



FORM 10-Q

PROVIDENCE SERVICE CORP – PRSC

Filed: May 04, 2005 (period: March 31, 2005)

Quarterly report which provides a continuing view of a company's financial position

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**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION**
Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended March 31, 2005

OR

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

For the transition period from _____ to _____

Commission File No. 000-50364

The Providence Service Corporation

(Exact name of registrant as specified in its charter)

Delaware
(State or other jurisdiction of
incorporation or organization)

86-0845127
(I.R.S. Employer
Identification No.)

**5524 East Fourth Street,
Tucson, Arizona**
(Address of principal executive offices)

85711
(Zip code)

(520) 747-6600
(Registrant's telephone number, including area code)

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

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

As of May 2, 2005, there were outstanding 9,442,269 shares (excluding treasury shares of 146,905) of the registrant's Common Stock, \$.001 par value per share.

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PART I—FINANCIAL INFORMATION

Item 1. Financial Statements.

The Providence Service Corporation
Consolidated Balance Sheets

	December 31, 2004	March 31, 2005
	(Note 1)	(Unaudited)
Assets		
Current assets:		
Cash and cash equivalents	\$10,657,483	\$13,478,884
Accounts receivable, net of allowance of \$221,000 and \$156,000	18,822,881	20,549,481
Management fee receivable	5,023,405	5,054,787
Prepaid expenses and other	3,533,311	3,519,171
Deferred tax asset	474,760	474,760
Total current assets	38,511,840	43,077,083
Property and equipment, net	2,315,911	2,289,945
Notes receivable	1,282,341	1,282,341
Goodwill	24,717,145	24,789,289
Intangible assets, net	7,510,808	7,376,937
Deferred tax asset	606,694	606,694
Other assets	975,917	836,935
Total assets	\$75,920,656	\$80,259,224
Liabilities and stockholders' equity		
Current liabilities:		
Accounts payable	\$ 1,243,444	\$ 1,871,617
Accrued expenses	7,995,425	8,739,686
Deferred revenue	948,434	548,740
Current portion of capital lease obligations	102,507	95,686
Current portion of long-term obligations	300,000	400,000
Total current liabilities	10,589,810	11,655,729
Capital lease obligations, less current portion	32,882	15,459
Long-term obligations, less current portion	700,000	600,000
Stockholders' equity:		
Common stock: Authorized 40,000,000 shares; \$0.001 par value; 9,486,879 and 9,558,886 issued and outstanding (including treasury shares)	9,487	9,559
Additional paid-in capital	65,731,824	67,027,505
Accumulated (deficit) earnings	(844,601)	1,249,718
Less 146,905 treasury shares, at cost	64,896,710	68,286,782
	298,746	298,746
Total stockholders' equity	64,597,964	67,988,036
Total liabilities and stockholders' equity	\$75,920,656	\$80,259,224

See accompanying notes to unaudited consolidated financial statements

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The Providence Service Corporation
Unaudited Consolidated Statements of Operations

	Three months ended March 31,	
	2004	2005
Revenues:		
Home and community based services	\$12,973,947	\$26,175,502
Foster care services	3,258,900	3,358,547
Management fees	2,221,814	2,499,210
	<u>18,454,661</u>	<u>32,033,259</u>
Operating expenses:		
Client service expense	13,749,970	24,175,298
General and administrative expense	2,563,194	3,959,277
Depreciation and amortization	228,162	370,535
	<u>16,541,326</u>	<u>28,505,110</u>
Total operating expenses		
	<u>16,541,326</u>	<u>28,505,110</u>
Operating income	1,913,335	3,528,149
Other (income) expense:		
Interest expense	118,555	85,551
Interest income	(41,900)	(47,933)
	<u>1,836,680</u>	<u>3,490,531</u>
Income before income taxes		
	<u>1,836,680</u>	<u>3,490,531</u>
Provision for income taxes	734,672	1,396,212
	<u>1,102,008</u>	<u>2,094,319</u>
Net income		
	<u>1,102,008</u>	<u>2,094,319</u>
Earnings per common share:		
Basic	\$ 0.13	\$ 0.22
	<u>\$ 0.13</u>	<u>\$ 0.22</u>
Diluted	\$ 0.13	\$ 0.22
	<u>\$ 0.13</u>	<u>\$ 0.22</u>
Weighted-average number of common shares outstanding:		
Basic	8,492,573	9,498,806
Diluted	8,785,917	9,659,489

See accompanying notes to unaudited consolidated financial statements

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The Providence Service Corporation
Unaudited Consolidated Statements of Cash Flows

	Three months ended March 31,	
	2004	2005
Operating activities		
Net income	\$ 1,102,008	\$ 2,094,319
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation	150,742	206,664
Amortization	77,420	163,871
Amortization of deferred financing costs and discount on investment	21,400	31,040
Stock compensation	43,158	—
Changes in operating assets and liabilities, net of effects of acquisitions:		
Trade accounts receivable, net	(1,785,165)	(1,726,600)
Management fee receivable	498,087	(31,382)
Prepaid expenses and other	(176,531)	122,082
Accounts payable	525,049	628,173
Accrued expenses	855,522	744,261
Deferred revenue	—	(399,694)
Net cash provided by operating activities	1,311,690	1,832,734
Investing activities		
Purchase of property and equipment	(130,256)	(180,698)
Acquisition of businesses, net of cash acquired	(3,475,762)	(102,144)
Net cash used in investing activities	(3,606,018)	(282,842)
Financing activities		
Net payments on revolving note	(93,661)	—
Payments of capital leases	(20,630)	(24,244)
Proceeds from common stock issued pursuant to stock option exercise, net	44,649	1,295,753
Public offering costs	(84,214)	—
Repayments of short-term debt	(1,400,000)	—
Repayments of long-term debt	(2,100,000)	—
Net cash provided by (used in) financing activities	(3,653,856)	1,271,509
Net change in cash	(5,948,184)	2,821,401
Cash at beginning of period	15,004,235	10,657,483
Cash at end of period	\$ 9,056,051	\$13,478,884
Supplemental cash flow information		
Notes payable issued for acquisition of business	\$ 1,000,000	\$ —

See accompanying notes to unaudited consolidated financial statements

The Providence Service Corporation
Notes to Unaudited Consolidated Financial Statements
March 31, 2005

1. Basis of Presentation

The accompanying unaudited consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by accounting principles generally accepted in the United States for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for fair presentation have been included. Operating results for the three months ended March 31, 2005 are not necessarily indicative of the results that may be expected for the fiscal year ending December 31, 2005.

The consolidated balance sheet at December 31, 2004 has been derived from the audited financial statements at that date but does not include all of the information and footnotes required by accounting principles generally accepted in the United States for complete financial statements. The consolidated financial statements contained herein should be read in conjunction with the audited financial statements and notes included in The Providence Service Corporation's annual report on Form 10-K for the year ended December 31, 2004.

2. Summary of Significant Accounting Policies and Description of Business

Description of Business

The Providence Service Corporation (the "Company") is a privatization company specializing in alternatives to institutional care. The Company responds to governmental privatization initiatives in adult and juvenile justice, corrections, social services, welfare systems, and education by providing home-based and community-based counseling services to at-risk families and children. These services are purchased primarily by state, city, and county levels of government, and are delivered under contracts ranging from capitation to fee-for-service arrangements. The Company also contracts with not-for-profit organizations to provide management services for a fee. The Company operates in Arizona, California, Delaware, Florida, Illinois, Indiana, Maine, Massachusetts, Michigan, Nebraska, Nevada, New Mexico, North Carolina, Ohio, Oklahoma, Pennsylvania, South Carolina, Tennessee, Texas, Virginia, West Virginia, and the District of Columbia.

Cash Equivalents

Cash and cash equivalents include all cash balances and highly liquid investments with an initial maturity of three months or less. The Company places its temporary cash investments with high credit quality financial institutions. At times such investments may be in excess of the Federal Deposit Insurance Corporation (FDIC) insurance limit.

Restricted Cash

At December 31, 2004 and March 31, 2005, the Company had \$961,000 of restricted cash of which \$786,000 and \$961,000 was included in prepaid expenses and other for December 31, 2004 and March 31, 2005 and \$175,000 was included in noncurrent other assets for December 31, 2004 in the accompanying consolidated balance sheets. The restricted cash serves as collateral for irrevocable standby letters of credit that provide financial assurance that the Company will fulfill its obligations with respect to certain contracts. At March 31, 2005, the cash was held in custody by the Bank of Tucson. In addition, the cash is restricted as to withdrawal or use, and is currently invested in money market funds.

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Impairment of Long-Lived Assets

Goodwill

The Company analyzes the carrying value of goodwill at the end of each fiscal year and between annual valuations if events occur or circumstances change that would more likely than not reduce the fair value of the reporting unit below its carrying value. Such circumstances could include, but are not limited to: (1) a significant adverse change in legal factors or in business climate, (2) unanticipated competition, or (3) an adverse action or assessment by a regulator. When determining whether goodwill is impaired, the Company compares the fair value of the reporting unit to which the goodwill is assigned to the reporting unit's carrying amount, including goodwill. The Company uses valuation techniques consistent with a market approach by deriving a multiple of the Company's EBITDA (earnings before interest, taxes, depreciation and amortization) based on the market value of the Company's common stock at year end and then applying this multiple to each reporting unit's EBITDA for the year to determine the fair value of the reporting unit. If the carrying amount of a reporting unit exceeds its fair value, then the amount of the impairment loss must be measured. The impairment loss would be calculated by comparing the implied fair value of reporting unit goodwill to its carrying amount. In calculating the implied fair value of reporting unit goodwill, the fair value of the reporting unit is allocated to all of the other assets and liabilities of that unit based on their fair values. The excess of the fair value of a reporting unit over the amount assigned to its other assets and liabilities is the implied fair value of goodwill. An impairment loss would be recognized when the carrying amount of goodwill exceeds its implied fair value. The Company's annual evaluation of goodwill completed as of December 31, 2004 resulted in no impairment loss.

