California, which resulted in an increase in revenues and Accounts receivable of \$2.3 million and an increase in provider tax expense included in Other operating and administrative expenses and Other accrued liabilities of \$968,000, related to prior years. This resulted in a net increase in pre-tax income for the third quarter of 2005 of \$1.4 million (\$0.01 per share diluted). Also included in pre-tax income for the third quarter of 2005 is the net impact related to the first and second quarters of 2005 of \$1.5 million (\$0.01 per share diluted).

For the nine-month period ended September 30, 2005, our pre-tax income increased \$19.9 million (\$0.16 per share diluted) as a result of the prior year impacts of retroactive Medicaid plan changes for the states of Indiana, Pennsylvania and California. All other changes in estimates related to third-party receivables resulted in an increase in revenues from continuing operations of \$417,000 and \$3.2 million for the three months ended September 30, 2005 and 2004, respectively, and \$2.0 million and \$8.3 million for the nine months ended September 30, 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.

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BEVERLY ENTERPRISES, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)
September 30, 2005
(Unaudited)

Note 1. General (Continued)**Earnings Per Share**

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

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|----------------------------------------------------------------------------------------------------------------------------------|-------------------------------------|-----------|------------------------------------|-----------|
| | 2005 | 2004 | 2005 | 2004 |
| Numerator: | | | | |
| Numerator for basic net income per share from continuing operations | \$ 21,446 | \$ 23,316 | \$ 79,113 | \$ 30,628 |
| Effect of dilutive securities: | | | | |
| Interest on 2.75% convertible subordinated notes, net of income taxes of \$0 | 828 | 825 | 2,482 | 2,474 |
| Numerator for diluted net income per share from continuing operations | \$ 22,274 | \$ 24,141 | \$ 81,595 | \$ 33,102 |
| Denominator: | | | | |
| Denominator for basic net income per share from continuing operations weighted average shares | 109,506 | 108,039 | 109,246 | 107,613 |
| Effect of dilutive securities: | | | | |
| Employee stock options | 2,283 | 1,022 | 2,221 | 1,060 |
| 2.75% convertible subordinated notes | 15,395 | 15,432 | 15,395 | 15,432 |
| Denominator for diluted net income per share from continuing operations adjusted weighted average shares and assumed conversions | 127,184 | 124,493 | 126,862 | 124,105 |
| Basic net income per share from continuing operations | \$ 0.20 | \$ 0.22 | \$ 0.72 | \$ 0.28 |
| Diluted net income per share from continuing operations | \$ 0.18 | \$ 0.19 | \$ 0.64 | \$ 0.27 |

Diluted net income per share from continuing operations does not include the impact of 10,000 employee stock options outstanding for the three-month and nine-month periods ended September 30, 2005 and 1.8 million and 6.9 million for the three-month and nine-month periods ended September 30, 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 for the three-month and nine-month periods ended September 30, 2005 and 2004. On September 30, 2005, one holder converted \$276,000 of our 2.75% convertible subordinated notes for 37,037 shares of our common stock.

Note 2. Insurance

Our provision for insurance is 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

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BEVERLY ENTERPRISES, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)
September 30, 2005
(Unaudited)

Note 2. Insurance (Continued)

period and our estimate of any experience adjustments to premiums. Our next actuarial study is expected to be completed in January 2006 using data through September 30, 2005. Based on the foregoing, 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.

The following table summarizes our provision for insurance and related items (in thousands):

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---------------------------------------------------------|-------------------------------------|-----------|------------------------------------|------------|
| | 2005 | 2004 | 2005 | 2004 |
| General and professional liability: | | | | |
| Continuing operations | \$ 23,506 | \$ 15,341 | \$ 64,610 | \$ 54,820 |
| Discontinued operations | | 1,252 | (317) | 9,017 |
| | \$ 23,506 | \$ 16,593 | \$ 64,293 | \$ 63,837 |
| Workers compensation: | | | | |
| Continuing operations | \$ 9,934 | \$ 10,991 | \$ 25,773 | \$ 29,570 |
| Discontinued operations | (552) | 383 | 261 | 1,843 |
| | \$ 9,382 | \$ 11,374 | \$ 26,034 | \$ 31,413 |
| Other insurance: | | | | |
| Continuing operations | \$ 2,367 | \$ 3,258 | \$ 7,033 | \$ 9,835 |
| Discontinued operations | 2 | 26 | 30 | 145 |
| | \$ 2,369 | \$ 3,284 | \$ 7,063 | \$ 9,980 |
| Total provision for insurance and related items: | | | | |
| Continuing operations | \$ 35,807 | \$ 29,590 | \$ 97,416 | \$ 94,225 |
| Discontinued operations | (550) | 1,661 | (26) | 11,005 |
| | \$ 35,257 | \$ 31,251 | \$ 97,390 | \$ 105,230 |

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

| | September 30, 2005 | December 31, 2004 |
|---------------------------------------|-----------------------|----------------------|
| Accrued wages and related liabilities | \$ 127 | \$ 488 |
| General and professional liabilities | 58,187 | 54,216 |
| Other liabilities and deferred items | 61,783 | 117,962 |

\$ 120,097 \$ 172,666

Our long-term other liabilities and deferred items decreased \$56.2 million from December 31, 2004, and our cash flows for the nine months ended September 30, 2005, decreased \$49.5 million, primarily due to payments for patient claims settlements. Total claim payments for the three months and nine months ended September 30, 2005, were in excess of the estimates derived from our last actuarial study completed in the second quarter of 2005. A portion of this amount relates to an \$18.9 million class action settlement associated

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BEVERLY ENTERPRISES, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)
September 30, 2005
(Unaudited)

Note 2. Insurance (Continued)

with two previously disposed facilities in the state of Arkansas. This class action settlement amount, along with certain related patient care claim settlements, were funded during the third quarter of 2005 and recorded against previously recorded patient care liability reserves. Our general and professional liability expense from continuing operations increased during the third quarter of 2005, as compared to the third quarter of 2004, primarily due to the impact of these accelerated settlements on the discount provisions of the liability.

Between each independent actuarial evaluation, the trends with respect to claims and settlements made and other relevant data may change. As a result, there is a reasonable possibility that our liabilities for patient care and related services, as determined by us and our actuaries, may be adjusted by a material amount in the near term. We cannot currently predict the impact, if any, of our current data trends on the actuarial study to be completed in January 2006.

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 (in thousands):

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|-------------------------------------------|---------------------------------------------|-------------|--------------------------------------------|-------------|
| | 2005 | 2004 | 2005 | 2004 |
| Asset impairments | \$ 70 | \$ | \$ 55 | \$ 2,885 |
| Workforce reductions | | (1) | | 97 |
| Other unusual items, including exit costs | 434 | (97) | 424 | (161) |
| Reversal of previously recorded charges | | (375) | | (1,699) |
| | \$ 504 | \$ (473) | \$ 479 | \$ 1,122 |

The following table summarizes activity in our accruals for estimated workforce reductions and exit costs (in thousands):

| | Three Months Ended September 30, | | | | Nine Months Ended September 30, | | | |
|----------------------------------|-----------------------------------------|-----------------------|---------------------------------|-----------------------|----------------------------------------|-----------------------|---------------------------------|-----------------------|
| | 2005 | | 2004 | | 2005 | | 2004 | |
| | Workforce Reductions | Exit Costs | Workforce Reductions | Exit Costs | Workforce Reductions | Exit Costs | Workforce Reductions | Exit Costs |
| Balance beginning of period | \$ 443 | \$ 4,353 | \$ 1,535 | \$ 6,667 | \$ 1,166 | \$ 4,572 | \$ 3,029 | \$ 7,270 |
| Charged to continuing operations | | 432 | 126 | (52) | | 529 | 553 | 51 |
| Charged to discontinued | | 594 | | 47 | | 3,684 | | 2,991 |

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| | | | | | | | | |
|-----------------------|--------|----------|----------|----------|--------|----------|----------|----------|
| operations | | | | | | | | |
| Cash payments | (24) | (789) | (364) | (1,649) | (711) | (4,103) | (2,302) | (5,299) |
| Reversals | (22) | (42) | (127) | | (58) | (134) | (110) | |
| Balance end of period | \$ 397 | \$ 4,548 | \$ 1,170 | \$ 5,013 | \$ 397 | \$ 4,548 | \$ 1,170 | \$ 5,013 |

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)
September 30, 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. Our Board of Directors unanimously rejected the Formation Capital Consortium's proposal, and on March 22, 2005, we announced that our Board of Directors had unanimously voted to conduct an auction process, to be overseen by the independent members of the Board, to maximize value for all of our stockholders as soon as practicable through a sale of BEI.

On April 11, 2005, we entered into a Settlement Agreement with the Formation Capital Consortium and Mr. Whitman under which, among other things, they 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. Concurrently, we agreed to allow the Formation Capital Consortium to participate in our on-going sales process on the same basis as all other potential buyers.

On August 16, 2005, following two rounds of due diligence and bidding by potential buyers, we entered into an Agreement and Plan of Merger (the Merger Agreement) with North American Senior Care, Inc. (NASC), NASC Acquisition Corp., a wholly-owned subsidiary of NASC (Merger Sub), and SBEV Property Holdings LLC, which provides that Merger Sub will be merged with and into the Company (the Merger) and the holders of outstanding shares of our common stock would receive cash consideration of \$12.80 per share.

