

people  
change  
people

Cornell Companies **2000**  
Annual Report

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# Critical Success Factors

In early 2000, Cornell senior management refined its strategic business plan to focus on company growth, increase shareholder value, and continue building a strong organization poised to manage rapid change. The plan incorporates five critical success factors that will allow us to achieve our overall financial and strategic goals:

**INCREASE SHAREHOLDER VALUE** – Cornell is committed to profitable annual revenue growth, superior margins, effective cost management, and enhanced shareholder value. We will employ increasingly sophisticated strategies and tools for budget planning, operations management, and strategic development, and will continue to provide meaningful and timely feedback to our stakeholders.

**ENSURE A QUALITY WORKFORCE** – Our employees are our most valuable resource, and our reputation as a diversified organization with a common culture of dedicated employees is unparalleled in our emerging industry. Aggressive recruitment, careful selection and screening, and intensive training (both initial and ongoing) of employees allow Cornell to continue to grow and prosper.

**CREATE GROWTH OPPORTUNITIES AND PROACTIVELY IMPACT THE EXTERNAL ENVIRONMENT** – Our marketing and development efforts are designed to create growth opportunities by identifying and evaluating all opportunities, though we pursue only those that meet our strict financial

requirements and match our strategic plan. In addition, we also communicate Cornell's positive outcomes to the media in order to educate the public and our government on the benefits of privatization as well as The Cornell Difference. And finally, on the legislative front, we advocate sound public policy that takes full advantage of the strengths of our industry and our company.

**CLIENTS/INMATES BENEFIT FROM THE CORNELL EXPERIENCE** – Our company is mission and values driven, client-oriented, and focused on exemplary service. Cornell provides quality correctional, treatment, counseling and educational services to those entrusted to our care. We ensure this outcome through continual program evaluation and effective, expedient responses to our own data.

**EXCEED CUSTOMER EXPECTATIONS** – Cornell provides the highest quality service because we are committed to meeting the needs of our stakeholders – the agencies we serve, our clients, inmates and their families, our communities, our employees and our shareholders.

**Our strategic business plan is centered on these critical success factors. When implemented with our continuing commitment to anticipate the market, our plan will ensure the financial growth of the company and an increase in shareholder value.**

# To Our Shareholders

Sports experts consider Wayne Gretzky one of the greatest ice hockey stars the game has ever known. He was the league's most prodigious goal scorer. He was asked once in an interview, "Why do you think you have become a legend in the game of hockey?" Gretzky is reported to have responded that while others skate aggressively to where the puck is, he skated, just as vigorously, to where he thought the puck was going to be.

"In this way," he said, "when the puck comes to me, I am ready to score."

In his response, Gretzky captures the business vision that has guided Cornell Companies. Our "goal" is to identify the market demands of the future, while enhancing our strength and capacity to respond to those demands before our competitors do so. And we are doing well: Cornell Companies has capitalized on opportunities in the past and we are positioned for dramatic success in the future.

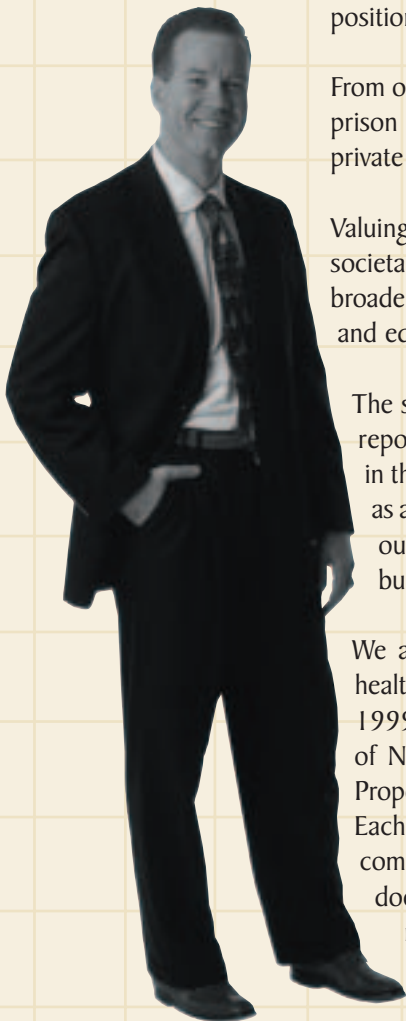
From our origins as a development company, we saw the opportunity to also operate the prison facilities we helped build. We "scored" and have become one of the largest private providers of corrections services in the nation.

Valuing diversification of service lines and recognizing juvenile justice as an ongoing societal need, we acquired one of the nation's leading juvenile operators, thus giving us broader experience and credibility. When the need for juvenile institutional, treatment and educational services increased in the marketplace, we scored.

The same is true in the area of adult community-based re-entry services. USA Today reports that an unprecedented 585,000 inmates will be released into the community in the year 2001, and society is beginning to understand that transition services, such as aftercare, is the key way to reduce recidivism. We anticipated this need, establishing our pre-release platform in the mid-1990s, providing us with the experience and business base to respond to the demand. Another score!

We anticipated the dramatic need for increased levels of treatment and behavioral health services, and enhanced our corporate resume with the acquisition at the end of 1999 of one of the nation's leading treatment providers. Today, the state governments of New York and Oklahoma and the voters of California, through the passage of Proposition 36, are increasing the market demand for alternatives to incarceration. Each state has decided to send first-time, non-violent drug and alcohol offenders to community-based treatment programs rather than to prison. While this important trend does not alleviate the tremendous need for additional prison beds, Cornell has the resources, talent and experience to meet this alternative need on a national scale.

Once again, we anticipated the demand and we are positioned to score.

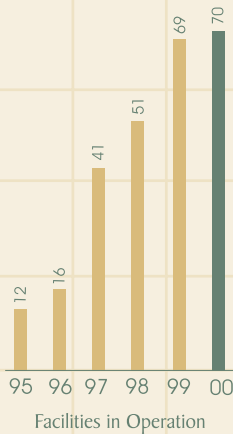


**Steven W. Logan**

Chief Executive Officer  
and President

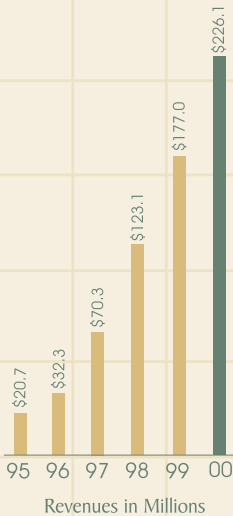
## FINANCIAL HIGHLIGHTS

With this foresight and positioning, Cornell Companies seized the opportunities and responded to the challenges of 2000. In spite of increased labor costs caused by last year's full economy, we significantly increased our income from operations. Although debt incurred to penetrate new markets combined with an increasing interest rate environment impacted net income, the recession-proof nature of our growth industry is an added strength and positions us to benefit as the economy slows.



- Year 2000 revenues increased 28% to \$226.1 million, up from \$177.0 million in 1999 and \$123.1 million in 1998.
- Income from operations was \$29.1 million for 2000, compared to \$22.2 million for 1999 and \$12.6 million for 1998.
- Net income was \$7.9 million for 2000, or \$.84 cents per diluted share, compared to \$8.3 million of income before cumulative effect of change in accounting principle for 1999, or \$.86 per diluted share, as stronger operating results were reduced by higher interest costs. The comparable numbers for 1998 are \$6.1 million, or \$.62 per diluted share.

I am pleased with the significant refinancing completed during 2000. We successfully refinanced our prior short-term \$40 million bridge loan with favorable long-term financing. In addition, we increased the capacity of our line of credit and lease financing for construction, and increased these maturity dates through 2005. This refinancing was completed on attractive terms and provides funding for the full construction of all awarded backlog contracts.



## THE STATE OF THE INDUSTRY

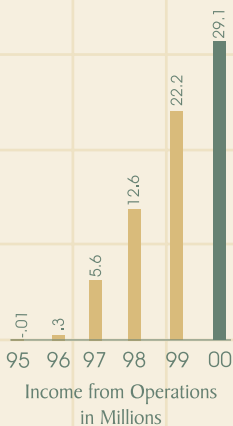
There are growing pains with any emerging industry and private corrections has had its share. Incidents occurring at privately operated facilities often receive disproportionate media scrutiny as compared to our counterpart government-run institutions. However, with the tremendous demand for correctional and treatment services, the best business models should prevail, thus creating additional opportunities for Cornell.

The core fundamentals of our industry remain strong. Because correctional facilities in the United States are currently operating at 120% of capacity, it is estimated that we would need to add 8,000 beds per week for a full year merely to bring us down to 100% of capacity. Once at capacity, we would have to continue to add another 2,000 beds per week just to keep demand from exceeding 100% capacity.

## OPERATIONS OVERVIEW

The operating elements of the company scored on many levels during 2000.

During the year, we opened the New Morgan Academy, in Morgantown, Pennsylvania. Focus groups of key juvenile justice leaders were conducted to identify the needs not being met by current facilities. These focus groups, comprised of juvenile justice experts, experienced probation officers, and juvenile court judges, helped us design this 214-bed facility to meet the special needs of their most serious of the juvenile offenders.



We have continued to respond to the needs of our customers by expanding our community-based treatment programs and are now carefully reviewing the growing demand for successful alternative education programs.

The awards and recognition our facilities earn present the highest testimony to the quality of Cornell Companies' efforts. Our D. Ray James prison in Folkston, Georgia, achieved its American Correctional Association (ACA) accreditation after earning a perfect 100% score. Our Santa Fe County Youth Development Program was awarded dual ACA accreditation (for both our training school and our detention center), making it one of only a few in the country to receive such an award.

## BUSINESS DEVELOPMENT

During 2000, our business development department anticipated changes in demand, diversified our bidding targets, and scored for the company. In addition to the traditional industry sectors of adult secure and juvenile justice, both residential and non-residential, we pursued increased initiatives involving grants as well as counseling, educational, treatment and behavioral health services.

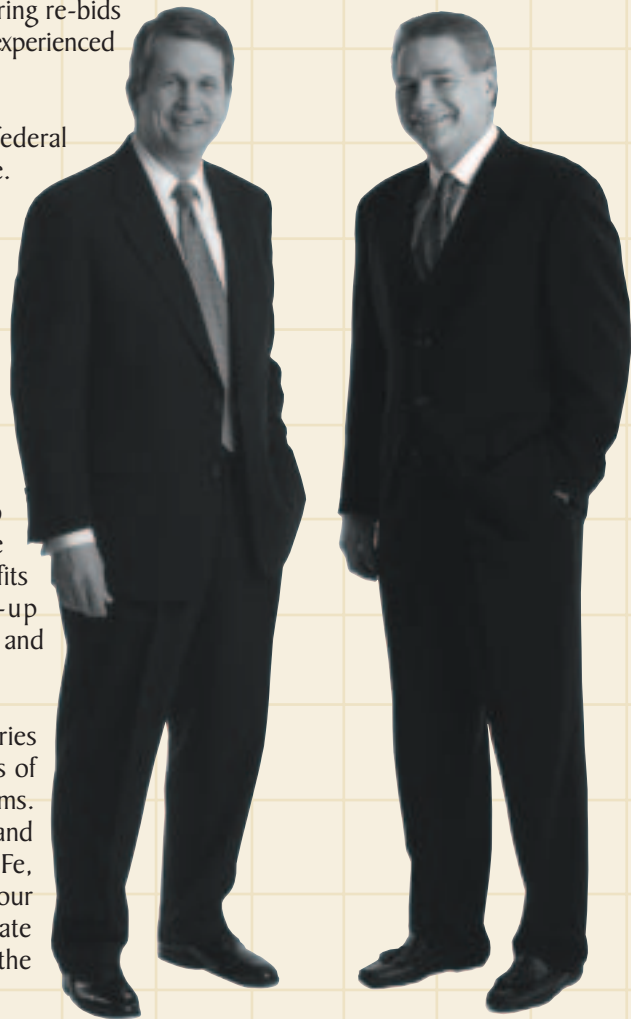
In anticipation of the tightening credit market during 2000, we placed heavy emphasis on increasing our non-capital intensive service lines. It was our success with high-margin facility expansions and treatment services that fueled much of our profits this past year without significant burden to the balance sheet. In addition, we have made great strides toward increasing our existing revenue per diem rates during re-bids of existing contracts to recoup certain increases in costs that were experienced last year.

We are also seeing an unprecedented level of demand for federal incarceration beds, and we anticipate this demand to continue. We have currently submitted proposals for four federal facilities, totaling 6,000 beds, and anticipate requests for proposals for another 3,000 federal beds before the end of this year. In addition, in December 2000, the president signed legislation supporting longer-term, easier-to-finance federal contracts.

## PUBLIC OUTREACH

In our emerging industry, we are committed to communicating the positive story of Cornell Companies and of privatization to key audiences around the country. The industry must educate the public, the media and the government as to the many benefits of privatization, and must respond quickly to clear-up misunderstandings. Once again, Cornell recognized this need and responded.

During 2000, we enhanced our ability to respond to media inquiries and, more importantly, to proactively promote public awareness of the good work and positive outcomes of our facilities and programs. The results have been impressive. The media in Big Spring and Dallas, Texas, Erie and Philadelphia, Pennsylvania, and Santa Fe, New Mexico, ran major stories on the positive work going on in our facilities. We are currently promoting our position on the private corrections industry to the editorial boards and reporters of the Atlanta Journal, Atlanta Constitution, Reading Eagle, San Francisco Examiner and Los Angeles Times. In addition, we are pitching positive stories about privatization and



**John L. Hendrix**

Senior Vice President  
and Chief Financial Officer

**Thomas R. Jenkins**

Senior Vice President  
and Chief Operating Officer

Cornell Companies to reporters from the Nightly Business Report, USA Today, Albuquerque Journal, Pittsburgh Tribune Review, Philadelphia Inquirer, plus various other financial media groups.

## INITIATIVES FOR THE YEAR 2001

Every day, the more than 3,500 Cornell Companies employees across five time zones work to improve the value of the company through the quality of our service, the efficiency of our operations, and the strength of our image. The initiatives we are pursuing include:

- Making significant progress toward eliminating the debt on our balance sheet through a potential sale-leaseback of our real estate portfolio. If we accomplish this, Cornell – and perhaps our entire industry – will be able to significantly increase its ability to grow without adding leverage to the balance sheet, and will realize reduced rental costs through more cost-effective financing.
- Rolling-out profit improvement initiatives and increasing systems capacity throughout our organization to capitalize on our strong foundation.
- Expanding our growth in the adult secure arena and also taking full advantage of the non-capital intensive growth available to us through expansions and increased emphasis on community-based treatment service lines.
- Further developing our outcome data systems, allowing us to define and replicate our most successful programs, thus increasing shareholder value.
- Continuing the leadership we have demonstrated by being a catalyst to the development of a new industry trade association, the “Association of Private Correctional and Treatment Organizations” (APCTO). Board Director Arlene Lissner has played a major role in the start-up and I am pleased to have been asked to serve as the Association’s first president.