Intangible assets subject to amortization

In accordance with Statement of Financial Accounting Standards No. 141, *Business Combinations* ("SFAS No. 141"), the Company separately values all acquired identifiable intangible assets apart from goodwill. The Company allocated a portion of the purchase consideration to certain management contracts and customer relationships acquired in 2004 based on the expected direct or indirect contribution to future cash flows over the useful life of the asset.

The Company assesses whether certain relevant factors limit the period over which acquired assets are expected to contribute directly or indirectly to future cash flows for amortization purposes. With respect to acquired management contracts, the useful life is limited by the stated terms of the agreements. The Company determines an appropriate useful life for acquired customer relationships based on the nature of the underlying contracts with state and local agencies and the likelihood that the underlying contracts to provide social services will renew over future periods. The likelihood of renewal is based on the Company's contract renewal experience and the contract renewal experiences of entities it has acquired.

Under certain conditions the Company may assess the recoverability of the unamortized balance of its long-lived assets based on expected future cash flows. Should the review indicate that the carrying value is not fully recoverable, the excess of the carrying value over the fair value of any intangible asset is recognized as an impairment loss.

Stock Compensation Arrangements

The Company follows the intrinsic value method of accounting for stock-based compensation plans. The following table reflects net income and earnings per share had the Company's stock options been accounted for using the fair value method:

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	Three months ended March 31,	
	2004	2005
Net income as reported	\$1,102,008	\$2,094,319
Add—Employee stock-based compensation expense included in reported net income, net of federal income tax benefit	25,895	—
Less—Total employee stock-based compensation expense determined under fair value based method for all awards, net of federal income tax benefit	214,826	559,457
Adjusted net income	\$ 913,077	\$1,534,862
Earnings per share:		
Basic—as reported	\$ 0.13	\$ 0.22
Basic—as adjusted	\$ 0.11	\$ 0.16
Diluted—as reported	\$ 0.13	\$ 0.22
Diluted—as adjusted	\$ 0.10	\$ 0.16

New Accounting Pronouncements

In December 2004, the Financial Accounting Standards Board, or FASB, finalized SFAS 123R, “Share-Based Payment”, effective for public companies for annual periods beginning after June 15, 2005. SFAS 123R requires all companies to measure compensation cost for all share-based payments (including employee stock options) at fair value. Retroactive application of the requirements of SFAS 123R is permitted, but not required. On April 15, 2005, the Securities and Exchange Commission (“SEC”) issued its final rule in Release No. 34-51558 regarding the compliance date for SFAS 123R related to public companies. The SEC has delayed the requirement for non-small business public companies to comply with the provisions of SFAS 123R until the first interim reporting period of the public company’s first fiscal year beginning on or after June 15, 2005. Accordingly, the Company plans to implement SFAS 123R beginning January 1, 2006 and is in the process of determining the affect this pronouncement will have the Company’s consolidated financial statements.

3. Goodwill

Changes in goodwill were as follows:

Balance at December 31, 2004	\$24,717,145
Adjustment to costs of the Aspen Companies acquisition	72,144
Balance at March 31, 2005	\$24,789,289

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4. Long-Term Obligations

The Company's long-term obligations were as follows:

	December 31, 2004	March 31, 2005
6% unsecured notes to former stockholders of acquired company, interest payable quarterly beginning April 2004 with equal quarterly principal payments of \$100,000 beginning April 2005 through July 2007	\$ 1,000,000	\$1,000,000
	1,000,000	1,000,000
Less current portion	300,000	400,000
	\$ 700,000	\$ 600,000

On January 9, 2003, the Company entered into a loan and security agreement with Healthcare Business Credit Corporation, which provided for a \$10.0 million revolving line of credit, a \$10.0 million acquisition term loan, and a \$1.0 million term loan. The amount the Company may borrow under the revolving line of credit is subject to the availability of a sufficient amount of eligible accounts receivable at the time of borrowing. Advances under the acquisition term loan are subject to the lender's approval. Proceeds initially borrowed under the revolving line of credit portion of this credit facility were used to repay and terminate the previous revolving line of credit with a former lender. Until its amendment in September 2003, the Company's credit facility was secured by substantially all of the Company's assets as well as certain of its managed entities' assets.

On September 30, 2003, following the Company's repayment of the \$1.0 million term loan portion of the credit facility, the Company's loan and security agreement was amended with respect to the remaining \$10.0 million revolving line of credit and the \$10.0 million acquisition term loan to release the not-for-profit organizations managed by the Company as co-borrowers under the loan and security agreement and extend the maturity date of the acquisition term loan through December 1, 2006. In addition, these not-for-profit organizations established separate stand-alone credit facilities. While the Company does not guarantee any portion of these stand-alone credit facilities, it has agreed to subordinate its management fee receivable in the event of a default under these stand-alone credit facilities. The provisions of the amended loan and security agreement with respect to the revolving line of credit remained the same as set forth in the original loan and security agreement described above. The Company is required to maintain certain financial covenants under the credit facility.

At December 31, 2004 and March 31, 2005, the Company's available credit under the revolving line of credit was \$10.0 million. The Company is required to pay a per annum unused facility fee of 0.5% for any unborrowed amounts under the revolving line of credit and acquisition term loan.

5. Common Stock

The Company adopted a second amended and restated certificate of incorporation and amended and restated bylaws commensurate with the consummation of the Company's initial public offering on August 22, 2003. The Company's second amended and restated certificate of incorporation provides that the Company's authorized capital stock consists of 40,000,000 shares of common stock, \$0.001 par value, and 10,000,000 shares of preferred stock, \$0.001 par value. At December 31, 2004 and March 31, 2005, there were 9,486,879 and 9,558,886 shares of the Company's common stock outstanding (including 146,905 treasury shares) and no shares of preferred stock outstanding.

During the three months ended March 31, 2005, the Company granted 385,000 ten year options under its 2003 stock option plan to directors, executive officers and key employees to purchase the Company's common stock at exercise prices equal the market value of the Company's common stock on the date of grant. The option exercise prices range from \$19.60 to \$22.89 and the options vest in equal installments over time ranging from three to four years. During the three months ended March 31, 2005, the Company issued 27,230 shares of its common stock in connection with the exercise of employee stock options under the Company's 1997 stock option and incentive plan, and 44,777 shares of its common stock in connection with the exercise of employee stock options under the Company's 2003 stock option plan.

[Table of Contents](#)**6. Earnings Per Share**

The following table details the computation of basic and diluted earnings per share:

	Three months ended March 31,	
	2004	2005
Numerator:		
Net income	\$ 1,102,008	\$ 2,094,319
Denominator:		
Denominator for basic earnings per share—weighted—average shares	8,492,573	9,498,806
Effect of dilutive securities:		
Common stock options	293,344	160,683
Denominator for diluted earnings per share—adjusted weighted—average shares assumed conversion	8,785,917	9,659,489
Basic earnings per share	\$ 0.13	\$ 0.22
Diluted earnings per share	\$ 0.13	\$ 0.22

For the three months ended March 31, 2005, employee stock options to purchase 1,387 shares of common stock were not included in the computation of diluted earnings per share as the exercise price of these options was greater than the average fair value of the common shares for the period and, therefore, the effect of these options would be antidilutive.

7. Income Taxes

The Company's effective income tax rate for the interim periods is based on management's estimate of the Company's effective tax rate for the applicable year and differs from the federal statutory income rate primarily due to nondeductible permanent differences and state income taxes.

8. Commitments and Contingencies

The Company is involved in various claims and legal actions arising in the ordinary course of business. In the opinion of management, the ultimate disposition of these matters will not have a material adverse effect on the Company's consolidated financial position, results of operations, or liquidity.

The Company provides management services under long-term management agreements and has relationships with certain tax-exempt organizations under Section 501(c)(3) of the Internal Revenue Code. While actions of certain tax authorities have challenged whether similar relationships by other organizations may violate the federal tax-exempt status of not-for-profit organizations, management is of the opinion that its relationships with these tax-exempt organizations do not violate their tax-exempt status and any unfavorable outcomes would not have a material adverse effect on the Company's consolidated financial position, results of operations, or liquidity.

9. Transactions with Related Parties

In June 1999, the Company was issued a promissory note by a not-for-profit affiliate in the amount of \$461,342. The note bears interest at a rate of 9% per annum and was due in June 2004. On February 20, 2003, a new promissory note in the same amount was issued by the not-for-profit affiliate which extends the due date for repayment of principal and unpaid accrued interest to February 2008 and lowers the interest rate to 5% per annum. Interest income of \$5,092 was recorded for the three months ended March 31, 2004 and 2005. The balance of the note at December 31, 2004 and March 31, 2005 was \$407,341 and is reflected in the accompanying consolidated balance sheets as "Notes receivable".

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In connection with the acquisition of Pottsville Behavioral Counseling Group, Inc. and the establishment of a management agreement with The ReDCo Group (“ReDCo”), in May 2004, the Company loaned \$875,000 to ReDCo to fund certain long-term obligations of ReDCo in exchange for a promissory note for the same amount. The note assumes interest equal to a fluctuating interest rate per annum based on a weighted-average of the daily Federal Funds Rate. The terms of the promissory note require ReDCo to make quarterly interest payments over twenty-one months commencing June 30, 2004 with the principal and any accrued and unpaid interest due upon maturity on March 31, 2006. Interest income of \$0 and \$5,401 was recorded for the three months ended March 31, 2004 and 2005, respectively. The promissory note is collateralized by a subordinated lien to ReDCo’s primary lender on substantially all of ReDCo’s assets. At December 31, 2004 and March 31, 2005, the balance of the note was \$875,000 and is reflected in the accompanying consolidated balance sheet as “Notes receivable”.