On August 19, 2005, we announced that we had received a proposal from the Formation Capital Consortium to acquire, subject to certain conditions, all of the outstanding shares of our common stock for \$12.90 per share in cash. On August 23, 2005, we entered into a First Amendment to the Merger Agreement with NASC, pursuant to which NASC agreed to increase the merger consideration to \$13.00 per share of our outstanding common stock. On September 22, 2005, we entered into a Second Amendment to the Merger Agreement with NASC which, among other things, granted NASC an extension of time to deliver debt commitment letters and a solvency opinion. In exchange for the extension of time, NASC paid BEI an additional \$3.0 million good faith deposit, which increased the total initial good faith deposit to \$10.0 million. In addition, NASC is obligated to deliver the full \$60.0 million good faith deposit on an unconditional basis and to provide an unconditional \$350.0 million equity commitment by November 18, 2005. NASC delivered the debt commitment letters and the solvency opinion on October 21, 2005.

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 Formation Capital Consortium's indication of interest, the proxy contest and the sales process, including legal fees, investment banking advisory fees and other related costs. During the first quarter of 2005, we engaged two investment banking firms to assist us in evaluating proposals, both solicited and unsolicited, to acquire us or any of our assets or businesses. Under the terms of the engagement we are required to pay fees to the two firms whether or not we are sold. In the case of a sale, the fees are a percentage of the consideration received in connection with our sale, with the percentage of compensation increasing with an increase in the sales value. If there is no sale, the firms each receive a flat fee. As a result, we recorded a liability of \$19.8 million, of which \$4.5 million has been paid as of September 30, 2005, with the remaining liability included in Other accrued liabilities on the September 30, 2005 condensed consolidated balance sheet. We have also incurred other costs related to the sales process and have recorded expenses of \$16.8 million, of which \$13.6 million has been paid and \$3.2 million remains accrued at September 30, 2005. In addition, the sales process may impact our ability to attract and retain

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BEVERLY ENTERPRISES, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)
September 30, 2005
(Unaudited)

Note 4. Sale of the Company and Related Items (Continued)

customers, management and employees and may result in the incurrence of additional advisory fees, legal fees and other expenses.

Note 5. Discontinued Operations

During the nine months ended September 30, 2005, we recognized net pre-tax gains of \$1.8 million, primarily relating to the sale of seven nursing facilities (889 beds) for cash proceeds totaling \$13.3 million. These assets were part of our Nursing Facilities segment, five of which were held for sale as of December 31, 2004. In addition, we sold 10 outpatient clinics for \$4.6 million, including \$710,000 in cash and \$3.8 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.

During the quarter ended September 30, 2005, the Centers for Medicare and Medicaid Services (CMS) approved a Medicaid rate plan change for the state of California (see Note 1). This plan change improves the projected cash flows of our facilities in California, all of which had previously been held for sale. Based on the new cash flow projections for the facilities, during the third quarter we reassessed the fair value of these 22 properties. The expected sales proceeds for these leased assets would not provide us with sufficient proceeds to offset the present value of their expected future cash flows. Consequently, management recommended, and the Board of Directors approved, that we continue to operate the California facilities and no longer market them for sale. The impact of this decision resulted in, among other things, incremental depreciation and amortization of \$1.4 million during the three months and nine months ended September 30, 2005, of which \$567,000 relates to the prior year. These assets have been reclassified as held and used on our condensed consolidated balance sheets for all periods presented and are stated at the lower of carrying value less incremental depreciation.

The remaining assets and liabilities of our former Matrix segment were included in assets and liabilities held for sale as of December 31, 2004. The asset line items from which the reclassifications were made was \$2.0 million from

Current assets, \$1.2 million from Property and equipment-net, \$332,000 from Goodwill and \$28,000 from Other assets.

The results of operations of disposed facilities and other assets in the three-month and nine-month periods ended September 30, 2005, 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-month and nine-month periods ended September 30, 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)
September 30, 2005
(Unaudited)

Note 5. Discontinued Operations (Continued)

A summary of discontinued operations by operating segment is as follows (in thousands):

| | 2005 | | | | 2004 | | | |
|----------------------------------------|-----------------------|--------|--------------|--------|-----------------------|----------|--------------|-----------|
| | Nursing Facilities | Matrix | Home Care | Total | Nursing Facilities | Matrix | Home Care | Total |
| <i>Three Months Ended</i> | | | | | | | | |
| <i>September 30</i> | | | | | | | | |
| Revenues | \$ 393 | \$ | \$ | \$ 393 | \$ 12,926 | \$ 3,563 | \$ | \$ 16,489 |
| Operating income (loss) ⁽¹⁾ | \$ 733 | \$ 4 | \$ 14 | \$ 751 | \$ (31) | \$ 211 | \$ 33 | \$ 213 |
| Gain (loss) on sales and exit costs | (311) | | | (311) | 228 | (24) | 366 | 570 |
| Impairments and other unusual items | | | | | 242 | | | 242 |
| Pre-tax income | \$ 422 | \$ 4 | \$ 14 | 440 | \$ 439 | \$ 187 | \$ 399 | 1,025 |
| Benefit from state income taxes | | | | (80) | | | | (59) |
| Discontinued operations, net of taxes | | | | \$ 520 | | | | \$ 1,084 |

(1) Includes net interest expense of \$41,000 for 2004, as well as depreciation and amortization expense of \$6,000 and \$323,000 for 2005 and 2004, respectively.

| | 2005 | | | | 2004 | | | |
|----------------------------------------|-----------------------|----------|--------------|-----------|-----------------------|-----------|--------------|------------|
| | Nursing Facilities | Matrix | Home Care | Total | Nursing Facilities | Matrix | Home Care | Total |
| <i>Nine Months Ended</i> | | | | | | | | |
| <i>September 30</i> | | | | | | | | |
| Revenues | \$ 8,943 | \$ 2,546 | \$ | \$ 11,489 | \$ 64,856 | \$ 10,466 | \$ 148 | \$ 75,470 |
| Operating income (loss) ⁽¹⁾ | \$ 129 | \$ 456 | \$ (220) | \$ 365 | \$ (5,898) | \$ 859 | \$ 1 | \$ (5,038) |
| Gain (loss) on sales and exit costs | 1,825 | | | 1,825 | (853) | (49) | 369 | (533) |

| | | | | | | | | |
|-------------------------------------------------|----------|--------|----------|----------|------------|--------|--------|------------|
| Impairments and other unusual items | | | | | (2,855) | | | (2,855) |
| Pre-tax income (loss) | \$ 1,954 | \$ 456 | \$ (220) | 2,190 | \$ (9,606) | \$ 810 | \$ 370 | (8,426) |
| Provision for (benefit from) state income taxes | | | | (1,438) | | | | 286 |
| Discontinued operations, net of taxes | | | | \$ 3,628 | | | | \$ (8,712) |

(1) Includes net interest expense of \$36,000 and \$262,000 for 2005 and 2004, respectively, as well as depreciation and amortization expense of \$352,000 and \$1.8 million for 2005 and 2004, respectively.

Note 6. Long-term Debt

As of October 1, 2005, our 2.75% convertible subordinated notes continue to be eligible for conversion into common stock. Under the indenture governing the notes, a holder may convert any of the 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. On September 30, 2005, one holder converted \$276,000 of our 2.75% convertible subordinated notes for 37,037 shares of our common stock.

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BEVERLY ENTERPRISES, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)
September 30, 2005
(Unaudited)

Note 6. Long-term Debt (Continued)

During June 2005, we entered into a mortgage loan for \$5.2 million for the construction of a nursing facility. This loan bears interest at 30-day LIBOR plus 2.5%, requires monthly principal and interest payments and is secured by the real property and a security interest in the personal property of the nursing facility.

Our 7⁷/₈% senior subordinated notes are jointly and severally, fully and unconditionally guaranteed by most of our subsidiaries (the Guarantor Subsidiaries). As of September 30, 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)
September 30, 2005
(Unaudited)

Note 6. Long-term Debt (Continued)

Condensed consolidating balance sheets as of September 30, 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 | \$ 168,910 | \$ 5,968 | \$ 42,965 | \$ | \$ 217,843 |
| Accounts receivable, less allowance for doubtful accounts | 3,933 | 223,233 | 42,491 | 739 | 270,396 |
| Notes receivable, less allowance for doubtful notes | 2,116 | 2,576 | 37 | | 4,729 |
| Operating supplies | 127 | 9,181 | | | 9,308 |
| Prepaid expenses and other | 23,267 | 8,824 | 12,893 | | 44,984 |
| Total current assets | 198,353 | 249,782 | 98,386 | 739 | 547,260 |
| Property and equipment, net | 6,342 | 666,241 | | | 672,583 |
| Other assets: | | | | | |
| Goodwill, net | | 122,090 | | | 122,090 |
| Other, less allowance for doubtful accounts and notes | 370,586 | 29,841 | 601 | (331,414) | 69,614 |
| Due from affiliates | 438,149 | | 76,791 | (514,940) | |
| Total other assets | 808,735 | 151,931 | 77,392 | (846,354) | 191,704 |
| | \$ 1,013,430 | \$ 1,067,954 | \$ 175,778 | \$ (845,615) | \$ 1,411,547 |

| LIABILITIES AND STOCKHOLDERS EQUITY | | | | | |
|--------------------------------------------|----------|-----------|--------|-----|-----------|
| Current liabilities: | | | | | |
| Accounts payable | \$ 3,384 | \$ 63,157 | \$ | \$ | \$ 66,541 |
| Accrued wages and related liabilities | 22,701 | 70,916 | | | 93,617 |
| Accrued interest | 7,694 | 874 | 219 | | 8,787 |
| General and professional liabilities | 28,871 | | 29,316 | | 58,187 |
| Federal government settlement obligations | | 15,386 | | | 15,386 |
| Other accrued liabilities | 36,311 | 69,027 | (736) | 739 | 105,341 |
| Current portion of long-term debt | 1,350 | 6,808 | | | 8,158 |