Our company has made great strides in pursuing its vision in this emerging industry. We are one of the leading private providers of adult correctional and juvenile justice services in the world and a recognized leader in quality service and treatment programs. We have anticipated the market trends correctly and we have the talent and experience necessary to meet the demand. We are prepared to capitalize on the opportunities and score!

Gretzky wasn’t great just because he skated to where the puck was going to be: he still had to handle the puck, out-manuever the opposition, and beat the goalie to score. As we look to the future, we too must continue to execute. We will use the talent and experience of our people to score victories for you, our shareholders.

On behalf of the other board members and the people of Cornell, I thank you for your continued commitment to Cornell Companies. We look forward to taking the shots that win victories and provide an outstanding return on your investment.



Steven W. Logan  
Chief Executive Officer and President

# People change people.

**C**hanging a person's behavior is not easy. At Cornell, it takes the united commitment of a wide range of people – investors • clients, inmates and their families • contracting agencies • employees • as well as communities – to effect change. Our company's business is to bring these people together . . .

To make something happen.

To make a difference.



Investor Roadshow  
John Hendrix and Steve Logan

# Investors

Other players go where the puck is, I go where it will be.

Wayne Gretzky

**O**ur investors expect us to “stay ahead of the puck.” They expect us to anticipate both the trends of this dynamic industry and the needs of the company. And we have a strong track record of doing just that.

“Society’s views on the growing industry of corrections are changing,” says Steve Logan, chief executive officer and president of Cornell, “and we position ourselves to be ahead of those changes.” Cornell’s 1999 strategic acquisition of Interventions, an Illinois-based substance abuse treatment company, was a direct result of our anticipation of an increased need across the country for such treatment. Since then, several state governments, including California, Oklahoma and New York, have either proposed or passed legislation supporting mandatory substance abuse treatment for drug and alcohol-related crimes.

With the need for incarceration continuing to steadily grow, society is also realizing what Cornell determined years ago: “Three hots and a cot incarceration” is not the way to effect change in a person’s behavior. Instead, it is imperative that offenders receive value-added

services in connection with incarceration, such as drug treatment, education and employment training, or, when appropriate, an alternative community-based program with similar educational, treatment and employment initiatives.

We saw this trend building, we prepared for it, and we are ready to capitalize on it as it grows throughout the nation. Our diversified service lines enable us to provide a broad range of treatment, education and job skills in numerous venues, including prisons, community-based programs, and juvenile treatment facilities. By staying ahead of society’s trends and by actually helping troubled youth, adults and families, we are becoming known as a leader in the marketplace. We are consistently adding more programs and contract awards. We are increasing our shareholder value.

The services required of a private corrections, treatment and education provider are certainly evolving. To be both successful and effective, we must “stay ahead of the puck.”

**And that is what we do. Every day.**

# Clients, Inmates and Their Families

**S**haron, mother of five, is a changed woman.

Five years ago, as a regular user of drugs and alcohol, Sharon was in denial of her situation. After a felony drug conviction and repeatedly testing positive for drug use, she was remanded to Cornell's Dallas County Judicial Treatment Center (DCJTC) in Wilmer, Texas.

"My life was upside down, and I didn't understand it," says Sharon. "It was obvious I had a problem with drugs, but the alcohol was nobody's business. That was my little secret." Within a few weeks of living at DCJTC and the personal confrontation of her own denial, Sharon did finally admit to both of her addictions. She became a willing participant in her own recovery and attributes her success to Cornell as well as to the loving support of her family – all of whom took part in counseling classes at the facility. "Cornell worked with my kids, my husband, my mom, my dad . . . they gave my family the tools

and taught them the skills necessary to help me succeed."

Sharon embraced the teachings of the program and vowed to use what she had learned at DCJTC to change her life and even to help others in recovery. "Today, I have a wonderful job as a legal assistant supporting eight federal judges, and I'm actively involved in the alumni (aftercare) program at DCJTC, helping others to be as successful as I am. I'll be in recovery all my life, but now I have a foundation upon which I can build a strong future. I've been clean and sober for five years and I thank God every day for Cornell."

Stories like Sharon's are found throughout Cornell. We are dedicated to returning a better person to our communities, and, in doing so, we build better programs, attract better staff, and ultimately win more contracts.

**Sharon is indeed a changed woman.  
And we are a better company for it.**



A Changed Life  
Sharon



Opportunities Abound  
A Cornell Abraxas Client

# Contracting Agencies

**W**hat happens when a juvenile contracting agency does not have a place to send its most troubled youth? “There is a tremendous need for appropriate treatment programs,” says Bill Ford, chief juvenile probation officer of Bucks County, located in southeastern Pennsylvania. “Improper placement can be harmful to people, property, and the community-at-large. Finding the right program for a young fire starter – especially one within our own region – is extremely difficult.”

In response to our contracting agencies’ needs, the company recently celebrated the opening of New Morgan Academy, a 214-bed secure residential treatment program for “hard-to-place kids.” This highly acclaimed, state-of-the-art facility is the result of extensive focus group studies and intensive data gathering sessions with a variety of juvenile contracting agencies. “Cornell set out to fill a service void and respond to the needs of kids with special problems. We are pleased with the results,” says Tom Jenkins, senior vice president, chief operating officer, and leader of the focus groups. “We have provided the northeast, and especially the state of

Pennsylvania, with an effective solution for specialized treatment for its kids.”

The New Morgan Academy is situated on a 50-acre campus near Morgantown, Pennsylvania. There, we utilize an interdisciplinary team of psychologists, therapists, certified teachers, counselors, life skills workers, medical staff and other professionals – in collaboration with court personnel and family members – to develop comprehensive treatment plans designed to address the individual needs of severely troubled youth.

Cornell’s successful partnership and collaboration with contracting agencies is paramount to our company’s growth and success. Only through proactive, open discussions with these agencies can we determine exactly what the marketplace requires. These partnerships help us to build better programs, better serve our clients, offenders and communities, and grow our company profitably.

**These partnerships are  
what make us strong.**

# Employees

In the gritty, tough streets of East St. Louis, Illinois, Cornell employee Don Otis understands the power and allure of drugs. Years ago, when Don went to college on a football scholarship, a career-ending injury wiped out the future he had planned. “So I experimented with drugs and became a guy who ‘knew how to hang out.’ People liked me. The problem was, I just didn’t like myself.”

That was more than 10 years ago. Since then, Don has overcome his substance abuse, rebuilt his life, and returned to the neighborhood of his youth. As facility director of Cornell’s East St. Louis Clinic, a methadone clinic located in the heart of the community, Don and his staff of doctors, nurses and counselors work with approximately 80 clients each day to overcome their addictions to opiates.

“I am fascinated by the internal, personal deception practiced by drug users . . . myself included. When I was at my lowest point in life, completely seduced by drugs, I never considered them as a source of my personal problems.

I had a college degree, a job and a family, and yet by using drugs I systematically destroyed all the good things about my life. Once I sought treatment, I understood that / was the problem. And better yet, I understood that / was also the solution.”

Don is indeed a solution to the rebuilding of the shattered lives of many former addicts in and around the East St. Louis area. His compassion and commitment to restoring dignity and respect to those affected by drugs is a great example shared by many Cornell employees throughout the country.

After all, “People change people.” When employees like Don Otis revive community pride and safety by bringing together the support of our company’s investors, the needs of contracting agencies, and the personal commitment of the clients, offenders and their families, lives change for the better.

**Together, we make a difference.**



Compassion and Commitment

Don Otis



Balanced and Restorative Justice  
Dixie McGurn, Mayor of Folkston, Georgia

# Communities

**T**he Mizell House, in Folkston, Georgia, had fallen into disrepair. This beautiful, historical mansion had been neglected and was ultimately purchased by the city, though the city did not have the funds to restore it. “So we put the word out in the community,” says Dixie McGurn, mayor of Folkston, “that we needed some help.”

And Cornell likes to help.

The D. Ray James Prison, our 1,550-bed secure institution in Folkston, is under contract with the Georgia Department of Corrections (DOC). The Georgia DOC recognizes the value of providing inmate labor within communities, and they allow us to send work details out into the city. Our inmates have built sidewalks, removed trash from the highway, cleaned parks and forests, and now work daily on the restoration of this magnificent landmark in Charlton County. “This is so exciting for our city,” says Mayor McGurn. “There are at least five and as many as ten inmates working on the house, five days a week. These inmates are tradesmen – electricians, painters and carpenters – and they get to use their skills and keep them sharp. Some men are apprentices and are getting on-the-job training. They are truly providing quality workmanship.”

The prison impacts the community in more ways than free labor (inmate work crews). The D. Ray James Prison is the single largest employer in Charlton County and provides an annual economic impact of nearly \$27 million.

“It’s true that Cornell represents growth in our region,” says Mayor McGurn, “but it’s not just that. It’s the community spirit. It’s what they have brought to this town. They are supportive of our Chamber of Commerce, our fundraisers, and our local businesses. It’s great to have their financial support as a taxpayer, but it’s even better to have a good neighbor.”

Growing a successful company that bridges the corrections, juvenile justice, treatment and education industries is enhanced through strong community support, and Cornell works hard to be a good neighbor. The people within our communities invest in our company, are employed by our company, and have family members entrusted to our care. A good relationship with them ensures that we are welcome, and that we can grow with them.

*And when we grow, everyone wins.*

# Outcomes

For Cornell to continue to thrive and compete, we must not only **deliver** high quality services but also **prove** that we are doing so. To this end, the mandate for Cornell's Research and Evaluation Department is to develop data systems that give us an objective understanding of our clientele, our program processes, the impact of our treatment programs and institutions on our clients and inmates, and how the clients and inmates fare after discharge. This data is fed back to Cornell's regions and programs so that our services can be constantly evaluated and improved. Further, the data thus developed for "performance improvement" is communicated to our current and potential customers and contract partners so that they see how well we are doing, which helps us promote additional value-added services.

Our data benefits everyone who has a stake in Cornell's services. As the only national company in the corrections industry that has a research and evaluation department at the senior management level, we have a significant advantage wherever we compete for business, particularly in a business environment that is increasingly moving to results-based contracting. Our approach to data standardization and integration across the wide diversity of our programs facilitates replication of our most successful and profitable programs into new markets, so that we can "stay ahead of the puck," grow our business, and increase the returns to our **investors**. Our **clients, inmates and their families** benefit as timely data ensures program quality. Our **contracting agencies** increasingly ask for additional correctional and treatment funding from their legislatures, and they are pleased when we can provide the data they need to demonstrate the benefits of contracting with Cornell. Cornell's **employees** benefit from programs that they can be proud of and in which they feel safe. And good programs help in our effort to recruit new employees – the lifeblood of our industry – to address staff turnover and to expand our business. Lastly, the **communities** in which we operate benefit from knowing they can rely on Cornell to run programs that are secure, safe and effective.

Together with Cornell's operational regions, our Research and Evaluation Department is developing data systems in support of Cornell's excellence as a service provider. These systems further differentiate Cornell within the world of correctional, treatment and educational services for juvenile and adult offenders. A sample of our results for the year 2000 follows.

## Company Scorecard:

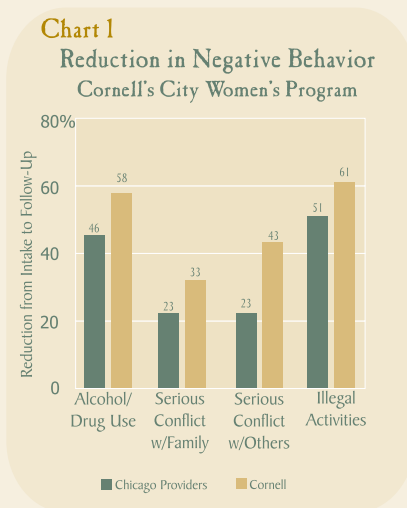
In April 2000, we began the roll-out of a standardized monthly reporting system to capture performance and outcome data for all of Cornell's facilities and programs nationwide. Here are a few "data nuggets" from that reporting system.

- **Only 1.8% out of more than 37,000** drug and alcohol screens administered on clients and inmates throughout the company during the fourth quarter of 2000 resulted in positive readings. Our programs administer screens at different times – by contract, on suspicion, after a home pass, or routinely as part of the program – and our programs remain virtually drug and alcohol free.
- **Approximately twice** the number of clients/inmates required to perform community service actually did community service while in a Cornell program during the last three quarters of the year. Our programs are providing opportunities for community service (or requiring it programmatically) far above what the courts require.
- **More than \$2,300,000** was collected in client and inmate financial contributions (co-payments and restitution for victims) during the last three quarters of 2000, with programs from the Western Region collecting **more than three quarters** of this total.
- **A total of 240,000 hours** of community service were performed by clients and inmates company-wide for the last three quarters of 2000. Most of the clients performing community service were from the Western Region, with an **average of 1,393** clients participating per month. Multiplying the total community service hours by the national minimum wage (\$5.15 per hour) indicates that an equivalent of **more than \$1,200,000** was given back to the community beyond the actual client financial payments noted immediately above.
- **An average of 632** clients and inmates throughout Cornell participated in vocational programs – and **nearly 2,000** of these programs were completed – during the last nine months of 2000.

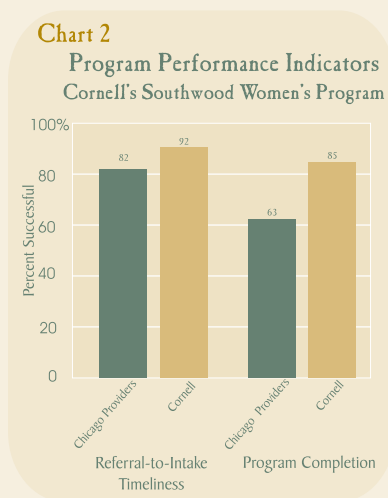
## Benchmarks:

Cornell has been ahead of the industry in tracking outcomes company-wide. However, the “Holy Grail” of outcomes evaluation is to find comparison data – “benchmarks” – with which to measure the success of an agency’s programs and services. The ability to demonstrate that Cornell’s program results not only meet our contract partners’ requirements, but also exceed available comparative data, enhances the continuity of our contracts and supports increases in contract rates.