Beginning in 2004, the Company began using an airplane operated by Las Montanas Aviation, LLC for business travel purposes on an as needed basis. Las Montanas Aviation, LLC is owned by Mr. McCusker, the Company’s chief executive officer. The Company reimburses Las Montanas Aviation, LLC for the actual cost of use currently equal to \$1,095 per flight hour. For the three months ended March 31, 2005, the Company reimbursed Las Montanas Aviation, LLC \$11,936 for use of the airplane for business travel purposes.

Item 2. Management’s Discussion and Analysis of Financial Condition and Results of Operations.

Overview of our business

We provide government sponsored social services directly and through not-for-profit social services organizations whose operations we manage. As a result of, and in response to, the large and growing population of eligible beneficiaries of government sponsored social services, increasing pressure on governments to control costs and increasing acceptance of privatized social services, we have increased our capacity to provide services in previously underserved geographic areas through the development of new programs and by consummating strategic acquisitions. As of March 31, 2005, we provided services directly and through the entities we manage to over 31,000 clients from 160 locations in 21 states and the District of Columbia. Our goal is to be the provider of choice to the social services industry. Focusing on our core competencies in the delivery of home and community based counseling, foster care and provider managed services, we believe we are well positioned to offer the highest quality of service to our clients and provide a viable alternative to state and local governments’ current service delivery systems.

Our industry is highly fragmented, competitive and dependent on government funding. We depend on our experience, financial strength and broad presence to compete vigorously in each service offering. Challenges for us include competing with local incumbent social services providers in some of the areas we seek to enter and in rural areas where significant growth opportunities exist, finding and retaining qualified employees. We seek strategic acquisitions as one way to enter competitive markets.

Our business is highly dependent on our obtaining contracts with government sponsored entities. When we are awarded a contract to provide services, we may incur expenses such as leasing office space, purchasing office equipment and hiring personnel before we receive any contract payments, and, under some of the large contracts we are awarded, we are required to invest significant sums of money before receiving any contract payments. We are also required to recruit and hire qualified staff to perform the services under contract. We strive to control these start-up costs by leveraging our existing infrastructure to maximize our resources and manage our growth effectively. However, with each contract we are awarded, we face the challenge of quickly and effectively building a client base to generate revenue to recover these costs.

Prior to our initial public offering in 2003, we were largely funded by venture capital and mezzanine debt. We used proceeds from our initial public offering to pay off our then existing long-term debt. Our working capital requirements are now primarily funded by cash from operations. In addition, we have a \$10.0 million revolving line of credit and a \$10.0 million acquisition term loan with Healthcare Business Credit Corporation or HBCC. Proceeds from our credit facilities with HBCC provide funding for general corporate purposes and potential acquisitions.

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How we earn our revenue

Our revenue is derived from our provider contracts with state and local government agencies and government intermediaries and from our management contracts with not-for-profit social services organizations. The government entities that pay for our services include welfare, child welfare and justice departments, public schools and state Medicaid programs. Under a majority of the contracts where we provide services directly, we are paid an hourly fee. In other such situations, we receive a set monthly amount or we are paid amounts equal to the costs we incur to provide agreed upon services. These revenues are presented in our financial statements as either revenue from home and community based services or foster care services.

Where we contract to manage the operations of not-for-profit social services organizations, we receive a management fee that is either based upon a percentage of the revenue of the managed entity or a predetermined fee. These revenues are presented in our financial statements as management fees. Because we provide substantially all administrative functions for these entities and our management fees are largely dependent upon their revenues, we also monitor for management and disclosure purposes the revenues of our managed entities. We refer to the revenues of these entities as managed entity revenue. In addition, from time to time, we provide short-term consulting services to other social services organizations for which we receive consulting fees that are a fixed amount per contract. Any such consulting revenues are presented in our statement of operations as management fees.

How we grow our business and evaluate our performance

Our business grows internally, through organic expansion into new markets and increases in the number of clients served pursuant to contracts we or our managed entities are awarded, and externally through acquisitions.

We typically pursue organic expansion into markets that are contiguous to our existing markets or where we believe we can quickly establish a significant presence. When we expand organically, we typically have no clients or perform no management services in the market and are required to incur start-up costs, including the costs of space, required permits and initial personnel. These costs are expensed as incurred, and our new offices can be expected to incur losses for a period of time until we adequately grow our revenue from clients or management fees.

We also pursue strategic acquisitions in markets where we see opportunities but where we lack the contacts and/or personnel to make a successful organic entry. Unlike organic expansion which involves start-up costs that may dilute earnings, expansion through acquisitions is generally accretive to our earnings. However, we bear financing risk and where debt is used, the risk of leverage in expanding through acquisitions. We also have to integrate the acquired business into our operations, which could disrupt our business, and we may not be able to realize operating and economic efficiencies upon integration.

In all our markets, we focus on several key performance indicators in managing our business. Specifically, we focus on growth in the number of clients served, as that particular metric is the key driver of our revenue growth. We also focus on the number of employees, as that is our most important variable cost and the key to our management of our margins.

Critical accounting policies and estimates

General

In preparing our financial statements in accordance with accounting principles generally accepted in the United States we are required to make estimates and judgments that affect the amounts reflected in our financial statements. We base our estimates on historical experience and on various other assumptions we believe to be reasonable under the circumstances. However, actual results may differ from these estimates under different assumptions or conditions.

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Critical accounting policies are those policies most important to the portrayal of our financial condition and results of operations. These policies require management's most difficult, subjective or complex judgments, often employing the use of estimates about the effect of matters inherently uncertain. Our most critical accounting policies pertain to revenue recognition, the allowance for doubtful accounts receivable, accounting for business combinations, goodwill and other intangible assets, and our management contract relationships.

Revenue recognition

We recognize revenue at the time services are rendered at the amounts stated in our contracts and when the collection of these amounts is considered to be probable.

At times we may receive funding for certain services in advance of services actually being rendered. These amounts are reflected in the accompanying consolidated balance sheets as deferred revenue until the actual services are rendered.

As services are rendered, documentation is prepared describing each service, time spent, and billing code under each contract to determine and support the value of each service provided. This documentation is used as a basis for billing under our contracts. The billing process and documentation submitted under our contracts vary among our payers. The timing, amount and collection of our revenues under these contracts are dependent upon our ability to comply with the various billing requirements specified by each payer. Failure to comply with these requirements could delay the collection of amounts due to us under a contract or result in adjustments to amounts billed.

The performance of our contracts is subject to the condition that sufficient funds are appropriated, authorized and allocated by each state, city or other local government. If sufficient appropriations, authorizations and allocations are not provided by the respective state, city or other local government, we are at risk of immediate termination or renegotiation of the financial terms of our contract.

Fee-for-service contracts. Revenues related to services provided under fee-for-service contracts are recognized as revenue at the time services are rendered and collection is determined to be probable. Such services are provided at established billing rates. Fee-for-service contracts represented approximately 73.4% and 64.1% of our revenue for the three months ended March 31, 2004 and 2005.

Cost based service contracts. Revenues from our cost based service contracts are generally recorded at one-twelfth of the annual contract amount less allowances for certain contingencies such as projected costs not incurred, excess cost per service over the allowable contract rate and/or insufficient encounters. The annual contract amount is based on projected costs to provide services under the contracts with adjustments for changes in the total contract amount. We annually submit projected costs for the coming year which assist the contracting payers in establishing the annual contract amount to be paid for services provided under the contracts. After June 30, which is the contracting payers' year end, we submit cost reports which are used by the contracting payers to determine the amount, if any, by which funds paid to us for services provided under the contracts were greater than the allowable costs to provide these services. In cases where funds paid to us exceed the allowable costs to provide services under contract, we may be required to pay back the excess funds.

Our cost reports are routinely audited on an annual basis. We periodically review our provisional billing rates and allocation of costs and provide for estimated adjustments from the contracting payers. We believe that adequate provisions have been made in our consolidated financial statements for any adjustments that might result from the outcome of any cost report audits. Differences between the amounts provided and the settlement amounts are recorded in our consolidated statement of operations in the year of settlement. Cost based service contracts represented approximately 0.0% and 17.7% of our revenue for the three months ended March 31, 2004 and 2005.

Case rate contract. Prior to July 1, 2004, we provided services under one contract pursuant to which we received a predetermined amount per month for a specified number of eligible beneficiaries. Under this contract, referred to as a case rate contract, we received the established amount regardless of the level of services provided to the beneficiaries during the month and thus recognized this contractual rate as

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revenue on a monthly basis. To the extent we provided services that exceeded the contracted revenue amounts, we requested the payer to reimburse us for these additional costs. Historically, the payer had reimbursed us for all such excess costs although it had no ongoing contractual obligation to do so under the case rate contract. Consequently, we did not recognize the excess cost amounts as additional revenue until the payer actually reimbursed us for such amounts or entered into an agreement contractually committing the payer to pay us and collection of such amount was determined to be probable.

Effective July 1, 2004, the case rate contract was amended to be an annual block purchase contract. In exchange for one-twelfth of the established annual contract amount each month, the agreement specifies that we are to provide or arrange for behavioral health services to eligible populations of beneficiaries as defined in the contract. We must provide a complete continuum of services including but not limited to intake, assessment, eligibility, case management and therapeutic services. There is no contractual limit to the number of eligible beneficiaries that may be assigned to us, or a limit to the level of services that must be provided to these beneficiaries. Therefore, we are at-risk if the costs of providing necessary services exceed the associated reimbursement.

We are required to regularly submit service encounters to the payer electronically. On an on-going basis and at the end of the payer's June 30 fiscal year, the payer is obligated to monitor the level of service encounters. If at any time the encounter data is not sufficient to support the year-to-date payments made to us, the payer has the right to prospectively reduce or suspend payments to us.