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| | | | | | |
|-----------------------------------------|--------------|--------------|------------|--------------|--------------|
| Total current liabilities | 100,311 | 226,168 | 28,799 | 739 | 356,017 |
| Long-term debt | 466,763 | 69,781 | | | 536,544 |
| Other liabilities and deferred items | 80,736 | 43,314 | 29,316 | | 153,366 |
| Due to affiliates | | 514,940 | | (514,940) | |
| Commitments and contingencies | | | | | |
| Stockholders' equity: | | | | | |
| Preferred stock | | | | | |
| Common stock | 11,781 | 5,908 | 121 | (6,029) | 11,781 |
| Additional paid-in capital | 912,400 | 414,340 | 44,434 | (458,774) | 912,400 |
| Retained earnings (accumulated deficit) | (450,063) | (206,497) | 73,108 | 133,389 | (450,063) |
| Treasury stock, at cost | (108,498) | | | | (108,498) |
| Total stockholders' equity | 365,620 | 213,751 | 117,663 | (331,414) | 365,620 |
| | \$ 1,013,430 | \$ 1,067,954 | \$ 175,778 | \$ (845,615) | \$ 1,411,547 |

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BEVERLY ENTERPRISES, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)
September 30, 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 | 9,559 | | | 9,660 |
| Assets held for sale | | 3,542 | | | 3,542 |
| Prepaid expenses and other | 10,952 | 10,285 | 16,029 | | 37,266 |
| Total current assets | 161,746 | 215,311 | 127,339 | | 504,396 |
| Property and equipment, net | 6,392 | 657,919 | | | 664,311 |
| Other assets: | | | | | |
| Goodwill, net | | 124,066 | | | 124,066 |
| Other, less allowance for doubtful accounts and notes | 255,350 | 32,607 | 709 | (220,054) | 68,612 |
| Due from affiliates | 453,483 | | 132,141 | (585,624) | |
| Total other assets | 708,833 | 156,673 | 132,850 | (805,678) | 192,678 |
| | \$ 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 |
| Other accrued liabilities | 18,694 | 64,403 | | | 83,097 |

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| | | | | | |
|-----------------------------------------|------------|--------------|------------|--------------|--------------|
| 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)
September 30, 2005
(Unaudited)

Note 6. Long-term Debt (Continued)

Condensed consolidating statements of income for the three months ended September 30, 2005 for Beverly Enterprises, Inc. (parent only), the combined Guarantor Subsidiaries and the combined Non-Guarantor Subsidiaries are as follows:

| | Parent | Guarantor Subsidiaries | Non- Guarantor Subsidiaries | Eliminations | Total |
|-----------------------------------------------------------------------------------|----------|---------------------------|-----------------------------------|--------------|------------|
| Revenues | \$ 227 | \$ 583,715 | \$ 1,930 | \$ (1,930) | \$ 583,942 |
| Costs and expenses: | | | | | |
| Wages and related | 18,563 | 312,563 | | | 331,126 |
| Provision for insurance and related items | 1,401 | 34,406 | 10,897 | (10,897) | 35,807 |
| Other operating and administrative | 6,578 | 150,103 | 164 | (318) | 156,527 |
| Overhead allocation | (21,530) | 21,530 | | | |
| Depreciation and amortization | 1,551 | 17,804 | | | 19,355 |
| Asset impairments, workforce reductions and other unusual items | | 504 | | | 504 |
| Total costs and expenses | 6,563 | 536,910 | 11,061 | (11,215) | 543,319 |
| Income (loss) before other income (expenses) | (6,336) | 46,805 | (9,131) | 9,285 | 40,623 |
| Other income (expenses): | | | | | |
| Interest expense | | (11,167) | (178) | 641 | (10,704) |
| Costs related to the sales process of the Company | (11,514) | | | | (11,514) |
| Interest income | 1,636 | 97 | 1,315 | (641) | 2,407 |
| Net gains on dispositions | | 44 | | | 44 |
| Equity in income of affiliates | 37,590 | | | (37,590) | |
| Total other income (expenses), net | 27,712 | (11,026) | 1,137 | (37,590) | (19,767) |
| Income (loss) before provision for income taxes and discontinued operations | 21,376 | 35,779 | (7,994) | (28,305) | 20,856 |
| Benefit from income taxes | (590) | | | | (590) |
| Income (loss) before discontinued operations | 21,966 | 35,779 | (7,994) | (28,305) | 21,446 |
| | | 520 | | | 520 |

Discontinued operations, net of
taxes of \$(80)

| | | | | | |
|-------------------|-----------|-----------|------------|-------------|-----------|
| Net income (loss) | \$ 21,966 | \$ 36,299 | \$ (7,994) | \$ (28,305) | \$ 21,966 |
|-------------------|-----------|-----------|------------|-------------|-----------|

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BEVERLY ENTERPRISES, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)
September 30, 2005
(Unaudited)

Note 6. Long-term Debt (Continued)

Condensed consolidating statements of income for the three months ended September 30, 2004 for Beverly Enterprises, Inc. (parent only), the combined Guarantor Subsidiaries and the combined Non-Guarantor Subsidiaries are as follows:

| | Parent | Guarantor Subsidiaries | Non- Guarantor Subsidiaries | Eliminations | Total |
|-----------------------------------------------------------------------------------|----------|---------------------------|-----------------------------------|--------------|------------|
| Revenues | \$ 1,728 | \$ 523,324 | \$ 13,811 | \$ (14,021) | \$ 524,842 |
| Costs and expenses: | | | | | |
| Wages and related | 14,100 | 297,750 | | | 311,850 |
| Provision for insurance and related items | 2,408 | 27,182 | 12,428 | (12,428) | 29,590 |
| Other operating and administrative | 7,728 | 127,483 | (235) | (14) | 134,962 |
| Overhead allocation | (20,189) | 20,189 | | | |
| Depreciation and amortization | 1,617 | 14,007 | | | 15,624 |
| Asset impairments, workforce reductions and other unusual items | 1,488 | (1,961) | | | (473) |
| Total costs and expenses | 7,152 | 484,650 | 12,193 | (12,442) | 491,553 |
| Income (loss) before other income (expenses) | (5,424) | 38,674 | 1,618 | (1,579) | 33,289 |
| Other income (expenses): | | | | | |
| Interest expense | | (12,183) | | 1,094 | (11,089) |
| Costs related to the early extinguishment of debt | (176) | | | | (176) |
| Interest income | 527 | 458 | 1,355 | (1,094) | 1,246 |
| Net gains on dispositions | | 582 | | | 582 |
| Equity in income of affiliates | 30,009 | | | (30,009) | |
| Total other income (expenses), net | 30,360 | (11,143) | 1,355 | (30,009) | (9,437) |
| Income (loss) before provision for income taxes and discontinued operations | 24,936 | 27,531 | 2,973 | (31,588) | 23,852 |
| Provision for income taxes | 536 | | | | 536 |
| Income (loss) before discontinued operations | 24,400 | 27,531 | 2,973 | (31,588) | 23,316 |
| | | 1,084 | | | 1,084 |

Discontinued operations, net of
taxes of \$(59)

| | | | | | |
|-------------------|-----------|-----------|----------|-------------|-----------|
| Net income (loss) | \$ 24,400 | \$ 28,615 | \$ 2,973 | \$ (31,588) | \$ 24,400 |
|-------------------|-----------|-----------|----------|-------------|-----------|

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BEVERLY ENTERPRISES, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)
September 30, 2005
(Unaudited)

Note 6. Long-term Debt (Continued)

Condensed consolidating statements of income for the nine months ended September 30, 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 | \$ 663 | \$ 1,760,892 | \$ 21,129 | \$ (21,129) | \$ 1,761,555 |
| Costs and expenses: | | | | | |
| Wages and related | 55,298 | 915,918 | | | 971,216 |
| Provision for insurance and related items | 4,215 | 93,201 | 34,151 | (34,151) | 97,416 |
| Other operating and administrative | 22,300 | 473,673 | 500 | (967) | 495,506 |
| Overhead allocation | (63,177) | 63,177 | | | |
| Depreciation and amortization | 4,662 | 48,959 | | | 53,621 |
| Asset impairments, workforce reductions and other unusual items | | 479 | | | 479 |
| Total costs and expenses | 23,298 | 1,595,407 | 34,651 | (35,118) | 1,618,238 |
| Income (loss) before other income (expenses) | (22,635) | 165,485 | (13,522) | 13,989 | 143,317 |
| Other income (expenses): | | | | | |
| Interest expense | | (34,278) | (532) | 2,759 | (32,051) |
| Costs related to the sales process of the Company | (36,566) | | | | (36,566) |
| Interest income | 4,240 | 406 | 4,547 | (2,759) | 6,434 |
| Net gains on dispositions | | 667 | | | 667 |
| Equity in income of affiliates | 140,390 | | | (140,390) | |
| Total other income (expenses), net | 108,064 | (33,205) | 4,015 | (140,390) | (61,516) |
| Income (loss) before provision for income taxes and discontinued operations | 85,429 | 132,280 | (9,507) | (126,401) | 81,801 |
| Provision for income taxes | 2,688 | | | | 2,688 |
| | 82,741 | 132,280 | (9,507) | (126,401) | 79,113 |

| | | | | | |
|----------------------------------------------------|-----------|------------|------------|--------------|-----------|
| Income (loss) before discontinued operations | | | | | |
| Discontinued operations, net of taxes of \$(1,438) | | 3,628 | | | 3,628 |
| Net income (loss) | \$ 82,741 | \$ 135,908 | \$ (9,507) | \$ (126,401) | \$ 82,741 |

