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SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

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Annual Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

For the fiscal year ended May 31, 1986

Commission file no. 0-5751

COMPREHENSIVE CARE CORPORATION

(Exact name of Registrant as specified in its charter)

Delaware (State or other jurisdiction of incorporation or organization)	95-2594724 (I.R.S. Employer Identification No.)
18551 Von Karman Avenue Irvine, California (Address of principal executive offices)	92715 (Zip code)

Registrant's telephone number, including area code (714) 851-2273

Securities registered pursuant to Section 12(b) of the Act: None

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

Common Stock, par value $.10 per share
7½% Convertible Subordinated Debentures due 2010
(Title of Class)

Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the Registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes X No __

The aggregate market value of voting stock held by non-affiliates of the Registrant at July 31, 1986 was $148,135,049.

At July 31, 1986, the Registrant had 15,178,668 shares of Common Stock outstanding.

Documents Incorporated by Reference

Part III incorporates information by reference from the Registrant's definitive proxy statement for the Registrant's annual meeting of stockholders to be held on September 25, 1986, which proxy statement will be filed no later than 120 days after the close of the Registrant's fiscal year ended May 31, 1986.

Total of sequentially numbered pages 131

Exhibit index on sequential page number 46

PART I

Item 1. BUSINESS

The Registrant, Comprehensive Care Corporation, is a Delaware corporation which was organized in January 1969. The Registrant is primarily engaged in the development, marketing and management of programs for the treatment of chemical dependency, including alcohol and drugs, and psychiatric disorders (the "Programs"). The Programs are provided under contractual agreements ("Contracts") with independent general hospitals or at freestanding facilities owned and/or operated by the Registrant. It is the largest private provider of hospital-based alcoholism treatment programs in the United States. During fiscal 1986, chemical dependency and psychiatric treatment Programs accounted for approximately 92% of the Registrant's total revenues. The following table sets forth for the five years ended May 31, 1986, the contribution to operating revenues and other income of the Registrant's freestanding hospital and Contract operations and its other activities.

	Years Ended May 31,				
	1986	1985	1984	1983	1982
Freestanding Operations	61%	63%	60%	57%	54%
Contract Operations	33	34	37	38	41
Other Activities	6	3	3	5	5
	100%	100%	100%	100%	100%

Freestanding Operations

The Registrant currently operates or participates in the operation of 19 facilities representing 1,687 available beds. Since 1982, the Registrant has expanded its freestanding operations through the construction of four freestanding chemical dependency facilities and the acquisition of seven chemical dependency or psychiatric facilities, representing approximately 980 beds. Freestanding facilities are either owned or leased by the Registrant or by joint ventures in which the Registrant and its partners share in the profits or losses. At May 31, 1986, two of the chemical dependency treatment facilities (111 available beds) and one psychiatric hospital (258 available beds) managed by the Registrant were owned or leased by such joint ventures, and one psychiatric hospital (100 available beds) was managed by the Registrant's partner in a joint venture.

The following table sets forth selected operating data regarding the Registrant's freestanding facilities. Facilities are designated either psychiatric or chemical dependency based on the predominant treatment provided. For information concerning the nature of Registrant's interest in the facilities, see Item 2. "PROPERTIES."

	Year Acquired(1)	Licensed Beds	Patient Days				
			1986	1985	1984	1983	1982
Chemical Dependency Facilities							
CareUnit Hospital of Dallas/Ft. Worth	1971	83	26,696	24,278	14,593	12,878	10,917
Crossroads Hospital	1972	43	13,657	14,503	13,266	11,551	11,295
CareUnit Hospital of Orange	1976	103	33,763	33,677	31,696	30,426	31,098
CareUnit Hospital of Los Angeles	1978	104	19,629	23,150	20,655	17,112	14,669
CareUnit Hospital of Kirkland	1981	83	24,336	27,099	25,530	25,818	25,391
CareUnit of Jacksonville Beach(2)	1982	84	22,818	16,539	19,355	12,416	35
CareUnit Hospital of Cincinnati	1982	84	29,065	29,181	26,880	27,598	—
CareUnit Hospital of St. Louis	1983	144	43,822	39,953	31,293	9,784	—