We recognize revenue from this contract equal to the lesser of a specified encounter value, which represents the actual level of services rendered, or the contract amount. For the nine months ended March 31, 2005, revenues under the annual block purchase contract totaled \$9.5 million. The payer has not reduced or suspended payments to us. We believe that our encounter data is sufficient to have earned all amounts paid to us under the amended contract.

The terms of the contract may be reviewed prospectively and amended as necessary to ensure adequate funding of our service offerings under the contract. Our revenues under the previous case rate contract and for the three months ended March 31, 2004 represented 14.6% of our total revenues. Our revenues under the annual block contract and for the three months ended March 31, 2005, represented 10.4% of our total revenues.

Management agreements. We maintain management agreements with a number of not-for-profit social services organizations whereby we provide certain management services for these organizations. In exchange for our services, we receive a management fee that is either based on a percentage of the revenues of these organizations or a predetermined fee. Management fees earned under our management agreements represented approximately 11.0% and 7.8% of our revenue for the three months ended March 31, 2004 and 2005.

We recognize management fee revenues from our management agreements as such amounts are earned, as defined by the respective management agreement, and collection of such amount is considered probable. We assess the likelihood of whether any of our management fee revenues may need to be returned to help our managed entities fund their working capital needs. If the likelihood is other than remote, we defer the recognition of all or a portion of the management fees received. To the extent we defer management fees as a means of funding any of our managed entities' losses from operations, such amounts are not recognized as management fee revenues until they are ultimately collected from the operating income of the not-for-profit entities.

Consulting agreements. From time to time we may enter into consulting agreements with other entities that provide government sponsored social services. Under the agreements, we evaluate and make recommendations with respect to their management, administrative and operational services. We may continue to enter into consulting agreements on a small scale in the future. In exchange for these consulting services, we receive a fixed fee that is either payable upon completion of the services or on a monthly basis. These consulting agreements are generally short-term in nature and are subject to termination by either party at any time, for any reason, upon advance written notice. Revenues related to these services are recognized at the time such consulting services are rendered and collection is determined to be probable. Fees earned pursuant to our consulting agreements represented approximately 1% of our revenue for the

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three months ended March 31, 2004. No such fees were earned for the three months ended March 31, 2005.

The costs associated with generating our management fee revenues are accounted for in client service expense and in general and administrative expense in our consolidated statements of operations.

Allowance for doubtful accounts receivable

We evaluate the collectibility of our accounts receivable on a monthly basis. We determine the appropriate allowance for doubtful accounts based upon specific identification of individual accounts and review of aging trends. Any account receivable older than 365 days is automatically deemed uncollectible.

In circumstances where we are aware of a specific payer's inability to meet its financial obligation to us, we record a specific addition to our allowance for doubtful accounts to reduce the net recognized receivable to the amount we reasonably expect to collect. If the financial condition of our payers were to deteriorate, further additions to our allowance for doubtful accounts may be required.

Our write-off experience for the three months ended March 31, 2004 and 2005 was less than 1% of revenue.

Accounting for business combinations, goodwill and other intangible assets

We analyze the carrying value of goodwill at the end of each fiscal year and between annual valuations if events occur or circumstances change that would more likely than not reduce the fair value of the reporting unit below its carrying value. Such circumstances could include, but are not limited to: (1) a significant adverse change in legal factors or in business climate, (2) unanticipated competition, or (3) an adverse action or assessment by a regulator. When determining whether goodwill is impaired, we compare the fair value of the reporting unit to which the goodwill is assigned to the reporting unit's carrying value, including goodwill. We use valuation techniques consistent with a market approach by deriving a multiple of our EBITDA (earnings before interest, taxes, depreciation and amortization) based on the market value of our common stock at year end and then applying this multiple to each reporting unit's EBITDA for the year to determine the fair value of the reporting unit. If the carrying value of a reporting unit exceeds its fair value, then the amount of the impairment loss is measured. The impairment loss would be calculated by comparing the implied fair value of reporting unit goodwill to its carrying value. In calculating the implied fair value of reporting unit goodwill, the fair value of the reporting unit is allocated to all of the other assets and liabilities of that unit based on their fair values. The excess of the fair value of a reporting unit over the amount assigned to its other assets and liabilities is the implied fair value of goodwill. An impairment loss would be recognized when the carrying value of goodwill exceeds its implied fair value. Our evaluation of goodwill completed as of December 31, 2004 resulted in no impairment losses.

When we consummate an acquisition we separately value all acquired identifiable intangible assets apart from goodwill in accordance with SFAS No. 141. In connection with our acquisitions, we allocated a portion of the purchase consideration to certain management contracts and customer relationships based on the expected direct or indirect contribution to future cash flows over the useful life of the assets.

We assess whether certain relevant factors limit the period over which acquired assets are expected to contribute directly or indirectly to future cash flows for amortization purposes. We determine an appropriate useful life for acquired customer relationships based on the nature of the underlying contracts with state and local agencies and the likelihood that the underlying contracts will renew over future periods. The likelihood of renewal is based on our contract renewal experience and the contract renewal experiences of the entities acquired.

Under certain conditions we may assess the recoverability of the unamortized balance of our long-lived assets based on expected future cash flows. If the review indicates that the carrying value is not fully recoverable, the excess of the carrying value over the fair value of any long-lived asset is recognized as an impairment loss.

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Accounting for management agreement relationships

Due to the nature of our business and the requirement or desire by certain payers to contract with not-for-profit social services organizations, we sometimes enter into management contracts with not-for-profit social services organizations where we provide them with business development, administrative, program and other management services. These not-for-profit organizations contract directly or indirectly with state and local agencies to supply a variety of community based mental health and foster care services to children and adults. Each of these organizations is separately incorporated and organized with its own independent board of directors.

Our management agreements with these not-for-profit organizations generally:

- require us to provide management, accounting, advisory, supportive, consultative and administrative services;
- require us to provide the necessary resources to effectively manage the business and services provided;
- require that we hire, supervise and terminate personnel, review existing personnel policies and assist in adopting and implementing progressive personnel policies such as employee enrichment programs; and
- compensate us with a management fee in exchange for the services provided.

All of our management services are subject to the approval or direction of the managed entities' board of directors.

The accounting for our relationships with these organizations is based on a number of judgments regarding certain facts related to the control of these organizations and the terms of our management agreements. Any significant changes in the facts upon which these judgments are based could have a significant impact on our accounting for these relationships. We have concluded that our management agreements do not meet the provisions of Emerging Issues Task Force 97-2, "Application of FASB Statement No. 94 and APB Opinion No. 16 to Physician Practice Management Entities and Certain other Entities with Consolidated Management Agreements," or the provisions of the Financial Accounting Standards Board Interpretation No. 46(R), "Consolidation of Variable Interest Entities", as revised, or Interpretation No. 46(R), thus the operations of these organizations are not consolidated with our operations. We will evaluate the impact of the provisions of Interpretation No. 46(R), if any, on future acquired management agreements.

Results of operations

The following table sets forth the percentage of consolidated total revenues represented by items in our consolidated statements of operations for the periods presented:

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	Three months ended March 31,	
	2004	2005
Revenues:		
Home and community based services	70.3%	81.7%
Foster care services	17.7	10.5
Management fees	12.0	7.8
Total revenues	100.0	100.0
Operating expenses:		
Client service expense	74.5	75.5
General and administrative expense	13.9	12.4
Depreciation and amortization	1.2	1.1
Total operating expenses	89.6	89.0
Operating income	10.4	11.0
Non-operating expense:		
Interest expense, net	0.4	0.1
Income before income taxes	10.0	10.9
Provision for income taxes	4.0	4.4
Net income	6.0%	6.5%

Three months ended March 31, 2005 compared to three months ended March 31, 2004

Revenues

	Three months ended March 31,		Percent change
	2004	2005	
Home and community based services	\$12,973,947	\$26,175,502	101.8%
Foster care services	3,258,900	3,358,547	3.1%
Management fee	2,221,814	2,499,210	12.5%
Total revenue	\$18,454,661	\$32,033,259	73.6%

Home and community based services. The acquisition of Pottsville Behavioral Counseling Group, Inc., or Pottsville, in May 2004 provided \$540,000 in home and community based services revenue for the three months ended March 31, 2005. We added 257 clients as a result of this acquisition and entered into the Pennsylvania market. The acquisition of the Aspen Companies, in July 2004, contributed \$5.7 million in home and community based services for the three months ended March 31, 2005. We added approximately 5,000 clients as a result of this acquisition and entered into the California and Nevada markets. In addition, start up services in the District of Columbia which began in June 2004 yielded additional home and community based services revenue of approximately \$840,000 for the three months ended March 31, 2005. Excluding the acquisition of Pottsville and the Aspen Companies and start up services in the District of Columbia, our home and community based services provided additional revenue of approximately \$6.1 million for three months ended March 31, 2005, as compared to the same prior year period due to client volume increases in new and existing locations. We experienced a net increase of approximately 1,600 new home and community based clients during the three months ended March 31, 2005 as compared to the same period in 2004, with increases at our existing locations and as a result of the new locations that we opened in Indiana, North Carolina, Tennessee and Virginia.