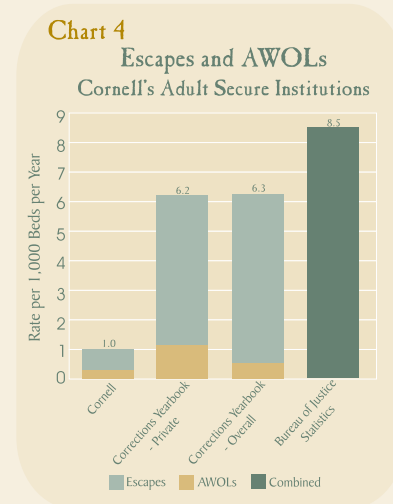
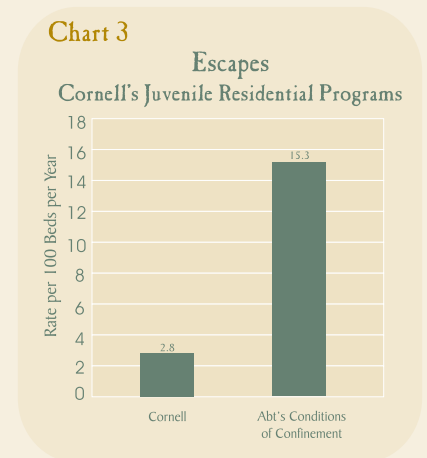
**Chart 1** compares our City Women’s program in Cornell’s Midwest Region with a group of 42 treatment programs that participated in the Chicago Target Cities project, sponsored by the federal Center for Substance Abuse Treatment. The data, from a five-year independent study ending in 1999 by the Illinois Office of Alcoholism and Substance Abuse, shows that the degree of improvement from intake to six-month follow-up on four critical indicators was better for our program than the field.



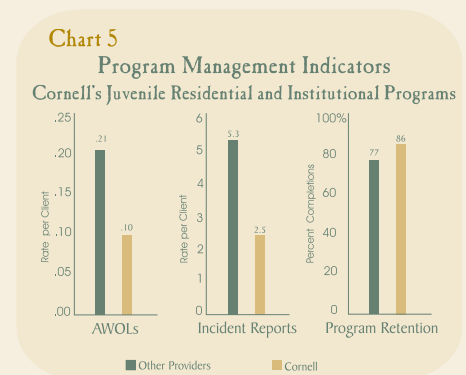
**Chart 2** compares another Midwest program, our Women’s Program at the Southwood facility in Chicago, with a group of local programs treating referrals from the Illinois Department of Children and Family Services during the latter six months of 2000. The independent study by Treatment Alternatives for Safe Communities found that our program was more timely in processing referrals and had a higher program completion rate than the field.



**Charts 3 and 4** compare Cornell’s escape and absent-without-leave (AWOL) rates over two years (July 1998 to June 2000) against the best available national benchmarks. The charts show Cornell’s rates for both juvenile residential and adult secure facilities to be dramatically lower than all of the references surveyed.



**Chart 5** compares Cornell’s juvenile residential and institutional programs in Pennsylvania with similar programs over the last three years (1998 through most of 2000). These data were developed by the Crime and Justice Research Institute, an independent agency tracking referrals from the city of Philadelphia. Cornell programs had much lower AWOL and incident report rates than the field, which resulted in an exceptional program completion rate.



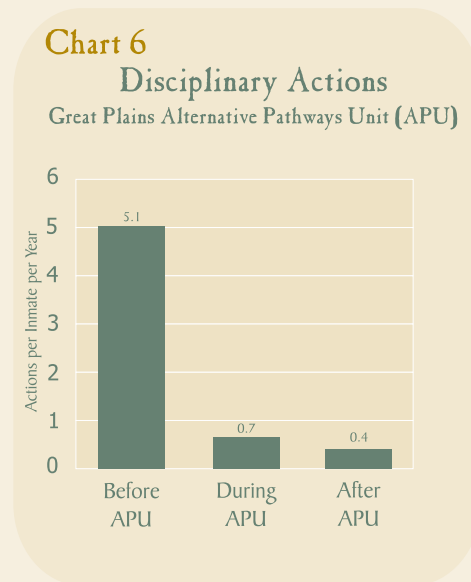
## Program Milestones:

We also compile statistics on individual programs, including data that tracks the progress of our inmates and clients on a variety of indicators as they move toward discharge. This data demonstrates that these programs are indeed working to improve the lives of those in our care so that they have the best chance to succeed after release.

- **1.7, 2.1, 2.6 and 1.3 grade levels** are the respective average gains in reading, math, science and social studies scores during 2000 at our Cornell Abraxas I school in northwest Pennsylvania in approximately seven months of program experience.
- **Almost 2,000** educational and vocational courses and course tracks were successfully completed by the inmate population at our D. Ray James Prison in Georgia during 2000. Additionally, **45, 55 and 21** inmates respectively achieved their GEDs, received certificates of credit from a local technical institute, and learned to read via a remedial literacy course.
- **48 and 164** inmates at our Great Plains Correctional Facility in Oklahoma achieved respectively their GEDs and vocational tech certificates during 2000. These results drew praise from the Oklahoma Department of Corrections: "The programs you provide give inmates the opportunity to address criminal behaviors and develop pro-social values," wrote the state administrator for private prisons.
- **100%** of the 61 clients discharged from our El Monte Center in California during the fourth quarter of 2000 were employed fulltime (more than 20 hours per week) with an average wage of \$7.00 per hour.
- **100%** of the parenting skills assessed by Cornell's Parenting Academy in Harrisburg, Pennsylvania, improved from admission to discharge, as measured on a sample of 48 parents by the program's parenting survey in 2000.
- **90% to 95%** is the improvement from 1999 to 2000 in the percentage of monthly program performance indicators, on average, that beat their targets, as shown by Cornell's Non-Residential Care program in Pennsylvania. This data demonstrates excellent initial achievement and continued improvement by the program in its new performance-based contract with the state of Pennsylvania.

- **840 calls, 13,200 hours, 72 miles, and \$200,000** are just some of the community service contributions made in 2000 by inmates at our Baker Correctional Facility in California. These represent respectively the number of calls responded to by inmate fire crews, time devoted to road maintenance, length of road maintained, and approximate money saved by taxpayers as a result.
- **More than \$200,000 and \$23,000** are respectively the dollar value of community services performed and actual restitution paid by clients in just one non-residential juvenile program, WorkBridge in Pittsburgh, during the last three quarters of 2000. The program's primary goal is to provide opportunities for community service and restitution payments for a population of **over 450** clients each day.

**Chart 6** shows the number of disciplinary actions recorded per inmate per year on a sample of 18 inmates who had graduated from the Alternative Pathways Unit, a voluntary drug treatment program at our Great Plains Correctional Facility, from October 1999 through November 2000. The data shows dramatic behavioral improvement during and after treatment relative to pre-treatment baseline.



## Client Surveys:

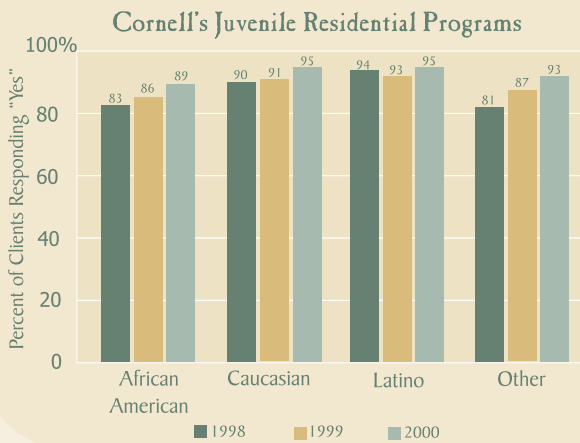
Cornell has a remarkable portfolio of client surveys dating back to 1994 that tracks satisfaction with our juvenile programs. These surveys provide valuable feedback from the populations we serve.

- 94% and 99% of clients respectively felt safe in their programs and had been held accountable for their actions, as reported by those about to be discharged from our juvenile residential programs during 2000.

**Chart 7** displays how clients in Cornell's juvenile residential programs felt about their program environments in regard to racial, ethnic and cultural issues over the last three years. The results show that cultural respect and awareness is not only key in our programs but also continually improving for all racial groups.

**Chart 7**

Was the program respectful of your racial/ethnic/cultural heritage and your religious beliefs?



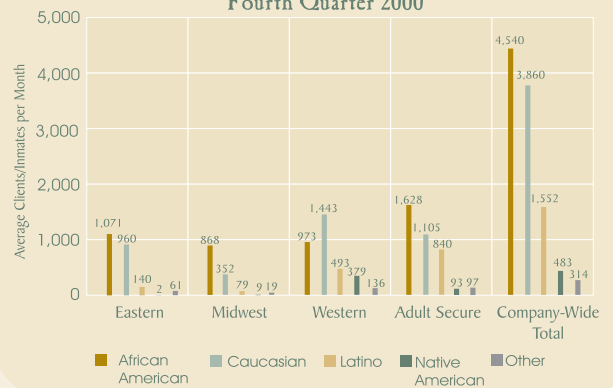
## Standardized Infrastructure:

Our Research and Evaluation and our Information Systems departments are working together to develop a comprehensive software system to capture company-wide program performance and outcome data of greatly enhanced scope and sophistication. The goal is to weave computerized data collection seamlessly into the day-to-day management of the programs, so that it is immediately available to program directors and wardens for quality improvement. The data will also be powerfully used to market current programs and develop new services. The value of the data that a universal tracking system can routinely produce is seen in the next chart, derived from our new standardized monthly reporting system.

**Chart 8** presents a company-wide breakdown by ethnicity of all of Cornell's inmates and clients. This information is used to stimulate and inform Cornell's staff training curriculum in cultural competency and target our programming to address the diversity of our populations.

**Chart 8**

Client/Inmate Ethnicity  
Fourth Quarter 2000



**Outside Agency Sources:**

- Crime and Justice Research Institute, Philadelphia, Pennsylvania
- Illinois Office of Alcoholism and Substance Abuse, Chicago, Illinois
- Treatment Alternatives for Safe Communities, Chicago, Illinois

# Facilities

## Adult Secure Institutions

	Location	Male/Female	Region	Total Capacity
Baker Community Correctional Facility	Baker, CA	Male	Adult Secure	262
Big Spring Correctional Center	Big Spring, TX	Male	Adult Secure	2,454
D. Ray James Prison	Folkston, GA	Male	Adult Secure	1,550
Great Plains Correctional Facility	Hinton, OK	Male	Adult Secure	812
Leo Chesney Community Correctional Facility	Live Oak, CA	Female	Adult Secure	200
Moshannon Valley Correctional Center	Philipsburg, PA	Male/Female	Adult Secure	1,095
Santa Fe County Detention Center	Santa Fe, NM	Male/Female	Adult Secure	661
Valencia County Detention Center	Valencia County, NM	Male/Female	Adult Secure	126
Donald W. Wyatt Detention Center	Central Falls, RI	Male	Adult Secure	302

Secure Institutions (9) 7,462

## Juvenile Facilities

	Location	Male/Female	Region	Total Capacity
Adams Behavioral Health Services	New Oxford, PA	Male/Female	Eastern	34
Campbell A. Griffin Center	San Antonio, TX	Male/Female	Western	170
City Girls Program	Chicago, IL	Female	Midwest	16
Contact				
Residential	Wauconda, IL	Female	Midwest	32
Outpatient	Wauconda, IL	Female	Midwest	15
Cornell Abraxas I	Marienville, PA	Male	Eastern	248
Cornell Abraxas II	Erie, PA	Male	Eastern	23
Cornell Abraxas III	Pittsburgh, PA	Male	Eastern	22
Cornell Abraxas Center for Adolescent Females	Pittsburgh, PA	Female	Eastern	46
Cornell Abraxas of Ohio	Shelby, OH	Male	Eastern	108
Cornell Abraxas Parenting Academy	Harrisburg, PA	Male/Female	Eastern	36
Cornell Abraxas Student Academy	Harrisburg, PA	Male/Female	Eastern	110
Cornell Abraxas Youth Center	South Mountain, PA	Male/Female	Eastern	72
South Mountain Alternative School	South Mountain, PA	Male/Female	Eastern	20
Danville Center for Adolescent Females	Danville, PA	Female	Eastern	64
Delaware Community Programs	Milford, DE	Male/Female	Eastern	33
DuPage Adolescent Center	Hinsdale, IL	Male	Midwest	34
Erie Behavioral Health Services	Erie, PA	Male/Female	Eastern	36
Erie Residential Behavioral Health Program	Erie, PA	Female	Eastern	16
Harrisburg				
Non-Residential Detention	Harrisburg, PA	Male/Female	Eastern	42
Non-Residential Treatment	Harrisburg, PA	Male/Female	Eastern	49
Harrisburg Day Treatment	Harrisburg, PA	Male/Female	Eastern	58
Juvenile Field Services				
Cook County	Chicago, IL	Male/Female	Midwest	40
Northern District	Aurora, IL	Male/Female	Midwest	30
Southern District	East St. Louis, IL	Male/Female	Midwest	40
Kline Plaza				
Dauphin County Behavioral Health Services	Harrisburg, PA	Male/Female	Eastern	88
Harrisburg Behavioral Health Services	Harrisburg, PA	Male/Female	Eastern	128
Non-Residential Care - Central	Harrisburg, PA	Male/Female	Eastern	35
Leadership Development Program	South Mountain, PA	Male	Eastern	120
Lehigh Valley Community Programs	Allentown, PA	Male/Female	Eastern	31
Life Works - Bolingbrook ***				
Juvenile Outpatient	Bolingbrook, IL	Male/Female	Midwest	5
Life Works - Joliet ***				
Juvenile Outpatient	Joliet, IL	Male/Female	Midwest	25
Lycoming/Clinton Behavioral Health Services	Williamsport, PA	Male/Female	Eastern	30
Maple Creek Home	Matteson, IL	Male	Midwest	8
New Morgan Academy	Morgantown, PA	Male/Female	Eastern	214
Non-Residential Care - West	Pittsburgh, PA	Male/Female	Eastern	25
Philadelphia Community Programs				
Family Preservation	Philadelphia, PA	Male/Female	Eastern	25
Services to Children in their Own Homes	Philadelphia, PA	Male/Female	Eastern	35
Psychosocial Rehabilitation Unit	Erie, PA	Male	Eastern	13
Residential School	Matteson, IL	Male/Female	Midwest	30
Salt Lake Valley Detention Center	Salt Lake City, UT	Male/Female	Western	160
Santa Fe County Youth Development Program	Santa Fe, NM	Male	Western	129
South Mountain Secure Treatment Unit	South Mountain, PA	Male	Eastern	52
Washington, DC, Community Programs				
Supervised Home Services	Washington, DC	Male/Female	Eastern	32
Detention Advocacy & Monitoring Programs	Washington, DC	Male/Female	Eastern	32
Woodridge ***				
Juvenile Multi-Systematic Therapy	Woodridge, IL	Male	Midwest	40
Juvenile Residential	Woodridge, IL	Male	Midwest	30
WorkBridge Allegheny	Pittsburgh, PA	Male/Female	Eastern	475
WorkBridge Philadelphia	Philadelphia, PA	Male/Female	Eastern	150