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BEVERLY ENTERPRISES, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)
September 30, 2005
(Unaudited)

Note 6. Long-term Debt (Continued)

Condensed consolidating statements of income for the nine months ended September 30, 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 | \$ 2,907 | \$ 1,534,099 | \$ 57,011 | \$ (57,221) | \$ 1,536,796 |
| Cash and expenses: | | | | | |
| Wages and related | 33,847 | 855,346 | | | 889,193 |
| Provision for insurance and related items | 7,203 | 87,022 | 53,990 | (53,990) | 94,225 |
| Other operating and administrative | 19,805 | 382,480 | (235) | (14) | 402,036 |
| Overhead allocation | (60,962) | 60,962 | | | |
| Depreciation and amortization | 5,018 | 40,845 | | | 45,863 |
| Asset impairments, workforce reductions and other unusual items | 97 | 1,025 | | | 1,122 |
| Total costs and expenses | 5,008 | 1,427,680 | 53,755 | (54,004) | 1,432,439 |
| Income (loss) before other income (expenses) | (2,101) | 106,419 | 3,256 | (3,217) | 104,357 |
| Other income (expenses): | | | | | |
| Interest expense | | (38,399) | | 3,434 | (34,965) |
| Costs related to the early extinguishment of debt | (40,430) | | | | (40,430) |
| Interest income | 1,755 | 1,732 | 4,037 | (3,434) | 4,090 |
| Net gains on dispositions | | 614 | | | 614 |
| Equity in income of affiliates | 65,730 | | | (65,730) | |
| Total other income (expenses), net | 27,055 | (36,053) | 4,037 | (65,730) | (70,691) |
| Income (loss) before provision for income taxes and discontinued operations | 24,954 | 70,366 | 7,293 | (68,947) | 33,666 |
| Provision for income taxes | 3,038 | | | | 3,038 |
| | 21,916 | 70,366 | 7,293 | (68,947) | 30,628 |

| | | | | | | |
|------------------------------------------------|-----------|-----------|----------|-------------|-----------|---------|
| Income (loss) before discontinued operations | | | | | | |
| Discontinued operations, net of taxes of \$286 | | (8,712) | | | | (8,712) |
| Net income (loss) | \$ 21,916 | \$ 61,654 | \$ 7,293 | \$ (68,947) | \$ 21,916 | |

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BEVERLY ENTERPRISES, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)
September 30, 2005
(Unaudited)

Note 6. Long-term Debt (Continued)

Condensed consolidating statements of cash flows for the nine months ended September 30, 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: | \$ 30,529 | \$ 65,444 | \$ (24,869) | \$ 71,104 |
| Cash flows from investing activities: | | | | |
| Capital expenditures | (5,306) | (62,888) | | (68,194) |
| Proceeds from dispositions of facilities and other assets, net | | 14,158 | | 14,158 |
| Collections on notes receivable | | 63 | | 63 |
| Proceeds from (payments for) designated funds, net | (740) | 555 | | (185) |
| Other, net | (2,343) | (4,029) | (37) | (6,409) |
| Net cash used for investing activities | (8,389) | (52,141) | (37) | (60,567) |
| Cash flows from financing activities: | | | | |
| Proceeds from issuance of new debt | | 5,200 | | 5,200 |
| Repayments of long-term debt | (1,013) | (17,668) | | (18,681) |
| Proceeds from exercise of stock options | 5,428 | | | 5,428 |
| Deferred financing costs paid | (160) | (104) | (42) | (306) |
| Net cash provided by (used for) financing activities | 4,255 | (12,572) | (42) | (8,359) |
| Net increase (decrease) in cash and cash equivalents | 26,395 | 731 | (24,948) | 2,178 |
| Cash and cash equivalents at beginning of period | 142,515 | 5,237 | 67,913 | 215,665 |
| Cash and cash equivalents at end of period | \$ 168,910 | \$ 5,968 | \$ 42,965 | \$ 217,843 |

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BEVERLY ENTERPRISES, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)
September 30, 2005
(Unaudited)

Note 6. Long-term Debt (Continued)

Condensed consolidating statements of cash flows for the nine months ended September 30, 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: | \$ (72,473) | \$ 84,115 | \$ 26,078 | \$ 37,720 |
| Cash flows from investing activities: | | | | |
| Capital expenditures | (3,912) | (34,052) | | (37,964) |
| Payments for acquisitions, net of cash acquired | | (71,479) | | (71,479) |
| Proceeds from dispositions of facilities and other assets, net | 1,324 | 21,022 | | 22,346 |
| Collections on notes receivable | | 32,268 | | 32,268 |
| Payments for designated funds, net | (230) | (728) | | (958) |
| Proceeds from Beverly Funding Corporation investment | 28,956 | | | 28,956 |
| Other, net | (10,446) | (13,870) | | (24,316) |
| Net cash provided by (used for) investing activities | 15,692 | (66,839) | | (51,147) |
| Cash flows from financing activities: | | | | |
| Proceeds from issuance of long-term debt | 211,384 | | | 211,384 |
| Repayments of long-term debt | (191,623) | (15,856) | | (207,479) |
| Proceeds from exercise of stock options | 1,399 | | | 1,399 |
| Deferred financing and other costs | (43,281) | | (51) | (43,332) |
| Net cash used for financing activities | (22,121) | (15,856) | (51) | (38,028) |
| Net increase (decrease) in cash and cash equivalents | (78,902) | 1,420 | 26,027 | (51,455) |
| Cash and cash equivalents at beginning of period | 223,575 | 5,351 | 29,889 | 258,815 |
| Cash and cash equivalents at end of period | \$ 144,673 | \$ 6,771 | \$ 55,916 | \$ 207,360 |

Note 7. Income Taxes

The provisions for income taxes from continuing operations of \$2.7 million and \$3.0 million for the nine months ended September 30, 2005 and 2004, respectively, primarily relate to state income taxes estimated to be due in

separate return filing states where we conduct business, as well as federal alternative minimum tax (AMT) in 2005. During the third quarter of 2005, we recorded a benefit from income taxes in continuing operations primarily due to a less than expected 2004 state tax liability and a related reduction in our estimated 2005 state tax liability. We recorded a tax benefit in discontinued operations of \$1.4 million for the nine months ended September 30, 2005, primarily 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 has

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BEVERLY ENTERPRISES, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)
September 30, 2005
(Unaudited)

Note 7. Income Taxes (Continued)

decreased \$41.7 million primarily due to the reversal of temporary differences and the utilization of net operating loss carryforwards and general business credits to offset taxable income during the year. For the nine months ended September 30, 2004, the valuation allowance decreased \$19.5 million primarily due to the reversal of temporary differences, partially offset by increases in net operating loss carryforwards.

In the ordinary course of business, our income tax returns are examined by various taxing authorities, including the Internal Revenue Service (the IRS). The IRS is currently examining our income tax returns for the 2000 through 2002 tax years. We cannot predict the ultimate outcome of this examination; however, we believe adequate provision has been made for any adjustments that may result from the IRS examination.

Note 8. Stockholders Equity

During the nine months ended September 30, 2005, we issued approximately 741,000 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 nine months ended September 30, 2005. 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.

For purposes of pro forma disclosures under Statement of Financial Accounting Standards (SFAS) No. 148, *Accounting for Stock-Based Compensation Transition and Disclosure* (SFAS No. 148), 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 assuming we accounted for our stock option grants using the fair value method (in thousands, except per share amounts):

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|----------------------------------------|-------------------------------------|-----------|------------------------------------|-----------|
| | 2005 | 2004 | 2005 | 2004 |
| Reported net income ⁽¹⁾ | \$ 21,966 | \$ 24,400 | \$ 82,741 | \$ 21,916 |
| Stock option compensation expense | 818 | 1,025 | 2,901 | 4,132 |
| Pro forma net income | \$ 21,148 | \$ 23,375 | \$ 79,840 | \$ 17,784 |
| Reported basic net income per share | \$ 0.20 | \$ 0.23 | \$ 0.76 | \$ 0.20 |
| Pro forma basic net income per share | \$ 0.19 | \$ 0.22 | \$ 0.73 | \$ 0.17 |
| Reported diluted net income per share | \$ 0.18 | \$ 0.20 | \$ 0.67 | \$ 0.20 |
| Pro forma diluted net income per share | \$ 0.17 | \$ 0.19 | \$ 0.65 | \$ 0.16 |

- (1) Includes total charges to our condensed consolidated statements of income related to restricted stock grants for the three-month periods ended September 30, 2005 and 2004 of approximately \$1.8 million and \$1.1 million, respectively, and for the nine-month periods ended September 30, 2005 and 2004 of approximately \$5.0 million and \$2.7 million, 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, when effective, will eliminate 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,

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BEVERLY ENTERPRISES, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)
September 30, 2005
(Unaudited)

Note 8. Stockholders Equity (Continued)

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 provides further clarification on the implementation of SFAS No. 123R and provides alternative phase-in methods. The SEC announced in the second quarter of 2005 that it is extending the phase-in period for expensing of stock-based awards, 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 and, based on the current estimated value of unvested stock options, we expect wages and related expenses to increase approximately \$500,000 in 2006.