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Foster care services. Foster care services revenue remained relatively constant with only a moderate increase of approximately \$100,000 for the three months ended March 31, 2005 as compared to the same period one year ago. In our Tennessee and Nebraska markets, we have experienced a decrease in the number of clients placed in foster homes due to systemic changes at the state level and lower inventory of licensed foster homes. In Tennessee certain systemic changes at the state level have led to a shorter length of stay per client and a lower number of clients eligible to receive care which resulted in a decrease in foster care services revenue of approximately \$302,000 for the three months ended March 31, 2005 as compared to the same prior year period. In Nebraska the inventory of licensed foster homes has declined leading to a decrease in the number of clients placed in foster homes and a decrease in foster care services revenue of approximately \$79,000 for the three months ended March 31, 2005 as compared to the same period one year ago. We are exploring opportunities to permanently place foster care clients through adoption programs in Tennessee that we expect will mitigate the decline in foster care clients and the decrease in foster care services revenue. In addition, we are increasing our efforts to license additional homes in Nebraska to increase our foster care service offering. In Delaware, where we are expanding our foster care service offering, our foster care services revenue increased approximately \$156,000 for the three months ended March 31, 2005 and partially offset decreases in foster care services revenue in Tennessee and Nebraska. In our traditional home and community based markets such as Arizona, Florida and Virginia, our cross-selling efforts yielded an additional \$325,000 of foster care services revenue from period to period. We expect cross-selling activities will continue and provide additional revenues in the future as we focus on continuous expansion of our foster care services.

Management fees. Revenue for entities we manage but do not consolidate for financial reporting purposes (managed entity revenue) increased to \$35.9 million for the three months ended March 31, 2005 as compared to \$20.3 million for the same prior year period. Management fee revenue as a percentage of managed entity revenue decreased to 7.0% for the three months ended March 31, 2005 compared to 10.9% for the same period one year ago primarily due to the effect of a predetermined monthly fee we charged The ReDCo Group, or ReDCo, a managed entity, and comparatively lower management fee percentages related to the management agreements with Care Development of Maine, or CDOM and FCP, Inc., or FCP, that we acquired in June 2004. The combined effects of business growth and the acquisition of the management agreements with CDOM, FCP and ReDCo yielded approximately \$277,000 in additional management fee revenue for the three months ended March 31, 2005 as compared to the three months ended March 31, 2004. The increase in management fee revenue for the three months ended March 31, 2005 as compared to the same prior year period was partially offset by a decrease in management fee revenue of approximately \$187,000 from our management agreement with Rio Grande Behavioral Health Services, Inc., or Rio Grande, described below.

On June 30, 2004, Rio Grande, received a notice canceling one of its provider HMO network contracts effective July 31, 2004. Subsequently, Rio Grande commenced negotiations for a new contract. Rio Grande and the payer have agreed to continue their relationship under new terms. In connection with this agreement, we amended the management agreement between us and Rio Grande to change the management fee charged to Rio Grande for management services from a per member per month based fee to a fixed fee per month. The fixed fee was comparable to the previous per member per month based fee and remained at this predetermined level until January 1, 2005, at which time the fixed fee was reduced. The new fixed fee will decrease our management fee revenue from this management services agreement by approximately \$400,000 for the first half of 2005 when compared to the six months ending December 31, 2004.

Currently, the State of New Mexico is modifying its behavioral health services delivery system. We expect that the state will finalize the modification of its behavioral health services delivery system by July 1, 2005, at which time new contracts for behavioral health services will be administered by one administrative services entity. We believe this change in the State of New Mexico's behavioral health services delivery system will be favorable to Rio Grande. We believe that the reduction in our management fee for the first half of 2005 will not significantly affect our total management fee revenue for the year as we expect to renegotiate the management fee with Rio Grande when the State of New Mexico has completed the modification of its behavioral health services delivery system. While we anticipate a favorable outcome will result from the modification of the State of New Mexico's behavioral health

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services delivery system, there are no assurances that such outcome will materialize or that our negotiations with Rio Grande regarding our management fee will be as expected.

Operating expenses

Client service expense. Client service expense includes the following for the three months ended March 31, 2004 and 2005:

	Three months ended March 31,		Percent change
	2004	2005	
Payroll and related costs	\$ 9,866,772	\$18,170,919	84.2%
Purchased services	2,431,668	3,291,532	35.4%
Other operating expenses	1,432,749	2,712,847	89.3%
Stock based compensation	18,781	—	-100.0%
Total client service expense	\$13,749,970	\$24,175,298	75.8%

Payroll and related costs. To support our growth, provide high quality service and meet increasing compliance requirements expected by the government agencies with which we contract to provide services, we must hire and retain employees who possess higher degrees of education, experience and licensures. As we enter new markets, we expect payroll and related costs to continue to increase. As a result of our organic growth, our payroll and related costs increased for the three months ended March 31, 2005, as compared to the same prior year period, as we added 382 new direct care providers, administrative staff and other employees. In addition, we added 347 new employees in connection with the acquisition of Pottsville and the Aspen Companies which resulted in an increase in payroll and related costs of approximately \$4.0 million for the three months ended March 31, 2005 as compared to the three months ended March 31, 2004. We continually evaluate client census, case loads and client eligibility to determine our staffing needs under each contract in order to optimize the quality of service we provide while managing the payroll and related costs to provide these services. Determining our staffing needs may not directly coincide with the generation of revenue as we are required at times to increase our capacity to provide services prior to starting new contracts. Alternatively, we may lag behind increases in client referrals as we may have difficulty recruiting employees to service our contracts. Furthermore, acquisitions may cause fluctuations in our payroll and related costs as a percentage of revenue from period to period as we attempt to merge new operations into our service delivery system. As a percentage of revenue, payroll and related expense increased from 53.5% for the three months ended March 31, 2004 to 56.7% for the three months ended March 31, 2005 primarily due to our efforts to increase the number of employees to service our growth.

Purchased services. Increases in the number of referrals requiring pharmacy and support services partially offset by a decrease in foster parent payments and the number of referrals requiring out-of-home placement accounted for the increase in purchased services for the three months ended March 31, 2005 as compared to the same period one year ago. We strive to manage our purchased services costs by constantly seeking alternative treatments to costly services that we do not provide. Although we manage and provide alternative treatments to clients requiring out-of-home placements and other purchased services, we sometimes cannot control the number of referrals requiring out-of-home placement and support services under our annual block contract. Despite the increase in purchased services for the three months ended March 31, 2005, as a percentage of revenue, purchased services decreased from 13.2% for the three months ended March 31, 2004 to 10.3% for the three months ended March 31, 2005. Increases in revenue from both organic growth and acquisitions outpaced the growth in purchased services for the three months ended March 31, 2005.

Other operating expenses. As a result of our organic growth during 2004 and the three months ended March 31, 2005, we added new locations in Indiana, North Carolina, Tennessee and Virginia that contributed to an increase in other operating expenses for the three months ended March 31, 2005 when compared to the three months ended March 31, 2004. The acquisition of Pottsville and the Aspen

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Companies added approximately \$773,000 to other operating expenses for the three months ended March 31, 2005. As a percentage of revenue other operating expenses increased from 7.8% to 8.5% from period to period primarily due to the relatively higher operating costs incurred in our new markets in California and Pennsylvania.

Stock based compensation. Stock based compensation of approximately \$19,000 for the three months ended March 31, 2004, represents stock and stock options granted to employees at prices and exercise prices less than the estimated fair value of our common stock on the date of the grant of such stock and stock options. All such costs were fully amortized by December 31, 2004. Stock options granted to employees under our 2003 stock option plan were granted at exercise prices equal to the market value of our common stock on the date of grant.

General and administrative expense.

Three months ended March 31,		Percent change
2004	2005	
\$2,563,194	\$3,959,277	54.5%

The addition of corporate staff to adequately support our growth and provide services under our management agreements, higher rates of pay for employees as well as increased accounting fees and professional fees related to increased services provided for SEC filings and regulatory compliance accounted for an increase of \$822,000 of corporate administrative expenses from period to period. In addition, as a result of our growth during the three months ended March 31, 2005, rent and facilities management increased \$574,000 in part due to our acquisition activities. As a percentage of revenue, general and administrative expense decreased to 12.4% for the three months ended March 31, 2005 from 13.9% for the three months ended March 31, 2004. Increases in revenue from both organic growth and acquisitions outpaced the growth in general and administrative expense for the three months ended March 31, 2005.

Depreciation and amortization.

Three months ended March 31,		Percent change
2004	2005	
\$228,162	\$370,535	62.4%

The increase in depreciation and amortization from period to period primarily resulted from the amortization of customer relationships of \$86,000 related to the acquisition of Pottsville and the Aspen Companies. Also contributing to the increase in depreciation and amortization was the amortization of the fair value of the acquired management agreements with Rio Grande, CDOM, FCP and ReDCo and increased depreciation expense due to the addition of software and computer equipment during the three months ended March 31, 2005. As a percentage of revenues, depreciation and amortization decreased from 1.2% for the months ended March 31, 2004 to 1.1% for the three months ended March 31, 2005 primarily due to a higher revenue growth rate.

Provision for income taxes

The provision for income taxes is based on our estimated annual effective income tax rate for the full fiscal year equal to approximately 40%. Our estimated effective income tax rate differs from the federal statutory rate primarily due to nondeductible permanent differences and state income taxes.

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Liquidity and capital resources

Our balance of cash and cash equivalents was \$13.5 million at March 31, 2005, up from \$10.7 million at December 31, 2004, primarily due to cash provided by operating activities and proceeds from issuance of stock related to the exercise of outstanding stock options during the three months ended March 31, 2005. At March 31, 2005 and December 31, 2004, our debt was \$1.1 million (including two notes issued in connection with the acquisition of Dockside Services, Inc., or Dockside, in January 2004, in the aggregate amount of \$1.0 million and our capital lease obligation of \$111,145 and \$135,389, respectively).

Cash flows

Operating activities. Net cash from operations of \$1.8 million for the three months ended March 31, 2005, were provided primarily from net income of \$2.1 million and the add back of non-cash depreciation and amortization expense of approximately \$371,000. Working capital increased for the three months ended March 31, 2005 with nearly \$1.7 million of cash used to finance our accounts receivable growth partially offset by approximately \$1.4 million increase in accrued expenses and accounts payable due to increased amounts due for purchased services expense, income tax liability, accrued payroll, accrued foster parent payments and audit fees. Revenue which was deferred in prior periods was earned during the three months ended March 31, 2005 related to our operations in Arizona and California and resulted in a decrease in deferred revenue of approximately \$400,000.