Juvenile Facilities (36)

3,306

Pre-Release Facilities	Location	Male/Female	Region	Total Capacity
Cordova Center	Anchorage, AK	Male	Western	192
Dallas County Judicial Treatment Center	Wilmer, TX	Male	Western	300
Durham Treatment Center	Durham, NC	Male	Eastern	75
East St. Louis				
Adult Outpatient	East St. Louis, IL	Male/Female	Midwest	65
Mentally Ill Substance Abuse Outpatient	East St. Louis, IL	Male/Female	Midwest	15
El Monte Center	El Monte, CA	Male	Western	55
Inglewood Men's Center	Los Angeles, CA	Male	Western	50
Leidel Comprehensive Sanctions Center	Houston, TX	Male/Female	Western	150
Life Works - Bolingbrook				
Adult Methadone Outpatient	Bolingbrook, IL	Male/Female	Midwest	41
Adult Methadone Private Outpatient	Bolingbrook, IL	Male/Female	Midwest	15
Adult Outpatient	Bolingbrook, IL	Male/Female	Midwest	50
Life Works - Joliet				
Adult Outpatient	Joliet, IL	Male/Female	Midwest	25
Adult Outpatient Work Release	Joliet, IL	Male	Midwest	50
Marvin Gardens Center	Los Angeles, CA	Male	Western	42
Midtown Center	Anchorage, AK	Male	Western	32
Northside	Chicago, IL	Male/Female	Midwest	202
Northstar Center	Fairbanks, AK	Male	Western	105
Oakland Center	Oakland, CA	Male	Western	61
Parkview Center	Anchorage, AK	Male	Western	112
Reid Community Correctional Center	Houston, TX	Male	Western	310
Salt Lake City Center	Salt Lake City, UT	Male	Western	58
San Diego Center	San Diego, CA	Male	Western	131
Santa Barbara Center	Goleta, CA	Male	Western	25
Santa Fe Electronic Monitoring	Santa Fe, NM	Male	Western	50
Seaside Center	Nome, AK	Male	Western	40
Southwood				
Day Reporting	Chicago, IL	Male/Female	Midwest	125
Residential Rehabilitation	Chicago, IL	Male	Midwest	35
Adult Short Term	Chicago, IL	Male/Female	Midwest	16
City Men	Chicago, IL	Male	Midwest	30
City Women	Chicago, IL	Female	Midwest	42
Women's Program	Chicago, IL	Female	Midwest	15
Residential Detox	Chicago, IL	Male/Female	Midwest	16
Outpatient	Chicago, IL	Male/Female	Midwest	50
Southwestern Illinois Correctional Center	East St. Louis, IL	Male	Midwest	671
Taylor Street Center	San Francisco, CA	Male	Western	177
Tundra Center	Bethel, AK	Male	Western	99
Woodridge				
Men's 1 Mentally Ill Substance Abuse Program	Woodridge, IL	Male	Midwest	4
Men's 1 Residential	Woodridge, IL	Male	Midwest	30
Men's 2 Residential	Woodridge, IL	Male	Midwest	35

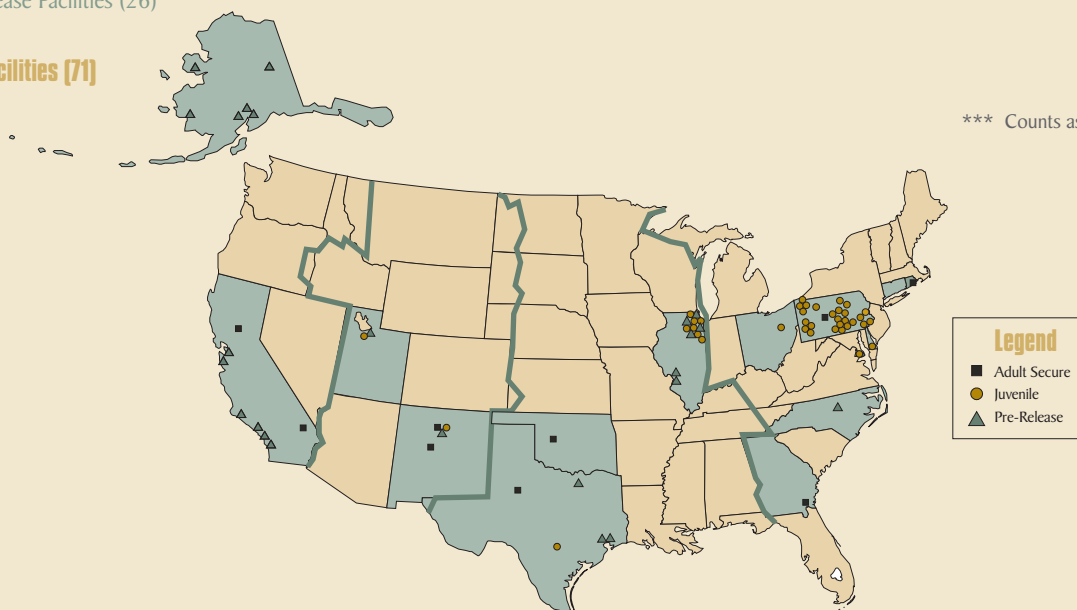
Pre-Release Facilities (26)

3,596

**Total Facilities (71)**

**14,364**

\*\*\* Counts as pre-release facility



# Financial Information

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

### GENERAL

The Company is a leading private provider of corrections, treatment and educational services to government agencies. As of December 31, 2000, the Company had contracts to operate 71 facilities with a total service capacity of 14,364. The Company's facilities are located in 13 states and the District of Columbia.

The Company provides integrated facility development, design, construction and operational services to government agencies within three operating divisions: (a) adult secure institutional, correctional and detention services, (b) juvenile treatment, educational and detention services and (c) pre-release correctional and treatment services. The following table sets forth for the periods indicated total service capacity, the service capacity and contracted beds in operation at the end of the periods shown and the average occupancy percentages.

	<i>Year Ended December 31,</i>		
	<i>2000</i>	<i>1999</i>	<i>1998</i>
Total service capacity <sup>(1)</sup> :			
Residential	11,318 <sup>(2)</sup>	11,796	9,135
Non-residential community-based	3,046	3,049	1,390
Total	14,364 <sup>(2)</sup>	14,845	10,525
Service capacity in operation (end of period)	13,269	12,240	8,700
Contracted beds in operation (end of period) <sup>(3)</sup>	10,061	9,029	7,310
Average occupancy based on contracted beds in operation <sup>(3) (4)</sup>	94.3%	95.8%	93.8%
Average occupancy excluding start-up operations <sup>(3)</sup>	96.0%	97.0%	98.3%

<sup>(1)</sup> The Company's service capacity is comprised of the number of beds available for service upon completion of construction of residential facilities and the average program capacity of non-residential community-based programs.

<sup>(2)</sup> The Utah DOC selected the Company's bid in June 1999 for the 490-bed Timpie Valley Correctional Facility subject to final contract negotiations. In 2000, the Utah DOC declined to pursue this project, therefore the Company's service capacity was reduced accordingly.

<sup>(3)</sup> Occupancy percentages are based on contracted service capacity of residential facilities in operation. Since certain facilities have service capacities that exceed contracted capacities, occupancy percentages can exceed 100% of contracted capacity.

<sup>(4)</sup> Occupancy percentages reflect less than normalized occupancy during the start-up phase of any applicable facility, resulting in a lower average occupancy in periods when the Company has substantial start-up activities.

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

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

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

The Company is responsible for all facility operating expenses, except for certain debt service and lease payments with respect to facilities for which the Company has only a management contract (nine facilities in operation at December 31, 2000).

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

Pre-opening and start-up expenses consist primarily of payroll, benefits, training and other operating costs prior to opening a new or expanded facility and during the period of operation while occupancy is ramping up.

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

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

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

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

## RESULTS OF OPERATIONS

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

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

	<i>Year Ended December 31,</i>		
	<i>2000</i>	<i>1999</i>	<i>1998</i>
Revenues	100.0%	100.0%	100.0%
Operating expenses	77.6	76.8	80.2
Pre-opening and start-up expenses	1.0	1.7	—
Depreciation and amortization	3.2	3.3	3.4
General and administrative expenses	5.3	5.6	6.2
Income from operations	12.9	12.6	10.2
Interest expense, net	6.9	4.8	2.0
Income before income taxes and cumulative effect of change in accounting principle	6.0	7.8	8.2
Provision for income taxes	2.5	3.1	3.3
Income before cumulative effect of change in accounting principle	3.5%	4.7%	4.9%

*Year Ended December 31, 2000 Compared to Year Ended December 31, 1999*

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

Adult secure institutional division revenues increased 19.9% to \$91.2 million for the year ended December 31, 2000 from \$76.0 million for the year ended December 31, 1999 due principally to (a) the final 550-bed expansion of the D. Ray James Prison which began housing inmates late in the first quarter of 2000 and reached a full occupancy level late in the second quarter of 2000, (b) the opening of the additional 450-bed second phase of the D. Ray James Prison in the first quarter of 1999, (c) expansions at the Big Spring Complex completed in the fourth quarter of 1999 and the first quarter of 2000 and (d) the opening of the Valencia County Detention Center in the fourth quarter of 2000. These revenue increases were offset, in part, by reductions in occupancy at certain facilities including a temporary reduction at the Great Plains Correctional Facility. As of December 31, 2000, occupancy at these facilities had returned to normal occupancy levels. Additionally, during the fourth quarter of 2000, the Company entered into a license agreement with its construction contractor that conveyed certain rights to the design of an adult secure institution. A non-recurring license agreement payment of \$950,000 was recognized as revenue by the Company. The Company has not licensed such designs in prior years and does not expect to generate significant revenues from such activity in future periods. Revenues attributable to start-up operations were approximately \$44,000 and \$866,000 for the years ended December 31, 2000 and 1999, respectively, and related primarily to the D. Ray James Prison expansions.

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

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

*Operating Expenses.* Operating expenses increased 29.1% to \$175.4 million for the year ended December 31, 2000 from \$135.9 million for the year ended December 31, 1999. For the years ended December 31, 2000 and 1999, operating expenses included approximately \$3.9 million and \$308,000, respectively, of rent expense resulting from the sale and leaseback of certain owned furniture and equipment during the fourth quarter of 1999. This operating rent expense was largely offset by a reduction of depreciation and interest expense.

Adult secure institutional division operating expenses increased 23.8% to \$68.2 million for the year ended December 31, 2000 from \$55.1 million for the year ended December 31, 1999 due principally to (a) the final 550-bed expansion of the D. Ray James Prison, which began housing inmates late in the first quarter of 2000 and reached a full occupancy level late in the second quarter of 2000, (b) the opening of the additional 450-bed second phase of the D. Ray James Prison in the first quarter of 1999, (c) increased occupancy at the Big Spring Complex due to expansions completed in the fourth quarter of 1999 and the first quarter of 2000, and (d) the opening of the Valencia County Detention Center in the fourth quarter of 2000. As a percentage of adult secure institutional division revenues, excluding start-up operations and the \$950,000 license agreement revenue, adult secure institutional division operating expenses were 75.0% for the year ended December 31, 2000 compared to 70.1% for the year ended December 31, 1999. The 2000 operating margin was impacted unfavorably due to (a) the sale and leaseback of certain owned furniture and equipment during the fourth quarter of 1999, (b) a reduction in occupancy at the Great Plains Correctional Facility offset, in part, by the expansion of the D. Ray James Prison, (c) a \$1.2 million bad debt provision related to a Santa Fe County Adult Detention Facility contract dispute, and (d) a reduction to operating expenses during the year ended December 31, 1999 of \$1.0 million at the Santa Fe County Adult Detention Facility resulting from a cost sharing agreement with the Company's construction contractor.

Juvenile division operating expenses increased 28.2% to \$73.9 million for the year ended December 31, 2000 from \$57.6 million for the year ended December 31, 1999. The increase in operating expenses was due to (a) the juvenile facilities and programs acquired from Interventions - Illinois in November 1999, (b) increased occupancy at the Cornell Abraxas I facility due to a facility expansion completed in the fourth quarter of 1999, (c) the opening of the Cornell Abraxas Youth Center late in the first quarter of 1999, (d) increased occupancy at certain facilities including the Santa Fe County Juvenile Detention Facility and the Griffin Juvenile Facility, (e) the opening of the New Morgan Academy in the fourth quarter of 2000, and (f) the addition of various programs including two new non-residential mental health programs and one residential mental health facility in Pennsylvania. As a percentage of juvenile division revenues, excluding start-up operations, juvenile division operating expenses were 85.1% for the year ended December 31, 2000 compared to 85.3% for the year ended December 31, 1999. The improved operating margin for the year ended December 31, 2000 compared to the year ended December 31, 1999 was due principally to the higher occupancy levels and revenue of certain facilities including Cornell Abraxas I, the Cornell Abraxas Youth Center, the Griffin Juvenile Facility and the Santa Fe County Juvenile Detention Facility. These operating margin improvements were offset, in part, by a margin reduction due to the sale and leaseback of certain owned furniture and equipment during the fourth quarter of 1999.

Pre-release division operating expenses increased 39.0% to \$36.0 million for the year ended December 31, 2000 from \$25.9 million for the year ended December 31, 1999 due principally to (a) the pre-release facilities and programs acquired from Interventions - Illinois in November 1999, (b) the opening of a new facility in Nome, Alaska late in the third quarter of 1999 and (c) increased occupancy at various facilities including the Leidel Comprehensive Sanctions Center, the Reid Community Correctional Center and the Dallas County Judicial Treatment Center. As a percentage of pre-release division revenues, excluding start-up operations, pre-release division operating expenses were 73.6% for the year ended December 31, 2000 compared to 75.4% for the year ended December 31, 1999. The improved operating margin for the year ended December 31, 2000 compared to the year ended December 31, 1999 was due principally to higher occupancy and revenues at certain facilities. These operating margin improvements were offset, in part, by margin reductions due to the sale and leaseback of certain owned furniture and equipment during the fourth quarter of 1999.

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

*Depreciation and Amortization.* Depreciation and amortization increased 21.1% to \$7.3 million for the year ended December 31, 2000 from \$6.0 million for the year ended December 31, 1999 due to (a) depreciation of buildings, furniture and equipment and amortization of non-compete agreements related to the acquisition of Interventions - Illinois in November 1999, (b) the completion of the expansions at the Big Spring Complex, (c) the completion of the additional 450-bed expansion in the first quarter of 1999 and the final 550-bed expansion in the first quarter of 2000 at the D. Ray James Prison, and (d) various facility expansions. These increases were partially offset due to the sale and leaseback of certain owned furniture and equipment during the fourth quarter 1999 and due to the Company's change in the estimated useful lives of certain adult secure institutions effective July 1, 1999.