Note 9. Contingencies and Legal Proceedings

We are contingently liable for approximately \$11.3 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 \$51.1 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 a liability of approximately \$578,000, included in Other accrued liabilities on the condensed consolidated balance sheets, representing the estimated fair value of guarantees.

As previously reported in our Annual Report on Form 10-K for the fiscal year ended December 31, 2004, on January 26, 2005, a putative class action complaint brought on behalf of all shareholders of the Company was filed against the Company and each of its directors in the Delaware Chancery Court in New Castle County. The complaint, captioned *Chaya Perlstein v. William R. Floyd, et al.*, Civil Action No. CA1050-N, asserted a claim for breach of fiduciary duty in connection with our response to an unsolicited expression of interest by a group of investors that collectively had purchased 8.1% of our common stock on the open market prior to January 24, 2005. A second, substantially identical, putative class action complaint was filed in the same court on February 1, 2005, bearing the caption *Robert Strougo v. Beverly Enterprises, Inc., et al.*, Civil Action No. CA1067-N. On February 23, 2005, the Delaware Chancery Court consolidated these cases under the caption *In re Beverly Shareholders Litigation*, Civil Action No. CA1050-N, and designated the *Floyd* complaint as operative. The Company moved to dismiss the consolidated action on May 9, 2005. On July 13, 2005, the plaintiffs requested a voluntary dismissal of the consolidated action. The court granted the request and dismissed the consolidated action with prejudice on July 14, 2005.

As previously reported in our Annual Report on Form 10-K for the fiscal year ended December 31, 2004, on October 31, 2002, a shareholder derivative action entitled *Paul Dunne and Helene Dunne, derivatively on behalf of nominal defendant Beverly Enterprises, Inc. v. Beryl F. Anthony, Jr., et al.* was filed in the Circuit Court of Sebastian County, Arkansas, Fort Smith Division (No. CIV-2002-1241). This case was purportedly brought derivatively on our behalf against various current and former officers and directors. The complaint alleges causes of action for breach of fiduciary duty against the defendants based on: (1) allegations that defendants failed to establish and maintain adequate accounting controls such that we failed to record adequate reserves for general and professional liability costs; and (2) allegations that certain defendants sold Company stock while purportedly in possession of material non-public information. On May 16, 2003, two additional derivative complaints (*Holcombe v. Floyd, et al.* and *Flowers v. Floyd, et al.*) were filed and

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BEVERLY ENTERPRISES, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)
September 30, 2005
(Unaudited)

Note 9. Contingencies and Legal Proceedings (Continued)

subsequently transferred to the Circuit Court of Sebastian County, Arkansas, Fort Smith Division and consolidated with the Dunne action as *Holcomb v. Beverly Enterprises, Inc.* The Dunes were subsequently dismissed as plaintiffs. On November 19, 2004, Beverly moved to dismiss these actions on the grounds that the plaintiffs failed to make a pre-suit demand upon Beverly's Board of Directors and did not show that the failure to make such demand was excused as futile. The other defendants also moved to dismiss the actions for failure to state a claim upon which relief can be granted. Plaintiffs have opposed both motions. On June 23, 2005, the court dismissed the actions with prejudice on the grounds that the plaintiffs failed to make the requisite demand on the board of directors.

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. 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. In addition, we are subject to audits by various governmental agencies. We do not believe that the ultimate resolution of such 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)
September 30, 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 September 30, 2005</i> | | | | | | |
| Revenues from external customers | \$ 513,267 | \$ 39,864 | \$ 28,876 | \$ 1,935 | \$ 583,942 | \$ 393 |
| Intercompany revenues | 59 | 40,987 | | 1,772 | 42,818 | |
| Interest income | 87 | 5 | | 2,315 | 2,407 | |
| Interest expense | 1,329 | | | 9,375 | 10,704 | |
| Depreciation and amortization | 16,922 | 260 | 258 | 1,915 | 19,355 | 6 |
| Pre-tax income (loss) | 36,680 | 13,785 | 4,867 | (34,476) | 20,856 | 440 |
| Goodwill | 44,170 | | 77,920 | | 122,090 | |
| Total assets | 905,551 | 36,163 | 104,862 | 360,987 | 1,407,563 | 3,984 |
| Capital expenditures | 20,758 | 46 | 138 | 1,280 | 22,222 | 792 |
| <i>Three months ended September 30, 2004</i> | | | | | | |
| Revenues from external customers | \$ 472,962 | \$ 31,975 | \$ 19,062 | \$ 843 | \$ 524,842 | \$ 16,489 |
| Intercompany revenues | | 36,946 | | 849 | 37,795 | |
| Interest income | 458 | 8 | | 780 | 1,246 | (7) |
| Interest expense | 1,756 | | | 9,333 | 11,089 | 34 |
| Depreciation and amortization | 13,212 | 231 | 217 | 1,964 | 15,624 | 323 |
| Pre-tax income (loss) | 28,093 | 9,697 | 2,863 | (16,801) | 23,852 | 1,025 |
| Goodwill | 44,159 | | 79,714 | | 123,873 | 594 |
| Total assets | 845,409 | 31,079 | 97,658 | 337,897 | 1,312,043 | 22,629 |
| Capital expenditures | 14,446 | 255 | 287 | 717 | 15,705 | 346 |
| <i>Nine months ended September 30, 2005</i> | | | | | | |
| Revenues from external customers | \$ 1,564,351 | \$ 113,068 | \$ 79,225 | \$ 4,911 | 1,761,555 | \$ 11,489 |
| Intercompany revenues | 212 | 122,455 | | 3,742 | 126,409 | |
| Interest income | 255 | 15 | 57 | 6,107 | 6,434 | 4 |
| Interest expense | 4,223 | 1 | | 27,827 | 32,051 | 40 |
| Depreciation and amortization | 46,420 | 773 | 707 | 5,721 | 53,621 | 352 |
| Pre-tax income (loss) | 125,093 | 43,865 | 9,419 | (96,576) | 81,801 | 2,190 |
| Goodwill | 44,170 | | 77,920 | | 122,090 | |
| Total assets | 905,551 | 36,163 | 104,862 | 360,987 | 1,407,563 | 3,984 |

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| | | | | | | |
|----------------------------------|--------------|-----------|-----------|----------|--------------|-----------|
| Capital expenditures | 59,334 | 500 | 798 | 5,800 | 66,432 | 1,762 |
| <i>Nine months ended</i> | | | | | | |
| <i>September 30, 2004</i> | | | | | | |
| Revenues from external customers | \$ 1,401,546 | \$ 89,023 | \$ 42,214 | \$ 4,013 | \$ 1,536,796 | \$ 75,470 |
| Intercompany revenues | | 112,228 | | 2,254 | 114,482 | |
| Interest income | 1,720 | 13 | 1 | 2,356 | 4,090 | 19 |
| Interest expense | 5,931 | 1 | | 29,033 | 34,965 | 281 |
| Depreciation and amortization | 38,770 | 650 | 427 | 6,016 | 45,863 | 1,793 |
| Pre-tax income (loss) | 75,017 | 34,530 | 6,439 | (82,320) | 33,666 | (8,426) |
| Goodwill | 44,159 | | 79,714 | | 123,873 | 594 |
| Total assets | 845,409 | 31,079 | 97,658 | 337,897 | 1,312,043 | 22,629 |
| Capital expenditures | 31,585 | 742 | 418 | 3,946 | 36,691 | 1,273 |

- (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 a special pre-tax charge of \$504,000 and a pre-tax credit of \$473,000 for the three months ended September 30, 2005 and 2004, respectively, and special pre-tax charges totaling \$479,000 and \$1.1 million for the nine months ended September 30, 2005 and 2004, respectively for asset impairments, workforce reductions and other unusual items, as well as \$11.5 million and \$36.6 million for the three-month and nine-month periods ending September 30, 2005, respectively, 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 losses on sales and exit costs of \$311,000 for the three months ended September 30, 2005, and net gains on sales, exit costs, asset impairments and other unusual items of \$812,000 for the three months ended September 30, 2004. Pre-tax income (loss) includes net gains on sales and exit costs of \$1.8 million for the nine months ended September 30, 2005, and net losses on sales, exit costs, asset impairments and other unusual items of \$3.4 million for the nine months ended September 30, 2004.

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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 condensed consolidated balance sheet of Beverly Enterprises, Inc. as of September 30, 2005, and the related condensed consolidated statements of income for the three-month and nine-month periods ended September 30, 2005 and 2004, and the condensed consolidated statements of cash flows for the nine-month periods ended September 30, 2005 and 2004 (Form 10-Q). These financial statements are the responsibility of the Company s management.