(Table continued on following page)

	Year Acquired(1)	Licensed Beds	Patient Days 1986	1985	1984	1983	1982
Starting Point, Oak Avenue	1983	68	22,705	21,136	13,492	1,491	—
Starting Point, Orange County	1983	59	17,421	15,332	4,515	—	—
Starting Point, Grand Avenue	1983	25	7,264	6,158	1,294	—	—
CareUnit Hospital of Albuquerque	1984	70	16,080	9,597	205	—	—
CareUnit of Nevada	1984	50	8,748	7,640	—	—	—
CareUnit of Coral Springs(2)	1985	100	12,398	—	—	—	—
CareUnit of Grand Rapids	1985	76	3,386	—	—	—	—
CareUnit Hospital of Portland	1986	160	2,161	—	—	—	—
Discontinued Operations			8,603	14,771	3,080	—	3,518
Psychiatric Facilities							
Brea Neuropsychiatric Center	1969	142	43,870	46,271	44,472	40,100	40,427
Woodview-Calabasas Hospital	1970	117	23,104	25,531	24,375	25,554	23,854
Golden Valley Health Center	1984	377	56,453	64,007	155	—	—
Patient days served during period			435,979	418,823	274,856	214,728	161,204
Admissions			17,964	16,754	10,585	8,074	5,849
Available beds at end of period(3)			1,687	1,609	1,538	1,015	659
Average occupancy rate for period			73.1%	72.0%	67.1%	70.1%	76.0%

(1) Calendar year acquired or leased.

(2) On October 1, 1985, the Registrant opened CareUnit of Coral Springs, a 100-bed chemical dependency treatment facility located in the Ft. Lauderdale, Florida area. At the time of its opening the Registrant had a 50% interest in the joint venture which owned the facility. On November 13, 1985 the Registrant exchanged its interests in the CareUnit of Tampa (120 beds) joint venture for its partners' interests in the CareUnit of Coral Springs and CareUnit of Jacksonville Beach (84 beds) ventures. As a result, the three Florida joint ventures in which the Registrant participated were terminated.

(3) A facility may have appropriate licensure for more beds than are in use for a number of reasons, including lack of demand, anticipation of future need, seasonality and practical limitations in assigning patients to multiple-bed rooms. Available beds is defined as the number of beds which are available for use at any given time.

Contract Operations

The Registrant also develops, markets and manages behavioral medicine programs under Contracts with independent general hospitals. Under these Contracts, the hospitals furnish patients with all hospital facilities and services necessary for their generalized medical care, including nursing, dietary and housekeeping services. The Registrant provides support in the areas of Program implementation and management, staff recruiting, continuing education, nurse and hospital employee training, community education, public relations and ongoing Program quality assurance. Patients are admitted to the Programs under the hospitals' standard admission policies and procedures. The hospital submits to the patient or the patient's insurance company a bill which covers the services of the hospital. The hospital pays the Registrant a fixed monthly management fee plus a fee for each patient day of service provided. Fees paid to the Registrant are subject to annual adjustments to reflect increases in the Consumer Price Index. The Registrant and the hospital share the risk of non-payment by patients based on a predetermined percentage participation by the Registrant in bad debts. To date, the Registrant's share of such bad debts has not exceeded 6% of Contract revenues in any one year. Contracts are generally entered into for a minimum period of two years; thereafter, either party may terminate the Contract by giving 90 days notice. A significant number of the Registrant's existing Contracts are terminable on 90 days notice.