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

*Interest.* Interest expense, net of interest income, increased to \$15.6 million for the year ended December 31, 2000 from \$8.4 million for the year ended December 31, 1999 due principally to (a) increased borrowings to fund the acquisition of Interventions - Illinois in November 1999, various facility expansions and the associated working capital and (b) increases in base interest rates and the Company's interest rate margin on its 2000 Credit Facility (see Note 6 to the Consolidated Financial Statements). Capitalized interest for the year ended December 31, 2000 was \$40,000 and related to an expansion at the Big Spring Complex. During the year ended December 31, 1999, the Company capitalized interest totaling \$1.2 million related principally to costs for construction of the D. Ray James Prison.

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

#### *Year Ended December 31, 1999 Compared to Year Ended December 31, 1998*

*Revenues.* Revenues increased 43.7% to \$177.0 million for the year ended December 31, 1999 from \$123.1 million for the year ended December 31, 1998.

Adult secure institutional division revenues increased 44.4% to \$76.0 million for the year ended December 31, 1999 from \$52.6 million for the year ended December 31, 1998 due principally to (a) the opening of the 560-bed expansion unit at the Big Spring Complex in the fourth quarter of 1998 and additional Big Spring Complex expansions during the fourth quarter of 1999, (b) the opening of the 550 initial beds in the D. Ray James Prison in the fourth quarter of 1998 and an additional 450 beds in the first quarter of 1999, and (c) the opening of the 661-bed Santa Fe County Adult Detention Facility in the third quarter of 1998. Revenues attributable to start-up operations for the Big Spring Complex and D. Ray James Prison expansions were approximately \$866,000 for the year ended December 31, 1999.

Juvenile division revenues increased 42.7% to \$67.1 million for the year ended December 31, 1999 from \$47.0 million for the year ended December 31, 1998 due to (a) the opening of the Santa Fe County Juvenile Detention Facility in the third quarter of

1998, (b) increased occupancy at the Cornell Abraxas I and Cornell Abraxas of Ohio facilities due to facility expansions completed in the third quarter of 1998, (c) the opening of the Danville Center for Adolescent Females in the second quarter of 1998 and the Cornell Abraxas Youth Center late in the first quarter of 1999, (d) the acquisition of Interventions-Illinois during the fourth quarter of 1999, (e) increased occupancy at the Campbell Griffin Facility in San Antonio, Texas, and (f) the addition of various new programs including two new non-residential mental health programs in Pennsylvania. Revenues attributable to start-up operations were approximately \$432,000 for the year ended December 31, 1999.

Pre-release division revenues increased 44.2% to \$33.8 million for the year ended December 31, 1999 from \$23.5 million for the year ended December 31, 1998 due principally to a full year of operations of five pre-release centers in Alaska acquired in August 1998 and the acquisition of Interventions-Illinois during the fourth quarter of 1999. Revenues attributable to start-up operations were approximately \$122,000 for the year ended December 31, 1999 and related to a new facility in Alaska.

*Operating Expenses.* Operating expenses increased 37.6% to \$135.9 million for the year ended December 31, 1999 from \$98.7 million for the year ended December 31, 1998.

Adult secure institutional division operating expenses increased 45.8% to \$55.1 million for the year ended December 31, 1999 from \$37.8 million for the year ended December 31, 1998 due principally to (a) the opening of the 560-bed expansion unit at the Big Spring Complex in the fourth quarter of 1998 and additional Big Spring Complex expansions during the fourth quarter of 1999, (b) the opening of the 550 initial beds at the D. Ray James Prison in the fourth quarter of 1998 and an additional 450 beds in the first quarter of 1999, and (c) the opening of the 661-bed Santa Fe County Adult Detention Facility in the third quarter of 1998. As a percentage of adult secure institutional division revenues, excluding start-up operations, adult secure institutional division operating expenses were 70.1% for the year ended December 31, 1999 compared to 71.9% for the year ended December 31, 1998. The improved operating margin was due principally to a greater mix of owned versus leased facilities and a reduction to operating expenses of \$1.0 million at the Santa Fe County Adult Detention Facility resulting from a cost-sharing agreement with the Company's construction contractor (See Note 3 to the Consolidated Financial Statements).

Juvenile division operating expenses increased 39.8% to \$57.6 million for the year ended December 31, 1999 from \$41.2 million for the year ended December 31, 1998. The increase in operating expenses was due to (a) the Santa Fe County Juvenile Detention Facility which began operations late in the third quarter of 1998, (b) increased occupancy at the Cornell Abraxas I and Cornell Abraxas of Ohio facilities due to facility expansions completed in the third quarter of 1998, (c) the Cornell Abraxas Youth Center which began operations late in the first quarter of 1999 and the Danville Center for Adolescent Females which began operations in the second quarter of 1998, (d) the acquisition of Interventions-Illinois during the fourth quarter of 1999, (e) increased occupancy at the Campbell Griffin Facility in San Antonio, Texas, and (f) the addition of new programs including two new non-residential mental health programs in Pennsylvania. As a percentage of juvenile division revenues, excluding start-up operations, operating expenses were 85.3% for the year ended December 31, 1999 compared to 87.7% for the year ended December 31, 1998. The improved operating margin was due principally to improved results from certain expanded residential facilities.

Pre-release division operating expenses increased 38.5% to \$25.9 million for the year ended December 31, 1999 from \$18.7 million for the year ended December 31, 1998 due principally to the acquisition of five pre-release centers in Alaska in August 1998 and the acquisition of Interventions-Illinois during the fourth quarter of 1999. As a percentage of pre-release divisions revenues, excluding start up operations, operating expenses were 75.4% for the year ended December 31, 1999 compared to 79.8% for the year ended December 31, 1998. The improved operating margin was due principally to a greater mix of owned versus leased facilities, including four owned facilities in Alaska.

*Pre-opening and Start-up Expenses.* Pre-opening and start-up expenses were \$2.9 million for the year ended December 31, 1999 and were primarily attributable to the pre-opening and start-up activities of the additional 450 beds during the first and second quarters of 1999 at the D. Ray James Prison, the Cornell Abraxas Youth Center during the first quarter of 1999 and other new juvenile programs in Pennsylvania and a new pre-release facility in Alaska.

*Depreciation and Amortization.* Depreciation and amortization increased 42.1% to \$6.0 million for the year ended December 31, 1999 from \$4.2 million for the year ended December 31, 1998 due to (a) depreciation of buildings and equipment acquired in Alaska in August 1998, (b) the opening of the 560-bed expansion unit at the Big Spring Complex in the fourth quarter of 1998 and

additional Big Spring Complex expansions during 1999, (c) the phase-in of 1,550 beds in the D. Ray James Prison from the fourth quarter of 1998 through the fourth quarter of 1999, and (d) various facility expansions and related equipment. Effective July 1, 1999, the lease term for the three original Big Spring Complex units was extended from an average of 35 years to 50 years. At this date, management revised its estimated useful lives of the Big Spring Complex and two other adult secure institutions to 50 years. The effect of this change reduced building depreciation and prepaid facility use amortization by approximately \$300,000 for the year ended December 31, 1999.

*General and Administrative Expenses.* General and administrative expenses increased 31.0% to \$9.9 million for the year ended December 31, 1999 from \$7.6 million for the year ended December 31, 1998. The increase in general and administrative expenses resulted principally from additional corporate executive, business development and administrative personnel, overhead and travel to manage the increased business of the Company and for the development of new contracts.

*Interest.* Interest expense, net of interest income, increased to \$8.4 million for the year ended December 31, 1999 from \$2.5 million for the year ended December 31, 1998 due principally to increased borrowings to finance (a) the acquisition of the Alaskan assets in August 1998, (b) construction costs of new facilities and expansions including the 560-bed Big Spring Complex expansion unit in 1998, additional Big Spring Complex expansions in 1999 and the 1,550-bed D. Ray James Prison and (c) the acquisition of Interventions-Illinois in the fourth quarter of 1999. For the year ended December 31, 1999, the Company capitalized interest totaling \$1.2 million related principally to costs for construction of the D. Ray James Prison expansions and other facility expansions.

*Income Taxes.* For the years ended December 31, 1999 and 1998, the Company recognized a provision for income taxes at an estimated effective rate of 40%.

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

## LIQUIDITY AND CAPITAL RESOURCES

*General.* The Company's primary capital requirements are for (a) construction of new facilities, (b) acquisitions, (c) expansions of existing facilities, (d) working capital, (e) start-up costs related to new operating contracts, (f) information systems hardware and software, and (g) furniture, fixtures and equipment. Working capital requirements generally increase immediately prior to the Company commencing management of a new facility as the Company incurs start-up costs and purchases necessary equipment and supplies before facility management revenue is realized.

*New Facilities and Projects Under Construction.* A majority of the New Morgan Academy was completed and became operational during the fourth quarter of 2000. A portion of the New Morgan Academy remained under construction at December 31, 2000 and was completed in the first quarter of 2001. In April 1999, the Company was awarded a contract to design, build and operate a 1,095-bed prison for the Federal Bureau of Prisons ("FBOP") in Moshannon Valley, Pennsylvania ("Moshannon Valley Correctional Center"). Construction and activation activities commenced immediately. In June 1999, the FBOP issued a Stop-Work Order pending a re-evaluation of their environmental documentation supporting the decision to award the contract. The environmental study was completed with a finding of no significant impact. While the Stop-Work Order remains in effect, management of the Company believes it will be lifted and construction will be resumed in the near-term. Development and construction costs for the New Morgan Academy and the Moshannon Valley Correctional Center have been financed with the Company's lease financing arrangement discussed below under "Long-Term Credit Facilities."

*Long-Term Credit Facilities.* Effective July 21, 2000, the Company formalized terms under the 2000 Credit Facility with a group of financial institutions. The 2000 Credit Facility provides for borrowings of up to \$75.0 million under a revolving line of credit. The revolving credit commitment is reduced by \$2.7 million quarterly beginning in January 2002. The 2000 Credit Facility matures in July 2005 and bears interest, at the election of the Company, at either the prime rate plus a margin of 1.0% to 2.0%, or a rate which is 2.0% to 3.0% above the applicable LIBOR rate, depending on the level of borrowings. At December 31, 2000, the margin was 3.0% above the LIBOR rate. The 2000 Credit Facility is secured by substantially all of the Company's assets, including the stock of all of the Company's subsidiaries; does not permit the payment of cash dividends; and requires the Company to comply with certain leverage,

net worth and debt service coverage covenants. At February 28, 2001, the Company had \$63.5 million outstanding under the revolving line of credit, therefore the remaining borrowing capacity was \$11.5 million.

Additionally, the 2000 Credit Facility provides the Company with an increased capacity to enter into operating lease agreements for the acquisition or development of operating facilities. This lease financing arrangement provides for funding to the lessor under the operating leases of up to \$100.0 million, of which approximately \$48.0 million had been utilized as of February 28, 2001. The remaining capacity under this lease financing arrangement is expected to be utilized to complete the Moshannon Valley Correctional Center. The leases under this arrangement have a term of five years, include purchase and renewal options, and provide for residual value guarantees for each lease which average 81.4% of the total cost and would be due by the Company upon termination of the leases. Upon termination of a lease, the Company could either exercise a purchase option or the facilities could be sold to a third party. The Company believes the fair value of the leased facilities will equal or exceed the residual guaranteed amounts. Lease payments under the lease financing arrangement are variable and are adjusted for changes in interest rates.

Concurrent with the closing of the 2000 Credit Facility, the Company's \$50.0 million Subordinated Bridge Loan Agreement was refinanced with proceeds from a Note and Equity Purchase Agreement ("Subordinated Notes"). The Subordinated Notes have a seven-year term and are interest-only, which is payable quarterly at a fixed rate of 12.875%. In conjunction with the issuance of the Subordinated Notes, the Company issued warrants to purchase 290,370 shares of the common stock at an exercise price of \$6.70. The warrants may only be exercised by a full payment of cash to the Company of the exercise price or by the cancellation of Company indebtedness to the warrant holder.

The Company has outstanding \$50.0 million of Senior Secured Notes (the "Senior Notes"). The Senior Notes bear interest at a fixed rate of 7.74% and mature on July 15, 2010. Under the Senior Notes purchase agreements, the Company is required to make eight annual principal payments of \$6.25 million beginning July 15, 2003 and comply with certain financial covenants. Earlier payments of principal are allowed subject to prepayment provisions. Interest is payable semi-annually. The holders of the Senior Notes and the lenders under the 2000 Credit Facility have a collateral-sharing agreement whereby both sets of creditors have an equal security interest in all of the assets of the Company.

*Cash Flows From Operating Activities.* For the year ended December 31, 2000, the Company reported net cash provided by operating activities of \$9.6 million. Cash provided by operating activities was reduced by approximately \$1.9 million due to the November 1999 acquisition of Interventions - Illinois which did not include working capital.

*Deferred Costs and Other.* At December 31, 2000, the Company had deferred professional fees and other costs totaling \$1.8 million related to its efforts on a facility sale and leaseback transaction. Upon consummation of this transaction, the transaction costs will be included in the determination of the gain from the sale which will be deferred over the initial lease term. If management of the Company determines that it is doubtful that this transaction will be consummated, these transaction costs will be expensed in the period such determination is made. See Note 1 to the Consolidated Financial Statements.

At December 31, 2000, the Company had deferred acquisition costs totaling \$628,000 related to the anticipated purchase of real property in Fort Greely, Alaska. Management anticipates that this property will be used in conjunction with the operations of an adult secure institution for the State of Alaska. If management determines that a contract to operate this facility in Fort Greely, Alaska will not be awarded, the Company will likely not purchase the real property and the deferred acquisition costs will be expensed. See Note 1 to the Consolidated Financial Statements.

At December 31, 2000, accounts receivable include costs totaling \$1.1 million for direct costs incurred by the Company since June 1999 for payroll and other operating costs related to the Moshannon Valley Correctional Center since the issuance of the Stop-Work Order. These costs were incurred at the direction of the FBOP with the understanding that such costs would be reimbursed. Although no formal written agreement exists, management believes that these costs will be reimbursed by the FBOP. In the event any portion of these costs are not reimbursed by the FBOP, such costs will be expensed.

*Capital expenditures.* Capital expenditures for the year ended December 31, 2000 were \$12.1 million and related principally to (a) an expansion of the Big Spring Complex, (b) the purchase of a building in Pennsylvania, (c) purchases of furniture and equipment for the New Morgan Academy, and (d) certain software development costs.