We conducted our review in accordance with the 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 the 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 review, we are not aware of any material modifications that should be made to the 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 the 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
November 1, 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 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.

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. Our Board of Directors unanimously rejected the Formation Capital Consortium's proposal, and on March 22, 2005, we announced that our Board of Directors had unanimously voted to conduct an auction process, to be overseen by the independent members of the Board, to maximize value for all of our stockholders as soon as practicable through a sale of BEI.

On April 11, 2005, we entered into a Settlement Agreement with the Formation Capital Consortium and Mr. Whitman under which, among other things, they 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. Concurrently, we agreed to allow the Formation Capital Consortium to participate in our on-going sales process on the same basis as all other potential buyers.

On August 16, 2005, following two rounds of due diligence and bidding by potential buyers, we entered into an Agreement and Plan of Merger (the Merger Agreement) with North American Senior Care, Inc. (NASC), NASC Acquisition Corp., a wholly-owned subsidiary of NASC (Merger Sub), and SBEV Property Holdings LLC, which provides that Merger Sub will be merged with and into the Company (the Merger) and the holders of outstanding shares of our common stock would receive cash consideration of \$12.80 per share.

On August 19, 2005, we announced that we had received a proposal from the Formation Capital Consortium to acquire, subject to certain conditions, all of the outstanding shares of our common stock for \$12.90 per share in cash. On August 23, 2005, we entered into a First Amendment to the Merger Agreement with NASC, pursuant to which NASC agreed to increase the merger consideration to \$13.00 per share of our outstanding common stock. On September 22, 2005, we entered into a Second Amendment to the Merger Agreement with NASC which, among other things, granted NASC an extension of time to deliver debt commitment letters and a solvency opinion. In exchange for the extension of time, NASC paid BEI an additional \$3.0 million good faith deposit, which increased the total initial good faith deposit to \$10.0 million.

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

In addition, NASC is obligated to deliver the full \$60.0 million good faith deposit on an unconditional basis and to provide an unconditional \$350.0 million equity commitment by November 18, 2005. NASC delivered the debt commitment letters and the solvency opinion on October 21, 2005.

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 Formation Capital Consortium's indication of interest, the proxy contest and the sales process, including legal fees, investment banking advisory fees and other related costs. During the first quarter of 2005, we engaged two investment banking firms to assist us in evaluating proposals, both solicited and unsolicited, to acquire us or any of our assets or businesses. Under the terms of the engagements we are required to pay fees to the two firms whether or not we are sold. In the case of a sale, the fees are a percentage of the consideration received in connection with our sale, with the percentage of compensation increasing with an increase in the sales value. If there is no sale, the firms each receive a flat fee. As a result, we recorded a liability of \$19.8 million, of which \$4.5 million has been paid as of September 30, 2005, with the remaining liability included in "Other accrued liabilities" on the September 30, 2005 condensed consolidated balance sheet. We have also incurred other costs related to the sales process and have recorded additional expenses of \$16.8 million, of which \$13.6 million has been paid and \$3.2 million remains accrued at September 30, 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 additional advisory fees, legal fees and other expenses.

General

Despite the Formation Capital Consortium's indication of interest and subsequent sales process, our business unit operating and financial trends continue to be positive. Our 2005 third quarter included revenue growth of nearly 11% with improvements in operating margins, compared to the year-earlier period. We continue to be dedicated to providing quality of care, executing the specific initiatives we have developed to achieve profitable growth in our business segments and improving our financial position.

Our three principal business segments performed ahead of 2004 third-quarter results. On a continuing operations basis, our Nursing Facilities revenue increased 8.5% and pre-tax income increased \$8.6 million, including \$2.9 million due to favorable rate increases in California. Aegis revenues from third-party customers rose 25%, compared with the 2004 third quarter, reflecting increased business with existing clients and the addition of customers. AseraCare revenues were up 51%, primarily due to a 46% increase in average daily census and the openings of 17 new hospice locations and five new home health agencies.

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 for the three months ended September 30, 2005, increased 23% from the same period in 2004, excluding \$11.5 million of costs related to the sales process discussed above and \$2.9 million of a retroactive Medicaid rate adjustment in California for the 2005 third quarter, as well as, \$176,000 of costs related to early extinguishments of debt in the 2004 third quarter.

Critical Accounting Policy Update

General and Professional Liabilities

Our long-term other liabilities and deferred items decreased \$56.2 million from December 31, 2004, and our cash flows for the nine months ended September 30, 2005 decreased \$49.5 million, primarily due to payments for patient claims settlements. Our provision for liabilities that may arise out of patient care and related services is 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

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

recent trends of claims, settlements and other relevant data. As part of this valuation, patient care liabilities are discounted at our incremental borrowing rate of 8.5%, using actuarially determined claims payment timing patterns. Our next actuarial study will be completed in late 2005 using data through September 30, 2005. Between each independent actuarial evaluation, the trends with respect to claims and settlements made and other relevant data will change. As a result, there is a reasonable possibility that our liabilities for patient care and related services, as determined by us and our actuaries, may be adjusted by a material amount in the near term. We cannot currently predict the impact, if any, of our current data trends on the actuarial study to be completed later this year.

Operating Results

Reclassification

Results of operations for the three-month and nine-month periods ended September 30, 2005 and 2004, reflect asset dispositions during 2005 and 2004, as discontinued operations. The following discussions reflect this reclassification and include the 22 California facilities as held and used (see Item 1. Note 5).

Results of Operations Continuing Operations

Third Quarter 2005 Compared to Third Quarter 2004. We reported pre-tax income from continuing operations of \$20.9 million for the three months ended September 30, 2005, compared to a pre-tax income of \$23.9 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 38%, for the three months ended September 30, 2005, compared to the same period in 2004.

Pre-tax income from continuing operations for the third quarter of 2005 included the following special pre-tax charges:

\$11.5 million for costs related to the sales process (see Item 1. Note 4). These costs primarily include legal fees, investment banking advisory fees and other related costs; and

\$400,000 for certain retention and severance agreements.

Nine Months 2005 Compared to Nine Months 2004. We reported an increase in pre-tax income from continuing operations to \$81.8 million for the nine months ended September 30, 2005, compared to \$33.7 million for the same period in 2004. The year-over-year 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 58% for the nine months ended September 30, 2005, compared to the same period in 2004.

Pre-tax income from continuing operations for 2005 included the following special pre-tax charges:

\$36.6 million for costs related to the sales process, of which \$18.1 million has been paid and \$18.5 million remains accrued as of September 30, 2005 (see Item 1. Note 4). These costs include legal, investment banking advisory fees and other related costs; and

\$400,000 for certain retention and severance agreements.

Pre-tax income from continuing operations for 2004 included the following special pre-tax charges (adjustments):

\$40.4 million for costs related to the early extinguishment of debt. During the second quarter of 2004, we issued \$215.0 million of 7⁷/₈% senior subordinated notes. The proceeds from the senior subordinated

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

notes, together with cash on hand, were used to purchase \$190.6 million of our 9⁵/₈% senior notes and to pay related fees and expenses. In conjunction with these transactions, we paid a prepayment premium of \$36.1 million and wrote off \$3.7 million of related deferred financing costs. We also paid \$681,000 in tender fees related to the cash tender offer on the 9⁵/₈% senior notes;

\$2.9 million for asset impairments, primarily related to two nursing facilities;

\$443,000 for workforce reduction charges, less \$346,000 in related credits, primarily due to the cancellation of restricted stock. The \$443,000 for workforce reductions primarily related to 35 associates who were notified in 2004 that their positions would be eliminated and included \$401,000 of cash expenses paid during the year ended December 31, 2004;

\$1.3 million reversal of a previously recorded charge as a result of an impaired foreign investment being sold above its carrying value;

\$375,000 adjustment to our Florida disposition costs as a result of collecting a note receivable, received as partial payment for that transaction, above the carrying value; and

\$161,000 adjustment to certain retention and severance agreements.

Revenues

Revenues from external customers by operating segment for the three months and nine months ended September 30 (in thousands) are as follows:

| | Three Months Ended September 30, | | Nine Months Ended September 30, | | Change | | | |
|-----------------------|----------------------------------|-------------------|---------------------------------|---------------------|------------------------------------------------|--------------|-----------------------------------------------|--------------|
| | September 30, | | September 30, | | Three Months Ended September 30, 2005 vs. 2004 | | Nine Months Ended September 30, 2005 vs. 2004 | |
| | 2005 | 2004 | 2005 | 2004 | \$ | % | \$ | % |
| Nursing Facilities | \$ 513,267 | \$ 472,962 | \$ 1,564,351 | \$ 1,401,546 | \$ 40,305 | 8.5% | \$ 162,805 | 11.6% |
| Aegis | 39,864 | 31,975 | 113,068 | 89,023 | 7,889 | 24.7% | 24,045 | 27.0% |
| AseraCare | 28,876 | 19,062 | 79,225 | 42,214 | 9,814 | 51.5% | 37,011 | 87.7% |
| Other | 1,935 | 843 | 4,911 | 4,013 | 1,092 | 129.5% | 898 | 22.4% |
| Total revenues | \$ 583,942 | \$ 524,842 | \$ 1,761,555 | \$ 1,536,796 | \$ 59,100 | 11.3% | \$ 224,759 | 14.6% |

Third Quarter 2005 Compared to Third Quarter 2004. Approximately 88% and 90% of our revenues for the three months ended September 30, 2005 and 2004, respectively, were derived from services provided by our Nursing Facilities segment. The increase in total revenues of \$59.1 million for the three months ended September 30, 2005, as compared to the same period in 2004, is primarily due to the following, by operating segment:

Nursing Facilities:

an increase of \$23.9 million, \$4.2 million and \$2.6 million due to increases in Medicaid, Medicare and private payment rates, respectively;

an increase of \$7.4 million due to a positive shift in our patient mix; and

an increase of \$400,000 due to an increase in census;

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

Aegis:

an increase of \$7.9 million from growth in Aegis external therapy business, including a 4% growth in average revenue per contract and an increase in new customers;

AseraCare:

an increase of \$9.8 million, including \$3.6 million due to the openings of 17 new hospice locations and \$6.2 million from the remaining operations.