Investing activities. Net cash used in investing activities totaled approximately \$283,000 for the three months ended March 31, 2005, and included additional acquisition costs of approximately \$72,000 related to the Aspen Companies and \$30,000 to acquire a management agreement with Triad Family Services, a California not-for-profit corporation. We spent approximately \$181,000 for property and equipment.

Financing activities. For the three months ended March 31, 2005, we generated cash of approximately \$1.3 million in financing activities. We issued common stock related to the exercise of outstanding stock options which provided proceeds of \$1.3 million and repaid amounts due under our capital lease agreements of approximately \$24,000.

Obligations and commitments

Credit facilities. Our amended loan and security agreement with Healthcare Business Credit Corporation, or HBCC, provides for a \$10.0 million revolving line of credit and a \$10.0 million acquisition term loan. The amount we may borrow under the revolving line of credit is subject to the availability of a sufficient amount of eligible accounts receivable at the time of borrowing. Advances under the acquisition term loan are subject to the lender's approval. Initial proceeds borrowed under the revolving line of credit portion of this credit facility were used to repay and terminate our revolving line of credit with a former lender. Borrowings under this credit facility bear interest at an annual rate equal to the prime rate in effect from time to time, plus 2.0% in the case of the revolving line of credit and prime plus 2.5% in the case of the acquisition term loan. In addition, we are subject to a 0.5% fee per annum on the unused portion of our credit facility, as well as certain other administrative fees.

Until its amendment in September 2003, our credit facility with HBCC was secured by substantially all of our assets as well as certain of our managed entities' assets. Prior to such amendment, the facility provided for a \$1.0 million term loan which we paid in full in August 2003, and for the acquisition term loan to mature on January 1, 2006. On September 30, 2003, our loan and security agreement with HBCC was amended to remove, as co-borrowers under the agreement, certain of the not-for-profit organizations whose operations we manage and to release their assets from those pledged as collateral under the agreement. The amendment also extended the maturity date of our acquisition term loan through December 1, 2006. The December 31, 2006 expiration date for the revolving line of credit, as well as the other provisions of our amended loan agreement remained the same as those set forth in our original January 2003 loan and security agreement. Concurrent with the amendment of our agreement, HBCC established stand-alone credit facilities on behalf of each of the managed entities that were removed from our facility, and, while we do not guarantee any portion of their stand-alone facilities, we have agreed in connection with the amendment of our loan and security agreement to subordinate our management fee receivable to the claims of HBCC in the event one of these managed entities defaults under its credit facility.

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At March 31, 2005, we had no borrowings under the revolving line of credit and no borrowings under the acquisition term loan, available credit of \$10.0 million on our revolving line of credit, and we were in compliance with all covenants.

In connection with our acquisition of Dockside, we issued two unsecured subordinated promissory notes each in the amount of \$500,000 to the former stockholders of Dockside in partial consideration for the purchase of all of Dockside's outstanding stock. Each note bears interest equal to 6% per annum with interest payable quarterly beginning April 2004 and principal payments of \$100,000 beginning April 2005. All principal and accrued but unpaid interest is due July 2007.

Management agreements

We maintain management agreements with a number of not-for-profit social services organizations that require us to provide the management and administrative services for each organization. In exchange for these services, we receive a management fee that is either based upon a percentage of the revenues of these organizations or a predetermined fee. Management fees generated under our management agreements represented 11.0% and 7.8% of our revenue for the three months ended March 31, 2004 and 2005. Fees generated under short term consulting agreements entered into in December 2003 and during 2004 represented approximately 1% of our revenue for the three months ended March 31, 2004. No such fees were generated for the three months ended March 31, 2005. (See "—Critical accounting policies and estimates—Revenue recognition"). In accordance with our management agreements with these not-for-profit organizations, we have obligations to manage their business and services.

Our management fee receivable is comprised of management fees we earn pursuant to our management agreements with certain not-for-profit social services organizations. Management fee receivable at December 31, 2004 and March 31, 2005 were \$5.0 million and \$5.1 million, and management fee revenues were recognized on all of these receivables. In order to enhance liquidity of the entities we manage, we, at times, may allow the managed entities to defer payment of their respective management fees. In addition, since government contractors who provide social or similar services to government beneficiaries sometimes experience collection delays due to either lack of proper documentation of claims, government budgetary processes or similar reasons outside the contractors' control (either directly or as managers of other contracting entities), we generally do not consider a receivable to be uncollectible due solely to its age until it is 365 days old.

The following is a summary of the aging of our management fees receivable balances as of March 31, June 30, September 30 and December 31, 2004 and March 31, 2005:

<u>At</u>	<u>Less than 30 days</u>	<u>30–60 days</u>	<u>60–90 days</u>	<u>90–180 days</u>	<u>Over 180 days</u>
March 31, 2004	\$ 579,269	\$ 568,310	\$ 498,683	\$ 1,030,772	\$ 422,707
June 30, 2004	\$ 710,762	\$ 672,588	\$ 585,792	\$ 934,751	\$ 268,689
September 30, 2004	\$ 935,749	\$ 916,579	\$ 860,450	\$ 1,402,976	\$ 593,278
December 31, 2004	\$ 886,440	\$ 866,315	\$ 949,436	\$ 1,945,326	\$ 375,888
March 31, 2005	\$ 843,523	\$ 848,517	\$ 807,170	\$ 2,210,418	\$ 345,159

We adhere to a strict revenue recognition policy regarding our management fee revenues and related receivables. Each month we examine each of our managed entities with regard to its solvency, outlook and ability to pay us any outstanding management fees. If the likelihood that we will not be paid is other than remote, we will defer the recognition of these management fees until we are certain that payment is probable. In keeping with our general corporate policy regarding our accounts receivable, we will also automatically reserve as uncollectible 100% of any management fee receivable that is 365 days old or older.

At March 31, 2005, none of our management fees receivable were older than 365 days, and our days sales outstanding for our managed entities had decreased from 181 days at December 31, 2004 to 177 days at March 31, 2005.

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In addition, Camelot Community Care, Inc., which represented \$2.4 million, or 48.3%, of our total management fee receivable at March 31, 2005, and Intervention Services Inc., referred to as ISI, which represented approximately \$734,000 million, or 14.5%, of our total management fee receivable at March 31, 2005, each obtained its own stand-alone line of credit from HBCC in September 2003. The loan agreements between HBCC and these not-for-profit organizations permit them to use their credit facilities to pay our management fees, provided they are not in default under these facilities at the time of the payment. As of March 31, 2005, they were not in default under their credit facilities with HBCC and Camelot Community Care, Inc. had availability of \$815,000 under its line of credit as well as \$2.9 million in cash and cash equivalents and ISI had availability of \$24,000 under its line of credit as well as \$298,000 in cash and cash equivalents.

The remaining \$1.9 million balance of our total management fees receivable at March 31, 2005, was due from Rio Grande, ReDCo, CDOM, FCP and Family Preservation Services of South Carolina.

We have deemed payment of all of the foregoing receivables to be probable based on our collection history with these entities as the long-term manager of their operations.

Transactions with ReDCo. In connection with the acquisition of Pottsville and the establishment of a management agreement with ReDCo, we loaned \$875,000 to ReDCo to fund certain long-term obligations of the entity in exchange for a promissory note for the same amount. The note assumes interest equal to a fluctuating interest rate per annum based on a weighted-average daily Federal Funds Rate. The terms of the promissory note require ReDCo to make quarterly interest payments over twenty-one months commencing June 30, 2004 with the principal and any accrued and unpaid interest due upon maturity on March 31, 2006. The promissory note is collateralized by a subordinated lien to ReDCo's primary lender on substantially all of ReDCo's assets.

We expect our liquidity needs on a short- and long-term basis will be satisfied by cash flow from operations, the net proceeds from the sale of equity securities and borrowings under debt facilities.

Recently issued accounting pronouncements

In December 2004, the Financial Accounting Standards Board, or FASB, finalized SFAS 123R, "Share-Based Payment", effective for public companies for annual periods beginning after June 15, 2005. SFAS 123R requires all companies to measure compensation cost for all share-based payments (including employee stock options) at fair value. Retroactive application of the requirements of SFAS 123R is permitted, but not required. On April 15, 2005, the SEC issued its final rule in Release No. 34-51558 regarding the compliance date for SFAS 123R related to public companies. The SEC has delayed the requirement for non-small business public companies to comply with the provisions of SFAS 123R until the first interim reporting period of the public company's first fiscal year beginning on or after June 15, 2005. Accordingly, we plan to implement SFAS 123R beginning January 1, 2006 and we are in the process of determining the affect this pronouncement will have on our consolidated financial statements.

Forward-Looking Statements

Certain statements contained in this quarterly report on Form 10-Q, such as any statements about our confidence or strategies or our expectations about revenues, results of operations, profitability, contracts or market opportunities, constitute forward-looking statements within the meaning of section 27A of the Securities Act of 1933 and section 21E of the Securities Exchange Act of 1934. These forward-looking statements are based on our current expectations, assumptions, estimates and projections about our business and our industry. You can identify forward-looking statements by the use of words such as "may," "should," "will," "could," "estimates," "predicts," "potential," "continue," "anticipates," "believes," "plans," "expects," "future," and "intends" and similar expressions which are intended to identify forward-looking statements.