Management believes that the cash flows generated from operations, together with the credit available under the 2000 Credit Facility and the operating lease capacity thereunder, will provide sufficient liquidity to meet the Company's committed capital and working capital requirements for currently awarded contracts. It is not anticipated that the current financing arrangements will provide sufficient financing to fund construction costs related to future adult secure institutional contract awards, or significant expansions or acquisitions. The Company anticipates obtaining additional sources of financing to fund such activities.

#### INFLATION

Other than personnel and offender medical costs at certain facilities during 2000, management of the Company believes that inflation has not had a material effect on its results of operations during the past three years. Most of the Company's facility management contracts provide for payments to the Company of either fixed per diem fees or per diem fees that increase by only small amounts during the terms of the contracts. Inflation could substantially increase the Company's personnel costs (the largest component of operating expenses) or other operating expenses at rates faster than any increases in contract revenues.

#### QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

In the normal course of business, the Company is exposed to market risk, primarily from changes in interest rates. The Company continually monitors exposure to market risk and develops appropriate strategies to manage this risk. The Company is not exposed to any other significant market risks, including commodity price risk, foreign currency exchange risk or interest rate risks from the use of derivative financial instruments. Management does not use derivative financial instruments for trading or to speculate on changes in interest rates or commodity prices.

#### INTEREST RATE EXPOSURE

The Company's exposure to changes in interest rates primarily results from its long-term debt with both fixed and floating interest rates. The Company's debt with fixed interest rates consists of the Senior Notes and the Subordinated Notes. At December 31, 2000, approximately 39% (\$58.0 million outstanding under the Company's revolving line of credit) of the Company's long-term debt was subject to variable interest rates. Additionally, the company had a subordinated bridge loan facility with a variable interest rate until the facility was refinanced with the Subordinated Notes in July 2000. The detrimental effect of a hypothetical 100 basis point increase in interest rates would be to reduce income before provision for income taxes by approximately \$830,000 for the year ended December 31, 2000. At December 31, 2000, the fair value of the Company's fixed rate debt approximated carrying value based upon discounted future cash flows using current market prices.

#### FORWARD LOOKING STATEMENT DISCLAIMER

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

## REPORT OF INDEPENDENT PUBLIC ACCOUNTANTS

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

We have audited the accompanying consolidated balance sheets of Cornell Companies, Inc. and subsidiaries as of December 31, 2000 and 1999, and the related consolidated statements of operations, stockholders' equity and cash flows for each of the three years in the period ended December 31, 2000. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Cornell Companies, Inc. and subsidiaries as of December 31, 2000 and 1999, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2000, in conformity with accounting principles generally accepted in the United States.



ARTHUR ANDERSEN LLP  
HOUSTON, TEXAS  
March 1, 2001

CONSOLIDATED FINANCIAL STATEMENTS

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

	December 31,	
	2000	1999
<b>ASSETS</b>		
<b>CURRENT ASSETS:</b>		
Cash and cash equivalents	\$ 620	\$ 1,763
Accounts receivable (net of allowance for doubtful accounts of \$2,578 and \$3,002, respectively)	55,262	48,092
Deferred tax assets	667	1,206
Prepays and other	4,363	1,356
Restricted assets	2,011	2,339
Total current assets	62,923	54,756
<b>PROPERTY AND EQUIPMENT, net</b>	201,683	194,498
<b>OTHER ASSETS:</b>		
Intangible assets, net	16,861	18,270
Deferred costs and other	9,972	5,524
Deferred tax assets	—	943
Total assets	\$291,439	\$273,991
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
<b>CURRENT LIABILITIES:</b>		
Accounts payable and accrued liabilities	\$ 33,179	\$ 27,392
Note payable	—	40,000
Current portion of long-term debt	41	—
Total current liabilities	33,220	67,392
<b>LONG-TERM DEBT, net of current portion</b>	146,926	101,500
<b>DEFERRED TAX LIABILITIES</b>	643	—
<b>OTHER LONG-TERM LIABILITIES</b>	6,330	7,891
<b>COMMITMENTS AND CONTINGENCIES</b>		
<b>STOCKHOLDERS' EQUITY:</b>		
Preferred stock, \$.001 par value, 10,000,000 shares authorized, none outstanding	—	—
Common stock, \$.001 par value, 30,000,000 shares authorized, 10,161,113 and 10,137,528 shares issued and outstanding, respectively	10	10
Additional paid-in capital	91,625	90,394
Notes from shareholders	(609)	(455)
Retained earnings	19,227	11,258
Treasury stock (955,500 and 697,100 shares at cost, respectively)	(5,933)	(3,999)
Total stockholders' equity	104,320	97,208
Total liabilities and stockholders' equity	\$291,439	\$273,991

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

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

Year Ended December 31,

	2000	1999	1998
Revenues	\$ 226,050	\$ 176,967	\$ 123,119
Operating Expenses	175,391	135,850	98,721
Pre-Opening and Start-Up Expenses	2,298	2,929	—
Depreciation and Amortization	7,276	6,007	4,228
General and Administrative Expenses	12,024	9,932	7,581
Income from Operations	29,061	22,249	12,589
Interest Expense	15,654	8,522	2,601
Interest Income	(100)	(117)	(116)
Income Before Income Taxes and Cumulative Effect of Change in Accounting Principle	13,507	13,844	10,104
Provision for Income Taxes	5,538	5,538	4,042
Income Before Cumulative Effect of Change in Accounting Principle	7,969	8,306	6,062
Cumulative Effect of Change in Accounting Principle, Net of Related Income Tax Benefit of \$1,969 in 1999	—	2,954	—
<b>NET INCOME</b>	<b>\$ 7,969</b>	<b>\$ 5,352</b>	<b>\$ 6,062</b>
Earnings (Loss) Per Share:			
Basic			
Income before cumulative effect of change in accounting principle	\$ .85	\$ .88	\$ .64
Cumulative effect of change in accounting principle	—	(.31)	—
Net income	\$ .85	\$ .57	\$ .64
Diluted			
Income before cumulative effect of change in accounting principle	\$ .84	\$ .86	\$ .62
Cumulative effect of change in accounting principle	—	(.31)	—
Net income	\$ .84	\$ .55	\$ .62
Number of shares used in per share computation:			
Basic	9,383	9,432	9,442
Diluted	9,495	9,660	9,772

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

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

	Common Stock		Additional Paid-In Capital	Notes From Shareholders	Retained Earnings (Deficit)	Treasury Stock
	Shares	Par Value				
Balances at December 31, 1997	9,945,904	\$ 10	\$ 89,684	\$ (455)	\$ (156)	\$ (2,353)
Exercise of Stock Options	160,012	—	176	—	—	—
Income Tax Benefits from Stock Options Exercised	—	—	178	—	—	—
Purchase of Treasury Stock (142,100 Shares, at Cost)	—	—	—	—	—	(1,646)
Net Income	—	—	—	—	6,062	—
Balances at December 31, 1998	10,105,916	10	90,038	(455)	5,906	(3,999)
Exercise of Stock Options	31,612	—	217	—	—	—
Income Tax Benefits from Stock Options Exercised	—	—	139	—	—	—
Net Income	—	—	—	—	5,352	—
Balances at December 31, 1999	10,137,528	10	90,394	(455)	11,258	(3,999)
Exercise of Stock Options	10,000	—	24	—	—	—
Income Tax Benefits from Stock Options Exercised	—	—	15	—	—	—
Purchase of Treasury Stock (258,400 Shares at Cost)	—	—	—	—	—	(1,934)
Issuance of Common Stock	13,585	—	97	—	—	—
Issuance of Stock Warrants	—	—	1,095	—	—	—
Accrued Interest on Notes From Shareholders	—	—	—	(154)	—	—
Net Income	—	—	—	—	7,969	—
Balances at December 31, 2000	10,161,113	\$ 10	\$ 91,625	\$ (609)	\$ 19,227	\$ (5,933)

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

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

Year Ended December 31,

	2000	1999	1998
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>			
Net income	\$ 7,969	\$ 5,352	\$ 6,062
Adjustments to reconcile net income to net cash provided by (used in)			
operating activities —			
Cumulative effect of change in accounting principle	—	2,954	—
Depreciation	4,178	4,601	2,880
Amortization	3,097	1,406	1,348
Non-cash interest expense	1,224	511	210
Provision for bad debts	2,416	1,025	509
(Gain) loss on sale of property and equipment	13	(305)	—
Deferred income taxes	2,125	(1,741)	2,106
Change in assets and liabilities, net of effects from acquisitions:			
Accounts receivable	(9,740)	(21,553)	(7,936)
Restricted assets	328	(319)	(1,049)
Other assets	(5,442)	(1,340)	(4,768)
Accounts payable and accrued liabilities	5,023	10,006	4,249
Other liabilities	(1,561)	(1,478)	(1,205)
Net cash provided by (used in) operating activities	9,630	(881)	2,406
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>			
Proceeds from sales of property and equipment	719	19,278	—
Capital expenditures	(12,096)	(29,067)	(49,483)
Acquisition of businesses, less cash acquired	—	(31,786)	(65,096)
Net cash used in investing activities	(11,377)	(41,575)	(114,579)
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>			
Proceeds from notes payable	—	69,335	—
Payments on notes payable	(40,000)	(29,335)	—
Proceeds from long-term debt	155,000	53,194	176,379
Payments on long-term debt	(108,500)	(50,174)	(78,331)
Payments on capital lease obligations	(10)	—	—
Payments for debt issuance costs	(4,073)	(1,676)	(1,032)
Proceeds from issuance of common stock	97	—	—
Proceeds from exercise of stock options	24	356	354
Purchases of treasury stock	(1,934)	—	(1,646)
Net cash provided by financing activities	604	41,700	95,724
<b>NET DECREASE IN CASH AND CASH EQUIVALENTS</b>	<b>(1,143)</b>	<b>(756)</b>	<b>(16,449)</b>
<b>CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD</b>	<b>1,763</b>	<b>2,519</b>	<b>18,968</b>
<b>CASH AND CASH EQUIVALENTS AT END OF PERIOD</b>	<b>\$ 620</b>	<b>\$ 1,763</b>	<b>\$ 2,519</b>
<b>SUPPLEMENTAL CASH FLOW DISCLOSURE:</b>			
Interest paid, net of amounts capitalized	\$ 15,588	\$ 7,956	\$ 765
Income taxes paid	\$ 8,619	\$ 3,964	\$ 3,341

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

CORNELL COMPANIES, INC.  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

I. ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Cornell Companies, Inc. (previously Cornell Corrections, Inc. and collectively with its subsidiaries, the "Company"), a Delaware corporation, provides to governmental agencies the integrated development, design, construction and management of facilities within three operating divisions: (i) adult secure institutional correctional and detention services, (ii) juvenile treatment, educational and detention services and (iii) pre-release correctional and treatment services.

*Consolidation*

The accompanying consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries. All significant intercompany balances and transactions have been eliminated.

*Cash and Cash Equivalents*

The Company considers all highly liquid investments with original maturities of three months or less to be cash equivalents.

*Accounts Receivable*

The Company increased its allowance for doubtful accounts during the years ended December 31, 2000, 1999 and 1998 by \$2.4 million, \$1.0 million and \$509,000, respectively. Write-offs totaling \$2.8 million, \$1.2 million and \$12,000 were charged against the allowance during the periods ended December 31, 2000, 1999 and 1998, respectively.

At December 31, 2000, accounts receivable include costs totaling \$1.1 million for direct costs incurred by the Company since June 1999 for payroll and other operating costs related to the Moshannon Valley Correctional Center since the issuance of a Stop-Work Order by the Federal Bureau of Prisons ("FBOP"). These costs were incurred at the direction of the FBOP with the understanding that such costs would be reimbursed. Although no formal written agreement exists, management believes that these costs will be reimbursed by the FBOP. In the event any portion of these costs are not reimbursed by the FBOP, such costs will be expensed.

*Restricted Assets*

For certain facilities, the Company maintains bank accounts for restricted cash belonging to offenders or residents, commissary operations, an equipment replacement fund used in state programs and a restoration fund for certain facilities. These bank accounts and commissary inventories are collectively referred to as restricted assets and the corresponding obligations are included in accrued expenses in the accompanying financial statements.

*Change in Accounting for Supplies Inventory (Unaudited)*

In fiscal year 2001, management plans to change its method of accounting for supplies whereby the Company will capitalize durable operating supplies' purchases such as uniforms, linens and books and amortize these costs to operating expense over the estimated period of benefit of 18 months. Effective January 1, 2001, the Company expects to capitalize a portion of previously expensed supplies and recognize a benefit of approximately \$770,000 (net of income taxes of \$535,000) for a cumulative effect of a change in accounting principle.

*Property and Equipment*

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

### *Capitalized Interest*

The Company capitalizes interest on facilities under development and construction. Interest capitalized for the years ended December 31, 2000, 1999 and 1998 was \$40,000, \$1.2 million and \$2.3 million, respectively.

### *Intangible Assets*

Goodwill represents the excess of the cost of acquired businesses over the fair market value of the net tangible and identified intangible assets. Goodwill is amortized using the straight-line method over 20 years, which represents management's estimation of the related benefit to be derived from the acquired businesses. The carrying value of goodwill is reviewed periodically if events and circumstances suggest that it may be permanently impaired. If the review indicates that goodwill will not be recoverable, as determined by the undiscounted cash flow method, the asset will be reduced to its estimated recoverable value. Accumulated amortization of goodwill was \$3.7 million and \$3.0 million as of December 31, 2000 and 1999, respectively.

Non-compete agreements have been obtained primarily through acquisitions of businesses and are amortized over periods of 9 to 10 years using the straight-line method. Accumulated amortization of non-compete agreements was \$1.2 million and \$324,000 at December 31, 2000 and 1999, respectively.

Intangible assets were as follows (in thousands):

	<i>December 31,</i>	
	<i>2000</i>	<i>1999</i>
Goodwill	\$13,658	\$13,658
Non-compete agreements	8,060	7,940
	21,718	21,598
Accumulated amortization	(4,857)	(3,328)
	\$16,861	\$18,270

### *Deferred Costs*

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

Costs incurred related to obtaining credit financing are capitalized and amortized over the term of the related indebtedness. At December 31, 2000, the Company had net deferred debt issuance costs of approximately \$5.3 million related to its credit facilities. At December 31, 2000, the Company had deferred professional fees and other costs totaling \$1.8 million related to its efforts on a facility sale and leaseback transaction. Upon consummation of this transaction, the transaction costs will be included in the determination of the gain from the sale which will be deferred over the initial lease term. If management of the Company determines that it is doubtful that this transaction will be consummated, these transaction costs will be expensed in the period such determination is made.