Nine Months 2005 Compared to Nine Months 2004. Approximately 89% and 91% of our revenues for the nine months ended September 30, 2005 and 2004, respectively, were derived from services provided by our Nursing Facilities segment. The increase in total revenues of \$224.8 million for the nine months ended September 30, 2005, as compared to the same period in 2004, is primarily due to the following, by operating segment:

Nursing Facilities:

an increase of \$54.9 million, primarily due to retroactive Medicaid rate adjustments in Indiana, Pennsylvania and California;

an increase of \$65.5 million, \$17.9 million and \$9.8 million due to increases in Medicaid, Medicare and private payment rates, respectively;

an increase of \$17.1 million due to a positive shift in our patient mix;

an increase of \$5.9 million in Medicare Part B revenues, primarily due to increased therapy-related services; partially offset by

a decrease of \$4.9 million due to one less calendar day during 2005, as compared to the same period in 2004; and

a decrease of \$3.5 million due to a decline in census;

Aegis:

an increase of \$24.0 million from growth in Aegis external therapy business, including a 4% growth in average revenue per contract and an increase in new customers;

AseraCare:

an increase of \$18.1 million due to the Hospice USA acquisition; and

an increase of \$18.9 million, including \$7.2 million due to the openings of new hospice locations and \$11.7 million from the remaining operations.

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

Costs and Expenses

The following table details costs and expenses, excluding special pre-tax charges (adjustments), for the three months and nine months ended September 30 (in thousands):

| | Three Months Ended September 30, | | Nine Months Ended September 30, | | Change | | | |
|--------------------------------------------------------------------------|----------------------------------|------------|---------------------------------|--------------|------------------------------------------------|-------|-----------------------------------------------|-------|
| | September 30, | | September 30, | | Three Months Ended September 30, 2005 vs. 2004 | | Nine Months Ended September 30, 2005 vs. 2004 | |
| | 2005 | 2004 | 2005 | 2004 | \$ | % | \$ | % |
| Wages and related | \$ 331,126 | \$ 311,850 | \$ 971,216 | \$ 889,193 | \$ 19,276 | 6.2% | \$ 82,023 | 9.2% |
| Provision for insurance and related items | 35,807 | 29,590 | 97,416 | 94,225 | 6,217 | 21.0% | 3,191 | 3.4% |
| Other operating and administrative | 156,527 | 134,962 | 495,506 | 402,036 | 21,565 | 16.0% | 93,470 | 23.2% |
| Depreciation and amortization | 19,355 | 15,624 | 53,621 | 45,863 | 3,731 | 23.9% | 7,758 | 16.9% |
| Total costs and expenses excluding special pre-tax charges (adjustments) | \$ 542,815 | \$ 492,026 | \$ 1,617,759 | \$ 1,431,317 | \$ 50,789 | 10.3% | \$ 186,442 | 13.0% |

Third Quarter 2005 Compared to Third Quarter 2004. Excluding special pre-tax charges (adjustments) discussed above, our total costs and expenses increased \$50.8 million quarter over quarter, primarily due to the following:

- an increase of \$10.9 million in state-imposed provider taxes, primarily associated with changes in state plans, including a retroactive Medicaid rate adjustment in California, included in our Nursing Facilities segment;

- an increase of \$9.5 million in Aegis wages and related expenses due to increased staffing associated with the increased volume of new contracts. This includes a \$560,000, or 12%, increase in Aegis contract therapy costs;

- an increase of \$6.2 million in our provision for insurance and related items, related to the discounting impact of the acceleration of certain patient care liability settlement payments;

- an increase of \$4.6 million in AseraCare wages and related expenses primarily due to openings of new hospice and home health locations;

- an increase in depreciation and amortization expense, primarily due to an increase in capital expenditures in our Nursing Facilities segment and incremental depreciation and amortization related to our facilities in California

which had been previously held for sale;

an increase of \$2.3 million in contracted services; and

an increase of \$700,000 in Nursing Facilities wages and related expenses primarily due to a 3% increase in the weighted average wage rate, substantially offset by a decrease in employee benefit plan expenses.

Nine Months 2005 Compared to Nine Months 2004. Excluding special pre-tax charges (adjustments) discussed above, our total costs and expenses increased \$186.4 million, primarily due to the following:

an increase of \$68.3 million in state-imposed provider taxes, primarily associated with Medicaid rate adjustments in Indiana, Pennsylvania and California, included 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 of \$28.4 million in Aegis wages and related expenses due to increased staffing associated with the higher volume of new contracts. This increase includes a \$3.9 million, or 32%, increase in Aegis contract therapy cost;

an increase of \$14.8 million in Nursing Facilities wages and related expenses, primarily due to a 3.8 % increase in the weighted average wage rate, partially offset by a decrease in employee benefit plan expenses;

an increase of \$26.4 million due to the Hospice USA acquisition and the opening of 17 new hospice locations and five home health centers;

an increase of \$8.0 million in contracted services;

an increase in depreciation and amortization expense, primarily due to an increase in capital expenditures in our Nursing Facilities segment and incremental depreciation and amortization related to our facilities in California which had previously been held for sale;

A \$3.2 million increase in our provision for insurance and related items, primarily related to the discounting impact of the acceleration of certain patient care liability settlement payments.

Other Income and Expenses, Net

Other income and expenses for the three months and nine months ended September 30 are as follows (in thousands):

| | Three Months Ended | | Nine Months Ended | | Change | | | |
|------------------------------------------------------|--------------------|-------------|-------------------|-------------|-----------------------------|--------|-----------------------------|--------|
| | September 30, | | September 30, | | Three Months Ended | | Nine Months Ended | |
| | 2005 | 2004 | 2005 | 2004 | September 30, 2005 vs. 2004 | | September 30, 2005 vs. 2004 | |
| | | | | \$ | % | \$ | % | |
| Other income (expenses): | | | | | | | | |
| Interest expense | \$ (10,704) | \$ (11,089) | \$ (32,051) | \$ (34,965) | \$ 385 | (3.5)% | \$ 2,914 | (8.3)% |
| Costs related to early extinguishment of debt(1) | | (176) | | (40,430) | 176 | | 40,430 | |
| Costs related to the sales process of the Company(1) | (11,514) | | (36,566) | | (11,514) | | (36,566) | |
| Interest income | 2,407 | 1,246 | 6,434 | 4,090 | 1,161 | 93.2% | 2,344 | 57.3% |
| Net gains on dispositions | 44 | 582 | 667 | 614 | (538) | | 53 | |

| | | | | | | | | |
|---------------------------|-------------|------------|-------------|-------------|-------------|--------|----------|---------|
| Total other expenses, net | \$ (19,767) | \$ (9,437) | \$ (61,516) | \$ (70,691) | \$ (10,330) | 109.5% | \$ 9,175 | (13.0)% |
|---------------------------|-------------|------------|-------------|-------------|-------------|--------|----------|---------|

(1) See *Results of Operations – Continuing Operations* for a discussion of these special pre-tax charges.

Interest expense decreased 3% and 8% for the three and nine-month periods ended September 30, 2005, as compared to the same periods in 2004, respectively, primarily due to the June 2004 refinancing of our 9⁵/₈% senior notes and the reduction of debt through the use of proceeds from sales of facilities.

Results of Operations – Discontinued Operations

The results of operations of facilities, clinics and other assets disposed of in the three-month and nine-month periods ended September 30, 2005, 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 to these transactions.