The forward-looking statements contained herein are not guarantees of our future performance and are subject to a number of known and unknown risks, uncertainties and other factors, some of which are beyond our control and difficult to predict and could cause our actual results or achievements to differ materially from those expressed, implied or forecasted in the forward-looking statements. These risks and

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uncertainties include, but are not limited to, our reliance on government-funded contracts (for instance, changes in budgetary priorities of the government entities that fund the services we provide could result in our loss of contracts or a decrease in amounts payable to us under our contracts); risks associated with government contracting in general, such as the short-term nature of our contracts and the fact that they can be terminated prior to expiration, without cause and without penalty to the payer, and are subject to audit and modification by the payers, in their sole discretion; risks associated with our cost based service contracts and annual block contract such as budgeted costs not incurred, cost per service may exceed allowable rate per contract and we may not encounter the projected number of clients necessary to earn the funds we receive to provide agreed upon social services; challenges resulting from growth or acquisitions; risks involved in managing government business, such as increased risks of litigation and other legal actions and liabilities; dependence on our licensed service provider status as our loss of such status in any jurisdiction could result in the termination of a number of our contracts; our reliance on a few providers for a significant amount of our revenues; legislative, regulatory or policy changes; adverse media exposure; opposition to privatization of government programs by government unions or others; the level and degree of our competition, both for attracting and retaining experienced personnel and in acquiring additional contracts; and legal, economic and other risks detailed in our other filings with the SEC.

All forward-looking statements attributable to us or persons acting on our behalf are expressly qualified in their entirety by the cautionary statements contained above and throughout this report. You are cautioned not to place undue reliance on these forward-looking statements, which speak only as of the date the statement was made. We do not intend to update publicly any forward-looking statements, whether as a result of new information, future events or otherwise.

Item 3. Quantitative and Qualitative Disclosures About Market Risk.

Interest rate and market risk

Upon the consummation of our initial public offering, we repaid all of the principal and accrued interest outstanding under our loan and security agreements. As of March 31, 2005, we had no borrowings under our revolving line of credit and no borrowings under our acquisition term loan. In connection with our acquisition of Docksider, we issued two subordinated notes each in the amount of \$500,000 to the sellers. The notes bear a fixed interest rate of 6%.

We believe our exposure to market risk related to the effect of changes in interest rates is immaterial at this time. We have not used derivative financial instruments to alter the interest rate characteristics of our debt instruments. We assess the significance of interest rate market risk on a periodic basis and may implement strategies to manage such risk as we deem appropriate.

Concentration of credit risk

We provide and manage government sponsored social services to individuals and families pursuant to 320 contracts. Among these contracts there are certain contracts under which we generate a significant portion of our revenue. We generated approximately \$3.3 million, or 10.4% of our revenues for the three months ended March 31, 2005, pursuant to one contract in Arizona with the Community Partnership of Southern Arizona, an Arizona not-for-profit organization. This contract is subject to statutory and regulatory changes, possible prospective rate adjustments and other retroactive contractual adjustments, administrative rulings, rate freezes and funding reductions. Reductions in amounts paid by this contract for our services or changes in methods or regulations governing payments for our services could materially adversely affect our revenue.

Item 4. Controls and Procedures.

(a) Evaluation of disclosure controls and procedures

The Company, under the supervision and with the participation of its management, including its principal executive officer and principal financial officer, evaluated the effectiveness of the design and operation of its disclosure controls and procedures as of the end of the period covered by this report (March 31, 2005). Based on this evaluation, the principal executive officer and principal financial officer concluded

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that, as of the end of the period covered by this report, the Company's disclosure controls and procedures were effective in reaching a reasonable level of assurance that information required to be disclosed by the Company in the reports that it files or submits under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time period specified in the Securities and Exchange Commission's rules and forms.

(b) *Changes in internal controls*

The principal executive officer and principal financial officer also conducted an evaluation of the Company's internal control over financial reporting ("Internal Control") to determine whether any changes in Internal Control occurred during the quarter ended March 31, 2005 that have materially affected or which are reasonably likely to materially affect Internal Control. Based on that evaluation, there has been no such change during the quarter ended March 31, 2005 covered by this report.

PART II—OTHER INFORMATION

Item 1. Legal Proceedings.

Although we believe we are not currently a party to any material litigation, we may from time to time become involved in litigation relating to claims arising from our ordinary course of business. These claims, even if not meritorious, could result in the expenditure of significant financial and managerial resources.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds.

Restrictions Upon the Payment of Dividends

Under our credit facility we are prohibited from paying any cash dividends if there is a default under the facility or if the payment of any cash dividends would result in default.

Item 3. Defaults Upon Senior Securities.

None

Item 4. Submission of Matters to a Vote of Security Holders.

None

Item 5. Other Information.

None

Item 6. Exhibits.

Exhibit Number	Description
10.1	Summary Sheet Of Director Fees and Executive Officer Compensation
31.1	Certification pursuant to Securities Exchange Act Rules 13a-14 and 15d-14 of the Chief Executive Officer
31.2	Certification pursuant to Securities Exchange Act Rules 13a-14 and 15d-14 of the Chief Financial Officer
32.1	Certification pursuant to 18 U.S.C Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, of the Chief Executive Officer

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- 32.2 Certification pursuant to 18 U.S.C Section 1350, as adopted pursuant to Section 906 of the Sarbanes–Oxley Act of 2002, of the Chief Financial Officer
- 99.1 Earnings release issued by The Providence Service Corporation on May 4, 2005.

SIGNATURES

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

THE PROVIDENCE SERVICE CORPORATION

Date: May 4, 2005

By: _____
/s/ FLETCHER JAY MCCUSKER

Fletcher Jay McCusker
Chairman of the Board, Chief Executive Officer
(Principal Executive Officer)

Date: May 4, 2005

By: _____
/s/ MICHAEL N. DEITCH

Michael N. Deitch
Chief Financial Officer
(Principal Financial and Accounting Officer)

EXHIBIT INDEX

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32.2	Certification pursuant to 18 U.S.C Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, of the Chief Financial Officer
99.1	Earnings release issued by The Providence Service Corporation on May 4, 2005.

SUMMARY SHEET OF DIRECTOR FEES AND EXECUTIVE OFFICER COMPENSATION**I. Director Compensation**

As compensation for their service as directors of The Providence Service Corporation (the “Company”), each non–employee member of the Board of Directors (the “Board”) receives a \$10,000 annual stipend, except for the Audit Committee Chair who receives a \$28,800 annual stipend. Payment of the annual stipends is made on a quarterly basis following each quarter of service. Additionally, each non–employee member of the Board receives \$3,500 for each Board meeting attended in person, \$1,000 for each telephonic meeting of the Board participated in, and \$1,000 for each committee meeting attended or participated in by telephone of which such non–employee member of the Board is a member that is not held the same day as a Board meeting, except that the Audit Committee Chair receives \$2,500 for each Audit Committee meeting attended or participated in by telephone that is not held the same day as Board meeting.

In addition, each non–employee member then serving on the first business day of each January receives a ten year option to purchase 10,000 shares of the Company’s common stock under the Company’s 2003 Stock Option Plan with an exercise price equal to the closing market price of the Company’s common stock on the date of grant. Such options will vest in three equal installments on each of the first, second and third anniversary of the date of grant.

II. Executive Compensation**Base Salaries**

The following table sets forth current base salaries of the Company’s CEO and each of the executive officers who were named in the Summary Compensation Table in the Company’s definitive proxy statement filed with the SEC on April 20, 2005 (the “Named Executive Officers”).

<u>Name</u>	<u>Base Salary</u>
Fletcher Jay McCusker	\$ 250,000
William Boyd Dover	190,000
Michael N. Deitch	195,000
Fred D. Furman	195,000
Craig A. Norris	200,000

Participation in Stock Option Plan and Other Arrangements

The Named Executive Officers are also eligible to:

- Participate in the Company's 2003 Stock Option Plan;
- Participate in certain group life, health, medical and other non-cash benefits generally available to all salaried employees; and
- Participate in certain health and dental benefits for their family, which are not available to all salaried employees.

CERTIFICATIONS

I, Fletcher Jay McCusker, certify that:

1. I have reviewed this Form 10-Q of The Providence Service Corporation;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
 - a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's

auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):

- a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
- b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: May 4, 2005

/s/ Fletcher J. McCusker

Fletcher J. McCusker
Chief Executive Officer
(Principal Executive Officer)

CERTIFICATIONS

I, Michael N. Deitch, certify that:

1. I have reviewed this Form 10-Q of The Providence Service Corporation;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
 - a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's

auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):

- a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
- b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: May 4, 2005

/s/ Michael N. Deitch

Michael N. Deitch
Chief Financial Officer
(Principal Financial and Accounting Officer)

THE PROVIDENCE SERVICE CORPORATION
CERTIFICATION PURSUANT TO
18 U.S.C. SECTION 1350,
AS ADOPTED PURSUANT TO
SECTION 906 OF THE SARBANES–OXLEY ACT OF 2002

Pursuant to Section 906 of the Sarbanes–Oxley Act of 2002 (Section 1350 of Chapter 63 of Title 18 of the United States Code), the undersigned officer of The Providence Service Corporation (the “Company”), does hereby certify with respect to the Quarterly Report of the Company on Form 10–Q for the quarter ended March 31, 2005 (the “Report”) that:

- (1) The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and

- (2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Date: May 4, 2005

/s/ Fletcher J. McCusker

Fletcher J. McCusker
Chief Executive Officer
(Principal Executive Officer)

The foregoing certification is being furnished solely pursuant to Section 906 of the Sarbanes–Oxley Act of 2002 (Section 1350 of Chapter 63 of Title 18 of the United States Code) and is not being filed as part of the Report or as a separate disclosure document.