At December 31, 2000, the Company had deferred acquisition costs totaling \$628,000 related to the anticipated purchase of real property in Fort Greely, Alaska. Management anticipates that this property will be used in conjunction with the operations of an adult secure institution for the State of Alaska. If management determines that a contract to operate this facility in Fort Greely, Alaska will not be awarded to the Company, the Company will likely not purchase the real property and the deferred acquisition costs will be expensed.

### *Realization of Long-Lived Assets*

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

### *Revenue Recognition*

Substantially all revenues are derived from contracts with federal, state and local government agencies, which pay either per diem rates based upon the number of occupant days or hours served for the period or cost-plus reimbursement. Revenues are recognized as services are provided. Deferred revenues result from advances or prepayments from agencies for future services to be provided.

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

### *Income Taxes*

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

### *Use of Estimates*

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

### *Business Concentration*

Contracts with federal, state and local governmental agencies account for nearly all of the Company's revenues. The loss of, or a significant decrease in, business from one or more of these governmental agencies could have a material adverse effect on the Company's financial condition and results of operations. For the years ended December 31, 2000, 1999 and 1998, 18.5%, 19.8% and 20.1%, respectively, of the Company's consolidated revenues were derived from contracts with the FBOP.

### *Financial Instruments*

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

### *Accounting for Stock-Based Compensation*

The Company accounts for its stock-based compensation plans under Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees." In accordance with SFAS No. 123, "Accounting for Stock-Based Compensation," certain pro forma disclosures are provided in Note 8 to the Consolidated Financial Statements.

### *Earnings Per Share*

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

## 2. ACQUISITIONS

### *1999 Acquisitions*

In November 1999, the Company acquired certain of the adult and juvenile behavioral health and correctional assets of Interventions, a not-for-profit corporation headquartered in Chicago, Illinois, and BHS Consulting Corporation ("BHS"), a for-profit firm that provides management services to Interventions. The assets acquired included more than 30 programs provided throughout Illinois and the real properties of seven facilities. The aggregate purchase price for the transactions was approximately \$31.8 million including transaction costs. The Company financed the transaction with borrowings under a bridge loan. See Note 6 to the Consolidated Financial Statements.

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

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

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

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

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

### 3. PROPERTY AND EQUIPMENT

Property and equipment were as follows (in thousands):

	<i>December 31,</i>	
	<u>2000</u>	<u>1999</u>
Land	\$ 20,694	\$ 19,929
Prepaid facility use	68,237	66,894
Buildings and improvements	115,872	108,605
Furniture and equipment	7,129	2,378
Construction in progress	4,487	5,838
	<u>216,419</u>	<u>203,644</u>
Accumulated depreciation and amortization	(14,736)	(9,146)
	<u>\$ 201,683</u>	<u>\$ 194,498</u>

Construction in progress at December 31, 2000, consisted primarily of construction costs attributable to an expansion of the Big Spring Complex.

The Company utilizes an unrelated privately owned construction company ("Construction Contractor") as its preferred contractor for construction projects. The Construction Contractor has received contracts to construct facilities, which the Company owns and/or operates, totaling approximately \$3.5 million, \$68.5 million and \$20.4 million during the years ended December 31, 2000, 1999 and 1998, respectively. Management believes the Company is a substantial customer of the Construction Contractor. During the fourth quarter of 2000, the Company entered into a license agreement with this construction contractor that conveyed certain rights to the design of an adult secure institution. A non-recurring license agreement payment of \$950,000 was recognized as revenue by the Company. The Company has not licensed such designs in prior years and does not expect to generate significant revenues from such activity in future periods. During the year ended December 31, 1999, this Construction Contractor paid the Company \$1.0 million related to a cost-sharing agreement in connection with the operations of the Santa Fe County Adult Detention Facility because the operating margins had not reached certain levels until June 1999. These cost-sharing payments were reported by the Company as a reduction of operating expenses. The Construction Contractor has no obligation to make any further cost-sharing payments.

### 4. ACCOUNTS PAYABLE AND ACCRUED LIABILITIES

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

	<i>December 31,</i>	
	<u>2000</u>	<u>1999</u>
Accounts payable	\$16,557	\$ 8,974
Accrued compensation expense	6,701	4,764
Accrued interest payable	2,484	2,418
Other	7,437	11,236
	<u>\$33,179</u>	<u>\$ 27,392</u>

## 5. INCOME TAXES

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

	<i>December 31,</i>	
	<i>2000</i>	<i>1999</i>
Deferred tax assets:		
Depreciation and amortization	\$ 531	\$ 2,045
Accrued expenses	1,667	1,935
Deferred compensation	325	339
Other	515	303
	3,038	4,622
Deferred tax liabilities:		
Amortization of intangible assets	18	89
Prepaid facility use amortization	1,332	931
Prepaid expenses	422	341
Other	1,242	1,112
	3,014	2,473
Net deferred tax asset	\$ 24	\$ 2,149

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

	<i>Year Ended December 31,</i>		
	<i>2000</i>	<i>1999</i>	<i>1998</i>
Current provision	\$ 3,413	\$ 7,279	\$ 1,936
Deferred provision (benefit)	2,125	(1,741)	2,106
Tax provision	\$ 5,538	\$ 5,538	\$ 4,042

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

	<i>Year Ended December 31,</i>		
	<i>2000</i>	<i>1999</i>	<i>1998</i>
Computed taxes at statutory rate	\$ 4,728	\$ 4,846	\$ 3,536
Amortization of non-deductible intangibles	129	119	119
State income taxes, net of federal benefit	460	369	399
Changes in valuation allowance	—	—	(420)
Other	221	204	408
	\$ 5,538	\$ 5,538	\$ 4,042

## 6. CREDIT FACILITIES

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

	<i>December 31,</i>	
	<i>2000</i>	<i>1999</i>
Revolving Line of Credit due July 2005 with an interest rate of prime plus 1.0% to 2.0%, or LIBOR plus 2.0% to 3.0%	\$ 58,000	\$ 51,500
Senior Secured Notes due July 2010 with an interest rate of 7.74%	50,000	50,000
Subordinated Notes, net of discount, due July 2007 with an interest rate of 12.875%	38,890	—
Capital lease obligations	77	—
Total debt	146,967	101,500
Less: current maturities	(41)	—
Long-term debt	\$146,926	\$101,500

Effective July 21, 2000, the Company formalized terms under an amended and restated credit agreement (the "2000 Credit Facility") with a group of financial institutions. The 2000 Credit Facility provides for borrowings of up to \$75.0 million under a revolving line of credit. At December 31, 2000, the remaining borrowing capacity was \$17.0 million. The revolving credit commitment is reduced by \$2.7 million quarterly beginning in January 2002. The 2000 Credit Facility matures in July 2005 and bears interest, at the election of the Company, at either the prime rate plus a margin of 1.0% to 2.0%, or a rate which is 2.0% to 3.0% above the applicable LIBOR rate, depending on the level of borrowings. At December 31, 2000, the margin was at 3.0% above the LIBOR rate. A commitment fee of 0.5% is charged on the unused portion of the revolving credit commitment. The 2000 Credit Facility is secured by substantially all of the Company's assets, including the stock of all of the Company's subsidiaries; does not permit the payment of cash dividends; and requires the Company to comply with certain leverage, net worth and debt service coverage covenants.

Concurrent with the closing of the 2000 Credit Facility, the Company's \$50.0 million Subordinated Bridge Loan Agreement was refinanced with proceeds from a Note and Equity Purchase Agreement (the "Subordinated Notes"). The Subordinated Notes have a seven-year term and are interest-only payable quarterly at a fixed rate of 12.875%. In conjunction with the issuance of the Subordinated Notes, the Company issued warrants to purchase 290,370 shares of the common stock at an exercise price of \$6.70. The Company recognized the fair value of these warrants of \$1.1 million as additional paid-in capital. The warrants may only be exercised by payment of the exercise price in cash to the Company or by the cancellation of Company indebtedness owed to the warrant holder.

In July 1998, the Company completed a private placement of \$50.0 million of Senior Secured Notes ("Senior Notes"), of which \$25.0 million was issued in July 1998 and \$25.0 million in August 1998. The Senior Notes, which bear interest at a fixed rate of 7.74%, mature on July 15, 2010. Under the Senior Notes purchase agreements, the Company is required to make eight annual principal payments of \$6.25 million beginning on July 15, 2003 and comply with certain financial covenants. Earlier payments of principal are allowed subject to certain prepayment provisions. Interest is payable semi-annually. The holders of the Senior Notes and the lenders under the 2000 Credit Facility have a collateral-sharing agreement whereby both sets of creditors have an equal security interest in substantially all the assets of the Company.

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

For the year ending December 31,

2001	\$ 41
2002	36
2003	10,679
2004	16,964
2005	49,107
Thereafter	70,140
Total	\$ 146,967

## 7. COMMITMENTS AND CONTINGENCIES

### *Operating Leases*

The Company leases office space, and certain facilities and furniture and equipment under long-term operating leases. Rent expense for all operating leases for the years ended December 31, 2000, 1999 and 1998, was approximately \$9.7 million, \$5.4 million and \$4.5 million, respectively. In November 1999, the Company entered into an agreement for the sale and leaseback of certain of its furniture and equipment. The Company has purchase and lease renewal options at projected future fair market values under the agreements. The leases are classified as operating leases. At the date of sale, furniture and equipment with carrying values totaling \$11.8 million were sold and the gains realized on the sale totaling \$7.3 million were deferred and are being amortized as a credit to rent expense over the lease term. The increase in 2000 rent expense compared to 1999 was due principally to rent expense resulting from this sale and leaseback transaction.

Under the 2000 Credit Facility, the Company entered into operating lease agreements for the acquisition or development of operating facilities. This lease financing arrangement provides for funding to the lessor under the operating leases of up to \$100.0 million, of which approximately \$46.4 million had been utilized at December 31, 2000. The remaining capacity under this lease financing arrangement is expected to be utilized to complete construction of the Moshannon Valley Correctional Center. At December 31, 2000, approximately \$13.6 million of this lease financing arrangement had been utilized for construction costs for the Moshannon Valley Correctional Center. The leases under this arrangement each have a term of five years, include purchase and renewal options, and provide for residual value guarantees for each lease which average 81.4% of the total cost and would be due by the Company upon termination of the leases. Upon termination of a lease, the Company could either exercise a purchase option, or the facilities could be sold to a third party. The Company expects the fair market value of the leased facilities to substantially reduce or eliminate the Company's potential obligation under the residual value guarantee. At December 31, 2000, there were two operating leases under this arrangement. Lease payments under the lease financing arrangements are variable and are adjusted for changes in interest rates.

As of December 31, 2000, the Company had rental commitments under noncancelable operating leases and anticipated lease payments under the Company's facility lease financing arrangement (in thousands):

For the year ending December 31,

2001	\$ 11,674
2002	9,752
2003	8,229
2004	5,022
2005	2,509
Thereafter	17,281
Total	\$ 54,467

Upon completion of the Moshannon Valley Correctional Center, the Company expects to enter into a lease pursuant to the terms of the lease financing agreement described above. Estimated annual rental commitments are expected to aggregate approximately \$5.0 million during the base lease term.

### *401(k) Plan*

The Company has a defined contribution 401(k) plan. The Company's matching contribution currently represents 50% of a participant's contribution, up to the first 6% of the participant's salary. For the years ended December 31, 2000, 1999 and 1998, the Company recorded \$923,000, \$754,000 and \$611,000, respectively, of contribution expense.

### *Other*

The Company is subject to certain claims and disputes arising in the normal course of the Company's business. In the opinion of the Company's management, uninsured losses, if any, resulting from the ultimate resolution of these matters will not have a material adverse impact on the Company's financial position or results of operations.

## 8. STOCKHOLDERS' EQUITY

### *Stockholder Rights Plan*

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

### *Preferred Stock*

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

### *Options*

In December 2000, the Company adopted the 2000 Broad-Based Employee Plan ("2000 Plan"). Pursuant to the 2000 Plan, the Company may grant non-qualified stock options for up to the greater of 400,000 shares or 4% of the aggregate number of shares of common stock outstanding. The 2000 Plan options vest up to five years and expire ten years from the grant date. In May 1996, the Company adopted the 1996 Stock Option Plan and amended and restated the plan in April 1998 ("1996 Plan"). Pursuant to the 1996 Plan, the Company may grant non-qualified and incentive stock options for up to the greater of 1,500,000 shares or 15% of the aggregate number of shares of common stock outstanding. The 1996 Plan options vest up to seven years and expire seven to ten years from the grant date. The Compensation Committee of the Board of Directors is responsible for determining the exercise price and vesting terms for the granted options. The 1996 Plan and 2000 Plan option exercise prices can be no less than the market price of the Company's common stock on the date of grant.

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

The following is a summary of the status of the Company's 2000 Plan, 1996 Plan and other options at December 31, 2000, 1999 and 1998, and changes during the years then ended:

	2000		1999		1998	
	Weighted Average Exercise		Weighted Average Exercise		Weighted Average Exercise	
	Shares	Price	Shares	Price	Shares	Price
Outstanding at beginning of year	1,242,637	\$ 11.46	1,338,839	\$ 15.73	854,454	\$ 6.60
Granted	378,877	5.30	463,000	11.98	932,872	22.83
Exercised	(10,000)	2.50	(57,200)	10.60	(177,187)	2.94
Forfeited or canceled	(317,466)	19.74	(502,002)	23.40	(271,300)	19.76
Outstanding at end of year	1,294,048	7.70	1,242,637	11.46	1,338,839	15.73
Exercisable at end of year	619,673	6.79	523,712	7.17	487,557	5.84
Weighted average fair value of options granted	\$ 3.03		\$ 9.48		\$ 16.41	

The following table summarizes information about stock options outstanding at December 31, 2000:

Range of Exercise Prices	Number Outstanding	Weighted Average Remaining Life	Weighted Average Exercise Price	Number Exercisable	Weighted Average Exercise Price
\$ 2.00 to \$ 2.50	93,919	4.4	\$ 2.02	93,919	\$ 2.02
3.75 to 5.64	594,525	7.8	4.66	318,177	4.91
7.59 to 9.00	82,000	9.0	8.36	61,000	8.23
10.375 to 15.19	444,100	8.3	11.31	111,660	12.25
15.81 to 24.38	79,504	7.4	16.27	34,917	16.86
	1,294,048	7.6	\$ 7.52	619,673	\$ 6.76

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

		Year Ended December 31,		
		2000	1999	1998
Net income:	As reported	\$ 7,969	\$ 5,352	\$ 6,062
	Pro forma	6,093	3,662	4,380
Earnings per share (diluted):	As reported	.84	.55	.62
	Pro forma	.64	.38	.45

Under SFAS No. 123, the fair value of each option grant was estimated on the date of grant using the minimum value calculation prior to the Company's initial public offering ("IPO") and the Black-Scholes option pricing model subsequent to the IPO. The following weighted average assumptions were used for grants in 2000, 1999 and 1998, respectively: risk-free interest rates of 5.4%, 6.6% and 5.8%; dividend rates of \$0, \$0 and \$0; expected lives of 6.6, 10.0 and 10.0 years; expected volatility of 52.76%, 65.74% and 54.70%.