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

A summary of discontinued operations by operating segment, is as follows (in thousands):

| | 2005 | | | | 2004 | | | |
|------------------------------------------|-----------------------|--------|--------------|--------|-----------------------|----------|--------------|-----------|
| | Nursing Facilities | Matrix | Home Care | Total | Nursing Facilities | Matrix | Home Care | Total |
| <i>Three Months Ended</i> | | | | | | | | |
| <i>September 30</i> | | | | | | | | |
| Revenues | \$ 393 | \$ | \$ | \$ 393 | \$ 12,926 | \$ 3,563 | \$ | \$ 16,489 |
| Operating income (loss)(1) | \$ 733 | \$ 4 | \$ 14 | \$ 751 | \$ (31) | \$ 211 | \$ 33 | \$ 213 |
| Gain (loss) on sales and exit costs | (311) | | | (311) | 228 | (24) | 366 | 570 |
| Impairments and other unusual items | | | | | 242 | | | 242 |
| Pre-tax income | \$ 422 | \$ 4 | \$ 14 | 440 | \$ 439 | \$ 187 | \$ 399 | 1,025 |
| Benefit from state income taxes | | | | (80) | | | | (59) |
| Discontinued operations, net of taxes | | | | \$ 520 | | | | \$ 1,084 |

(1) Includes net interest expense of \$41,000 for 2004, as well as depreciation and amortization expense of \$6,000 and \$323,000 for 2005 and 2004, respectively.

| | 2005 | | | | 2004 | | | |
|----------------------------------------|-----------------------|----------|--------------|-----------|-----------------------|-----------|--------------|------------|
| | Nursing Facilities | Matrix | Home Care | Total | Nursing Facilities | Matrix | Home Care | Total |
| <i>Nine Months Ended</i> | | | | | | | | |
| <i>September 30</i> | | | | | | | | |
| Revenues | \$ 8,943 | \$ 2,546 | \$ | \$ 11,489 | \$ 64,856 | \$ 10,466 | \$ 148 | \$ 75,470 |
| Operating income (loss)(1) | \$ 129 | \$ 456 | \$ (220) | \$ 365 | \$ (5,898) | \$ 859 | \$ 1 | \$ (5,038) |
| Gain (loss) on sales and exit costs | 1,825 | | | 1,825 | (853) | (49) | 369 | (533) |
| | | | | | (2,855) | | | (2,855) |

**Impairments and other
unusual items**

| | | | | | | | | |
|-----------------------|----------|--------|----------|-------|------------|--------|--------|---------|
| Pre-tax income (loss) | \$ 1,954 | \$ 456 | \$ (220) | 2,190 | \$ (9,606) | \$ 810 | \$ 370 | (8,426) |
|-----------------------|----------|--------|----------|-------|------------|--------|--------|---------|

| | | | | | | | | |
|----------------------------------------------------|--|--|--|---------|--|--|--|-----|
| Provision for (benefit from) state income taxes | | | | (1,438) | | | | 286 |
|----------------------------------------------------|--|--|--|---------|--|--|--|-----|

| | | | | | | | | |
|------------------------------------------|--|--|--|----------|--|--|--|------------|
| Discontinued operations, net of taxes | | | | \$ 3,628 | | | | \$ (8,712) |
|------------------------------------------|--|--|--|----------|--|--|--|------------|

(1) Includes net interest expense of \$36,000 and \$262,000 for 2005 and 2004, respectively, as well as depreciation and amortization expense of \$352,000 and \$1.8 million for 2005 and 2004, respectively.

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

Income Taxes

Our provision for income taxes from continuing operations of \$2.7 million for the nine months ended September 30, 2005 primarily relates to state income taxes estimated to be due in separate return filing states where we conduct business, as well as federal alternative minimum tax (AMT). We recorded a tax benefit in discontinued operations of \$1.4 million for the nine months ended September 30, 2005, primarily related to state tax refunds in a state where we have ceased operations. The valuation allowance on our net deferred tax assets decreased by \$41.7 million during the nine months ended September 30, 2005 to \$116.6 million, primarily due to the reversal of temporary differences and the utilization of net operating loss carryforwards and general business tax credits to offset taxable income for the period.

New Accounting Standard

In December 2004, the FASB issued SFAS No. 123R which, when effective, will eliminate 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 provides further clarification on the implementation of SFAS No. 123R and provides alternative phase-in methods. The SEC announced in the second quarter of 2005 that it is extending the phase-in period for expensing of stock-based awards, 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 and based on the current estimated value of unvested stock options, we expect wages and related expenses to increase approximately \$500,000 in 2006.

Liquidity and Capital Resources

At September 30, 2005, we had \$217.8 million in cash and cash equivalents and \$7.3 million of investments with maturities between three and six months. We anticipate that \$42.8 million of our 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 September 30, 2005, we had approximately \$12.9 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 September 30, 2005, we had positive working capital of \$191.2 million reflected on our condensed consolidated balance sheet, a 16% increase from year-end 2004. At September 30, 2005, we had \$90 million of unused commitments under our revolving credit facility and \$17.7 million of unused commitments under our letter of credit facility.

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

Cash Flows. Our cash flows consisted of the following for the three-month and nine-month periods (in thousands):

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|------------------------------------------------------|-------------------------------------|------------|------------------------------------|-------------|
| | 2005 | 2004 | 2005 | 2004 |
| Net cash provided by (used for): | | | | |
| Operating activities | \$ 35,737 | \$ 59,696 | \$ 71,104 | \$ 37,720 |
| Investing activities | (24,011) | (65,306) | (60,567) | (51,147) |
| Financing activities | (6,471) | (3,493) | (8,359) | (38,028) |
| Net increase (decrease) in cash and cash equivalents | \$ 5,255 | \$ (9,103) | \$ 2,178 | \$ (51,455) |

Net cash provided by operating activities, under the direct method, for the nine months ended September 30, consists of the following (in thousands):

| | 2005 | 2004 |
|----------------------------------------------------|--------------|--------------|
| Cash received from patients and third-party payors | \$ 1,727,883 | \$ 1,558,311 |
| Interest received | 6,438 | 4,109 |
| Cash paid to suppliers, employees and others | (1,640,214) | (1,487,910) |
| Interest paid | (24,834) | (30,969) |
| Income tax (paid) refunds received | 1,831 | (5,821) |
| Net cash provided by operating activities | \$ 71,104 | \$ 37,720 |

The \$71.1 million of net cash provided by operating activities and \$14.2 million of proceeds from dispositions were primarily used to fund capital expenditures of \$68.2 million and to pay down long-term debt for the nine months ended September 30, 2005. For the nine months ended September 30, 2004, net cash provided by operating activities was affected by an increase in accounts receivable, principally 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 detriment to cash from operating activities on our condensed consolidated statement of cash flows for 2004. Accounts receivable increased during the nine months ended September 30, 2005, primarily due to the recording of retroactive receivables from Indiana, Pennsylvania and California associated with a change in the Medicaid plans in those states and increased revenues.

Debt transaction. During June 2005, we entered into a mortgage loan for \$5.2 million for the construction of a nursing facility. This loan bears interest at 30-day LIBOR plus 2.5%, requires monthly principal and interest payments and is secured by the real property and a security interest in the personal property of the nursing facility.

Divestitures. During the nine months ended September 30, 2005, we sold two nursing facilities for \$13.0 million in cash and 10 outpatient clinics for \$4.6 million, including \$710,000 cash and \$3.8 million of notes receivable.

Sale of the Company. Our results of operations, financial condition, cash flows and liquidity will continue to be adversely impacted by the ongoing sales process. To date we have incurred various costs as a result of the Formation Capital Consortium's indication of interest, the proxy contest and the sales process, including legal fees, investment banking advisory fees and other related costs. During the nine months ended

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

September 30, 2005, we recorded \$36.6 million of such costs, of which \$18.1 million has been paid and \$18.5 million remains accrued as of September 30, 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 additional advisory fees, legal fees and other expenses. The amount and impact of these potential additional expenses cannot be reasonably estimated at this time.

Insurance. Our cash flows for the nine months ended September 30, 2005 decreased by \$49.5 million for insurance related items, primarily due to payments for patient claims settlements. Total claim payments for the three months and nine months ended September 30, 2005, were in excess of the estimates derived from our last actuarial study. A portion of this amount relates to an \$18.9 million class action settlement associated with two previously disposed facilities in the state of Arkansas. This class action settlement amount, along with certain related patient care claim settlements, were funded during the third quarter of 2005 and recorded against previously recorded patient care liability reserves.

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 \$8.2 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 September 30, 2006.

Our ability to make payments on, and to refinance, our indebtedness, as well as to fund planned capital expenditures, including strategic acquisitions, 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, 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 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 September 30, 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
September 30, 2005
(Unaudited)

ITEM 1. LEGAL PROCEEDINGS.

There have been no material developments to the information presented under Part II. Item 1. Legal Proceedings in our Quarterly Report on Form 10-Q for the quarter ended June 30, 2005.

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 | Certificate of Designations of Series A Junior Participating Preferred Stock of Beverly Enterprises, Inc. |
| 3.4 | 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)) |
| 10.1 | Agreement and Plan of Merger by and among North American Senior Care, Inc. (incorporated by reference to Exhibit 2.1 to Beverly Enterprises, Inc. s Current Report on Form 8-K filed on August 17, 2005) |
| 10.2 | First Amendment to Agreement and Plan of Merger by and among North American Senior Care, Inc. (incorporated by reference to Exhibit 2.1 to Beverly Enterprises, Inc. s Current Report on Form 8-K filed on August 24, 2005) |
| 10.3 | Resolution, dated September 6, 2005, of the Board of Directors of Beverly Enterprises, Inc., authorizing the Special Compensation for Mr. John D. Fowler, Jr. (incorporated by reference to Exhibit 10.1 to Beverly Enterprises, Inc. s Current Report on Form 8-K filed on September 7, 2005) |
| 10.4 | Second Amendment to Agreement and Plan of Merger by and among North American Senior Care, Inc. (incorporated by reference to Exhibit 2.1 to Beverly Enterprises, Inc. s Current Report on Form 8-K filed on August 23, 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 |

Filed herewith

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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: November 7, 2005