THE PROVIDENCE SERVICE CORPORATION
CERTIFICATION PURSUANT TO
18 U.S.C. SECTION 1350,
AS ADOPTED PURSUANT TO
SECTION 906 OF THE SARBANES–OXLEY ACT OF 2002

Pursuant to Section 906 of the Sarbanes–Oxley Act of 2002 (Section 1350 of Chapter 63 of Title 18 of the United States Code), the undersigned officer of The Providence Service Corporation (the “Company”), does hereby certify with respect to the Quarterly Report of the Company on Form 10–Q for the quarter ended March 31, 2005 (the “Report”) that:

- (1) The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and

- (2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Date: May 4, 2005

/s/ Michael N. Deitch

Michael N. Deitch
Chief Financial Officer
(Principal Financial and Accounting Officer)

The foregoing certification is being furnished solely pursuant to Section 906 of the Sarbanes–Oxley Act of 2002 (Section 1350 of Chapter 63 of Title 18 of the United States Code) and is not being filed as part of the Report or as a separate disclosure document.



PROVIDENCE SERVICE CORPORATION

AT THE COMPANY

Fletcher McCusker – Chairman and CEO
 Kate Blute – Director of Investor and Public Relations
 520/747-6600

AT CAMERON ASSOCIATES

Alison Ziegler
 212-554-5469

FOR IMMEDIATE RELEASE

Providence Service Corporation Announces 90% Increase in First Quarter Earnings

First Quarter Highlights:

- **Total revenue grew 74% to a record \$32.0 million**
- **Managed revenue grew 77% to a record \$35.9 million**
- **Diluted earnings per share of \$0.22, ahead of expectations**
- **Total client census grew to 31,706 from 15,009, a 111% increase**
- **Total direct and managed contracts grew to 320, up 56%**

TUCSON, ARIZONA – May 4, 2005 — The Providence Service Corporation (Nasdaq: PRSC) today announced financial results for the first quarter ended March 31, 2005.

For the first quarter, the Company reported net income of \$2.1 million, or \$0.22 per diluted share. In the quarter ended March 31, 2004, net income was \$1.1 million, or \$0.13 per diluted share, for a year over year gain of \$992,000, or 90%. Revenue was \$32.0 million for the first quarter of 2005, an increase of 74% from \$18.5 million for the comparable period in 2004. Providence's direct client census grew to 16,859 at March 31, 2005, a 148% increase from 6,787 at March 31, 2004. The number of direct contracts increased to 201 at March 31, 2005 from 141 at March 31, 2004.

Managed revenue, which represents revenue of the not-for-profit social services organizations the Company provides management and/or administrative services to in return for a negotiated management fee, increased 77% to \$35.9 million for the quarter ended March 31, 2005 from \$20.3 million for the prior year period. Managed revenue is presented to provide investors with an additional measure of the size of the operations under Providence's management or administration and can help investors understand trends in management fee revenue. Managed client census grew to 14,847 at March 31, 2005 as compared to 8,222 at March 31, 2004. Contracts of managed entities grew from 64 to 119 year over year.

"We are very pleased with our first quarter results, another record revenue quarter," commented Fletcher McCusker, Chairman and CEO of Providence. "We experienced

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our strongest results yet from many of our new markets including Washington, DC, Indiana, California and Massachusetts. Mature states like Virginia, Arizona, Illinois and North Carolina also had record quarters. We also recorded over \$500,000 of audit and Sarbanes-Oxley related expenses in the first quarter which will not recur until this time next year.”

“Given our strong first quarter, we continue to be comfortable with estimated diluted earnings per share of approximately \$0.96 for 2005 and revenues of \$130 million. These results are based on current contract estimates, rate and census projections and do not include any new contract wins or acquisitions. We also expect our business to be supported by the recent passage of the Congressional budget, which included a 6.3% increase in spending in programs that include Medicaid, State Children’s Health Insurance and substance abuse treatment,” McCusker concluded.

Providence will hold a conference call at 11:00 a.m. ET (9:00 a.m. MT, 8:00 a.m. Arizona and PT) on Thursday, May 5, 2005. Interested parties are invited to listen to the call live over the Internet at <http://investor.provcorp.com> or <http://www.fulldisclosure.com>. The call will also be available by dialing (800) 259-0251 or for international callers, (617) 614-3671 and by using the passcode 61657302. A replay of the teleconference will be available on <http://investor.provcorp.com> and www.fulldisclosure.com. A replay will also be available until May 12, 2005 by dialing (888) 286-8010 or (617) 801-6888, and using passcode 83929314.

Providence Service Corporation, through its owned and managed entities, provides home and community based social services to government sponsored clients under programs such as welfare, juvenile justice, Medicaid and corrections. Providence operates no beds, treatment facilities, hospitals, or group homes preferring to provide services in the client’s own home or other community setting. Through its owned and managed entities, Providence maintains 320 government contracts in 21 states and the District of Columbia as of March 31, 2005.

Certain statements herein, such as any statements about Providence’s confidence or strategies or its expectations about revenues, results of operations, profitability, contracts or market opportunities, constitute “forward-looking statements” within the meaning of the private Securities Litigation Reform Act of 1995. Such forward-looking statements involve a number of known and unknown risks, uncertainties and other factors which may cause Providence’s actual results or achievements to be materially different from those expressed or implied by such forward-looking statements. These factors include, but are not limited to, reliance on government-funded contracts, risks associated with government contracting, risks involved in managing government business, legislative or policy changes, challenges resulting from growth or acquisitions, adverse media and legal, economic and other risks detailed in Providence’s filings with the Securities and Exchange Commission. Words such as “believe,”

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“demonstrate,” “expect,” “estimate,” “anticipate,” “should” and “likely” and similar expressions identify forward-looking statements. Readers are cautioned not to place undue reliance on those forward-looking statements, which speak only as of the date the statement was made. Providence undertakes no obligation to update any forward-looking statement contained herein.

—financial tables to follow—

The Providence Service Corporation
Condensed Consolidated Statements of Operations
(in thousands except share and per share data)
(UNAUDITED)

	Three months ended March 31,	
	2005	2004
Revenues:		
Home and community based services	\$ 26,175	\$ 12,974
Foster care services	3,359	3,259
Management fees	2,499	2,222
	32,033	18,455
Operating expenses:		
Client service expense	24,175	13,750
General and administrative expense	3,959	2,563
Depreciation and amortization	371	228
	28,505	16,541
Total operating expenses		
	3,528	1,914
Operating income		
Other (income) expense:		
Interest expense	86	119
Interest income	(48)	(42)
	3,490	1,837
Income before income taxes		
Provision for income taxes	1,396	735
	2,094	1,102
Net income		
Earnings per common share:		
Basic	\$ 0.22	\$ 0.13
Diluted	\$ 0.22	\$ 0.13
Weighted-average number of common shares outstanding:		
Basic	9,498,806	8,492,573
Diluted	9,659,489	8,785,917

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The Providence Service Corporation
Condensed Consolidated Balance Sheets
(in thousands except share and per share data)

	March 31, 2005	December 31, 2004
	(Unaudited)	(Audited)
Assets		
Current assets:		
Cash and cash equivalents	\$ 13,479	\$ 10,657
Accounts receivable, net of allowance of \$156,000 and \$221,000	20,549	18,823
Management fee receivable	5,055	5,023
Prepaid expenses and other	3,519	3,534
Deferred tax asset	475	475
	<hr/>	<hr/>
Total current assets	43,077	38,512
Property and equipment, net	2,290	2,316
Notes receivable	1,282	1,282
Goodwill	24,789	24,717
Intangible assets, net	7,377	7,511
Deferred tax asset	607	607
Other assets	837	976
	<hr/>	<hr/>
Total assets	\$ 80,259	\$ 75,921
	<hr/>	<hr/>
Liabilities and stockholders' equity		
Current liabilities:		
Accounts payable	1,872	1,244
Accrued expenses	8,740	7,995
Deferred revenue	549	948
Current portion of capital lease obligations	95	103
Current portion of long-term obligations	400	300
	<hr/>	<hr/>
Total current liabilities	11,656	10,590
Capital lease obligations, less current portion	15	33
Long-term obligations, less current portion	600	700
	<hr/>	<hr/>
Stockholders' equity:		
Common stock: Authorized 40,000,000 shares; \$0.001 par value; 9,558,886 and 9,486,879 issued and outstanding (including treasury shares)	10	9
Additional paid-in capital	67,027	65,732
Accumulated earnings (deficit)	1,250	(844)
	<hr/>	<hr/>
	68,287	64,897
Less 146,905 treasury shares, at cost	299	299
	<hr/>	<hr/>
Total stockholders' equity	67,988	64,598
	<hr/>	<hr/>
Total liabilities and stockholders' equity	\$ 80,259	\$ 75,921
	<hr/>	<hr/>

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The Providence Service Corporation
Condensed Consolidated Statements of Cash Flows
(in thousands)
(UNAUDITED)

	Three months ended	
	March 31,	
	2005	2004
Operating activities		
Net income	\$ 2,094	\$ 1,102
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation	207	151
Amortization	164	78
Amortization of deferred financing costs and discount on investment	31	21
Stock compensation	—	43
Changes in operating assets and liabilities, net of effects of acquisitions:		
Trade accounts receivable, net	(1,726)	(1,785)
Management fee receivable	(31)	498
Prepaid expenses and other	122	(177)
Accounts payable	628	525
Accrued expenses	744	856
Deferred revenue	(400)	—
Net cash provided by operating activities	1,833	1,312
Investing activities		
Purchase of property and equipment	(181)	(130)
Acquisition of businesses, net of cash acquired	(102)	(3,476)
Net cash used in investing activities	(283)	(3,606)
Financing activities		
Net payments on revolving note	—	(94)
Payments of capital leases	(24)	(21)
Proceeds from common stock issued pursuant to stock option exercise, net	1,296	45
Public offering costs	—	(84)
Repayments of short-term debt	—	(1,400)
Repayments of long-term debt	—	(2,100)
Net cash provided by (used in) financing activities	1,272	(3,654)
Net change in cash	2,822	(5,948)
Cash at beginning of period	10,657	15,004
Cash at end of period	\$13,479	\$ 9,056

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