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

#### *Notes from Shareholders*

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

#### *Treasury Stock*

During the years ended December 31, 2000 and 1998, the Company repurchased 258,400 and 142,100 shares, respectively, of common stock on the open market under a share repurchase program at an aggregate cost of \$1.9 million and \$1.6 million, respectively.

#### *Employee Stock Purchase Plan*

The Company has an employee stock purchase plan whereby employees can make contributions to purchase the Company's common stock. Purchases of common stock are made annually at the lower of the beginning or end of year market value, less a 15% discount. For the year ended December 31, 2000, contributions of \$97,000 were used to purchase 13,585 shares of the Company's common stock.

## **9. SEGMENT DISCLOSURE**

The Company's three operating divisions are its reportable segments. The secure adult institutional segment consists of the operation of secure adult incarceration facilities. The juvenile segment consists of providing residential treatment and educational programs and non-residential community-based programs to juveniles between the ages of 10 and 17 who either have been adjudicated or suffer from behavioral problems. The pre-release segment consists of providing pre-release and halfway house programs for adult offenders who are either on probation or serving the last three to six months of their sentences on parole and preparing for re-entry into society at large. The accounting policies of the Company's segments are the same as those described in the summary of significant accounting policies in Note 1. Intangible assets are not included in each segment's reportable assets, and the amortization of intangible assets is not included in the determination of a segment's operating income or loss. The Company evaluates performance based on income or loss from operations before general and administrative expenses, incentive bonuses, amortization of intangibles, interest and income taxes. Corporate and other assets are comprised primarily of cash, accounts receivable, deposits, deferred costs and deferred taxes.

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

	<i>Year Ended December 31,</i>		
	<i>2000</i>	<i>1999</i>	<i>1998</i>
Revenues		<i>(in thousands)</i>	
Adult secure institutional	\$ 91,163	\$ 76,011	\$ 52,630
Juvenile	86,033	67,131	47,032
Pre-release	48,854	33,825	23,457
<b>Total revenues</b>	<b>\$226,050</b>	<b>\$176,967</b>	<b>\$123,119</b>
Depreciation and amortization			
Adult secure institutional	\$ 2,873	\$ 3,013	\$ 2,145
Juvenile	1,162	1,001	739
Pre-release	1,100	831	685
Amortization of intangibles	1,528	810	415
Corporate and other	613	352	244
<b>Total depreciation and amortization</b>	<b>\$ 7,276</b>	<b>\$ 6,007</b>	<b>\$ 4,228</b>
Income (loss) from operations			
Adult secure institutional	\$ 20,126	\$ 17,930	\$ 12,638
Juvenile	10,976	8,482	5,058
Pre-release	11,786	7,122	4,043
General and administrative expenses	(12,024)	(9,932)	(7,581)
Incentive bonuses	—	(50)	(803)
Amortization of intangibles	(1,528)	(810)	(415)
Corporate and other	(275)	(493)	(351)
<b>Total income from operations</b>	<b>\$ 29,061</b>	<b>\$ 22,249</b>	<b>\$ 12,589</b>
Assets			
Adult secure institutional	\$143,743	\$141,268	\$127,774
Juvenile	59,630	53,498	37,917
Pre-release	51,802	47,952	28,815
Intangible assets, net	16,861	17,911	9,935
Corporate and other	19,403	13,362	8,254
<b>Total assets</b>	<b>\$291,439</b>	<b>\$273,991</b>	<b>\$212,695</b>
Capital expenditures			
Adult secure institutional	\$ 5,172	\$ 13,536	\$ 40,243
Juvenile	3,924	4,203	5,927
Pre-release	786	5,184	2,188
Corporate and other	2,214	6,144	1,125
<b>Total capital expenditures</b>	<b>\$ 12,096</b>	<b>\$ 29,067</b>	<b>\$ 49,483</b>

## 10. SELECTED QUARTERLY FINANCIAL DATA (UNAUDITED)

	<i>1st Quarter</i>	<i>2nd Quarter</i>	<i>3rd Quarter</i>	<i>4th Quarter</i>	<i>Year</i>
	<i>(in thousands, except per share data)</i>				
<b>2000:</b>					
Revenues	\$53,468	\$55,408	\$56,746	\$60,428	\$226,050
Income from operations	6,901	7,466	7,516	7,178	29,061
Net income	1,971	2,193	1,932	1,873	7,969
Earnings per share:					
- Basic	\$ .21	\$ .23	\$ .21	\$ .20	\$ .85
- Diluted	\$ .21	\$ .23	\$ .20	\$ .20	\$ .84
<b>1999:</b>					
Revenues	\$38,356	\$43,609	\$45,321	\$49,681	\$176,967
Income from operations	3,987	4,815	5,945	7,502	22,249
Income before cumulative effect of change in accounting principle	1,440	1,783	2,287	2,796	8,306
Net income (loss) <sup>(1)</sup>	(1,514)	1,783	2,287	2,796	5,352
Earnings per share before cumulative effect of change in accounting principle:					
- Basic	\$ .15	\$ .19	\$ .24	\$ .30	\$ .88
- Diluted	\$ .15	\$ .18	\$ .24	\$ .29	\$ .86
Earnings per share:					
- Basic	\$ (.16)	\$ .19	\$ .24	\$ .30	\$ .57
- Diluted	\$ (.16)	\$ .18	\$ .24	\$ .29	\$ .55
<b>1998:</b>					
Revenues	\$27,041	\$29,099	\$30,731	\$36,248	\$123,119
Income from operations	2,393	2,482	3,285	4,429	12,589
Net income	1,258	1,281	1,596	1,927	6,062
Earnings per share:					
- Basic	\$ .13	\$ .14	\$ .17	\$ .20	\$ .64
- Diluted	\$ .13	\$ .13	\$ .16	\$ .20	\$ .62

<sup>(1)</sup> The Company adopted SOP 98-5 in January 1999 and recorded a net-of-tax charge of approximately \$3.0 million for the cumulative effect of a change in accounting principle.

**CORNELL COMPANIES, INC.**  
**SELECTED CONSOLIDATED FINANCIAL DATA**

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

	2000	<i>Year Ended December 31,</i>			
		1999 <sup>(1)</sup>	1998 <sup>(2)</sup>	1997 <sup>(3)</sup>	1996 <sup>(4)</sup>
<i>(dollars in thousands, except per share data)</i>					
<b>Statement of Operations Data:</b>					
Revenues	\$ 226,050	\$ 176,967	\$ 123,119	\$ 70,302	\$ 32,327
Income from operations	29,061	22,249	12,589	5,630	339
Income (loss) before income taxes and cumulative effect of change in accounting principle	13,507	13,844	10,104	5,553	(2,304)
Income (loss) before cumulative effect of change in accounting principle	7,969	8,306	6,062	3,554	(2,379)
Cumulative effect of change in accounting principle, net of related income tax benefit of \$ 1,969 in 1999	—	2,954	—	—	—
Net income (loss)	\$ 7,969	\$ 5,352	\$ 6,062	\$ 3,554	\$ (2,379)
Earnings (loss) per share:					
- Basic					
Income before cumulative effect of change in accounting principle	\$ .85	\$ .88	\$ .64	\$ .48	\$ (.65)
Net income (loss)	\$ .85	\$ .57	\$ .64	\$ .48	\$ (.65)
- Diluted					
Income before cumulative effect of change in accounting principle	\$ .84	\$ .86	\$ .62	\$ .46	\$ (.65)
Net income (loss)	\$ .84	\$ .55	\$ .62	\$ .46	\$ (.65)
Number of shares used to compute EPS (in thousands):					
- Basic	9,383	9,432	9,442	7,350	3,673
- Diluted	9,495	9,660	9,772	7,740	3,673
<b>Operating Data:</b>					
Total service capacity:					
Residential	11,318 <sup>(5)</sup>	11,796	9,135	6,172	3,577
Non-residential community-based	3,046	3,049	1,390	900	—
Total	14,364 <sup>(5)</sup>	14,845	10,525	7,072	3,577
Service capacity in operation (end of period)	13,269	12,240	8,700	5,061	2,899
Contracted beds in operation (end of period) <sup>(6)</sup>	10,061	9,029	7,310	4,161	2,899
Average occupancy based on contracted beds in operation <sup>(6)</sup> <sup>(7)</sup>	94.3%	95.8%	93.8%	97.6%	97.0%
Average occupancy excluding start-up operations <sup>(6)</sup>	96.0%	97.0%	98.3%	97.6%	97.0%
<b>Balance Sheet Data:</b>					
Working capital (deficit)	\$ 29,703	\$ (12,636)	\$ 16,828	\$ 26,220	\$ 7,747
Total assets	291,439	273,991	212,695	104,109	46,824
Long-term debt	146,926	101,500	98,480	432	745
Stockholders' equity	104,320	97,208	91,500	86,730	41,051

## NOTES TO SELECTED CONSOLIDATED FINANCIAL DATA

- (1) Includes the operations of Interventions-Illinois acquired in November 1999.
- (2) Includes the operations of the Great Plains Correctional Facility acquired in January 1998 and the Alaska facilities purchased from Allvest in August 1998.
- (3) Includes the operations of Interventions-Texas and Abraxas acquired in January 1997 and September 1997, respectively.
- (4) Includes the operations of the Reid Community Correctional Center and the Big Spring Complex acquired in May 1996 and July 1996, respectively.
- (5) The Utah Department of Corrections ("Utah DOC") selected the Company's bid in June 1999 for the 490-bed Timpie Valley Correctional Facility subject to final contract negotiations. In 2000, the Utah DOC declined to pursue this project, therefore the Company's service capacity was reduced accordingly.
- (6) Occupancy percentages are based on contracted service capacity of residential facilities in operation. Since certain facilities have service capacities that exceed contracted capacities, occupancy percentages can exceed 100% of contracted capacity.
- (7) Occupancy percentages reflect less than normalized occupancy during the start-up phase of any applicable facility, resulting in a lower average occupancy in periods when the Company has substantial start-up activities.

CORNELL COMPANIES, INC.  
STOCK DATA

The common stock of the Company is currently listed on the New York Stock Exchange (“NYSE”) under the symbol “CRN.” As of February 28, 2001, there were approximately 44 record holders of common stock. The quarterly high and low closing sales prices for the common stock from January 1, 1999 through February 28, 2001 are shown below:

	<i>High</i>	<i>Low</i>
1999:		
First Quarter	\$ 19 <sup>5/8</sup>	\$ 13 <sup>1/4</sup>
Second Quarter	22 <sup>5/8</sup>	15 <sup>1/2</sup>
Third Quarter	17 <sup>1/8</sup>	13 <sup>15/16</sup>
Fourth Quarter	16 <sup>3/8</sup>	8 <sup>1/8</sup>
2000:		
First Quarter	11	7 <sup>9/16</sup>
Second Quarter	11	6 <sup>9/16</sup>
Third Quarter	9	6 <sup>1/8</sup>
Fourth Quarter	8 <sup>3/16</sup>	3 <sup>1/2</sup>
2001:		
First Quarter (through February 28, 2001)	8 <sup>1/4</sup>	5 <sup>11/16</sup>

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

## CORPORATE DIRECTORY

### DIRECTORS

Anthony R. Chase<sup>1</sup> (46)  
*Chairman and Chief Executive Officer, ChaseCom, LP*

James H.S. Cooper<sup>2</sup> (46)  
*Founder and Chairman, Brentwood Capital Advisors, LLC*

David M. Cornell (65)  
*Retired Chairman of the Board*

Peter A. Leidel<sup>2</sup> & <sup>3</sup>(44)  
*Partner, Ticonderoga Capital  
Managing Director, Yorktown Partners, LLC  
Chairman of the Board*

Arlene R. Lissner (70)  
*Managing Director, National Marketing*

Steven W. Logan<sup>3</sup> (39)  
*President and Chief Executive Officer*

Harry J. Phillips, Jr.<sup>1</sup> (50)  
*President, Timberlake Interests, Inc.,  
and Phillips Investments, Inc.*

Tucker Taylor<sup>1</sup> (62)  
*President, CBCA, Inc.*

Marcus A. Watts<sup>2</sup> & <sup>3</sup> (42)  
*Senior Partner, Locke, Liddell & Sapp LLP*

- 1 Compensation Committee
- 2 Audit Committee
- 3 Nominating Committee

### CORPORATE INFORMATION

Annual Meeting of Shareholders  
Date: June 14, 2001  
Time: 10:00 a.m.  
Location: Houston Marriott West Loop by The Galleria  
1750 West Loop South  
Houston, Texas 77027  
713-960-0111

### INDEPENDENT ACCOUNTANTS

Arthur Andersen LLP  
711 Louisiana, Suite 1300  
Houston, Texas 77002

### STOCK LISTING

New York Stock Exchange  
Ticker Symbol: **CRN**

## STOCK TRANSFER AGENT AND REGISTRAR

Computershare Trust Company  
12039 West Alameda Parkway, Z-2  
Lakewood, Colorado 80228  
303-986-5400

### CORPORATE HEADQUARTERS

Cornell Companies, Inc.  
1700 West Loop South, Suite 1500  
Houston, Texas 77027  
713-623-0790

### EXECUTIVE OFFICERS AND KEY EMPLOYEES

Steven W. Logan (39)  
*President and Chief Executive Officer*

John L. Hendrix (52)  
*Senior Vice President and Chief Financial Officer*

Thomas R. Jenkins (53)  
*Senior Vice President and Chief Operating Officer*

Arlene R. Lissner (70)  
*Managing Director, National Marketing*

Leslie A. Balonick (49)  
*Vice President, Midwest Region*

Luis A. Collazo (34)  
*Chief Accounting Officer and Corporate Controller*

John C. Godlesky (54)  
*Vice President, Eastern Region*

Gary L. Henman, Ph.D. (61)  
*Vice President, Adult Secure Institutions*

Kevin B. Kelly (38)  
*Treasurer and Corporate Secretary*

Patrick N. Perrin (40)  
*Chief Administrative Officer*

Laura J. Shol (45)  
*Vice President, Western Region*

Kevin T. Smyley (50)  
*Managing Director, Development*

Marvin H. Wiebe (53)  
*Senior Vice President*

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