The following table sets forth selected operating data regarding Programs the Registrant manages on a Contract basis:

	Years Ended May 31,				
	1986	1985	1984	1983	1982
Number of Contracts at end of period(1):					
Adult CareUnits(2)	95	84	81	73	72
Adolescent CareUnits(2)	28	20	16	11	12
Adult CarePsychCenters(2)	22	17	12	9	8
Adolescent CarePsychCenters(2)	8	5	3	1	—
Eating Disorder Units	11	7	4	—	—
Total	164(3)	133	116	94	92
Available beds at end of period	3,981	3,145	2,648	2,168	2,113
Patient days served during period	803,225	697,509	588,321	494,740	474,964
Admissions	44,136	38,443	32,834	28,158	27,211
Average occupied beds per Contract	15.1	15.8	15.4	14.5	16.8
Average occupancy rate for period(4)	62.2%	66.5%	66.9%	64.6%	72.5%

(1) Excludes Contracts which have been executed but are not operational as of the end of the period.

(2) CareUnit is the service mark under which the Registrant markets chemical dependency treatment programs. CarePsychCenters is the service mark under which the Registrant markets mental health treatment programs.

(3) During the twelve-month period ended May 31, 1986, the Registrant opened 50 new Contracts and closed 19 Contracts. Eighteen of these new Contracts were added by Behavioral Medical Care ("BMC"), a 70% owned joint venture. Of the 19 closed Contracts, eight Contracts were terminated by the Registrant and 11 were terminated by the contracting hospitals. Ten of these hospitals have continued treatment programs.

(4) Average occupancy rate is calculated by dividing total patient days by the number of available bed-days during the relevant period.

Program Descriptions

CHEMICAL DEPENDENCY. The Registrant developed and first introduced chemical dependency treatment Programs in 1973. Originally, these Programs, delivered under the name CareUnit, were directed toward the adult alcoholic but have been adapted and expanded to treat both adults and adolescents suffering from substance abuse.

The chemical dependency Program is hospital based. Each patient admitted to the hospital is subject to a full medical and social history as well as a physical examination which includes those diagnostic studies ordered by the patient's attending physician. Patients are detoxified under close medical supervision for a period averaging four days prior to entry to the rehabilitation phase of treatment.

The rehabilitation phase of treatment begins as soon as detoxification is completed. This phase of treatment includes lectures; individual, family and group counseling sessions; and such medical, psychological, and other modalities that may be necessary to meet the individual patient's needs. The average length of hospital stay for an adult patient is 18 days, which includes detoxification. The average length of stay for an adolescent patient is approximately 33 days. After discharge from the hospital, the patient's recovery is monitored for a 10-week period during which the patient and family members return to the hospital once a week for outpatient counseling sessions.

For individuals who do not require the structure and intensity of inpatient hospital services, the Registrant has developed outpatient Programs which generally operate in conjunction with existing inpatient Programs. At May 31, 1985, 34 such Programs were in operation.

MENTAL HEALTH. The Registrant has, since 1969, managed mental health treatment Programs for individuals suffering from acute emotional problems. Until recently, these Programs were delivered under the name StressCenter. During fiscal 1985, the Registrant changed the name of the Programs to CarePsychCenters. The Registrant believes this name better reflects the Program provided. These Programs, which are hospital-based, offer diagnostic and therapeutic treatment services conducted by an interdisciplinary team of professionals experienced in the treatment of mental health problems. Admission to the Program is typically voluntary and treatment is tailored to the specific needs of the patient, under the supervision of a psychiatrist.

The length of stay varies in accordance with the severity of the patient's condition but rarely exceeds 90 days. A comprehensive discharge plan is prepared for each patient which may include outpatient psychiatric or psychological treatment, or referral to an alternate treatment facility.

EATING DISORDERS. The Registrant offers a hospital-based, comprehensive eating disorders Program. The Registrant began operation of this Program in fiscal 1983. The Program treats those suffering from anorexia nervosa, bulimia and gross obesity. Each patient entering the Program is subject to a physical examination and nutritional assessment. Additional diagnostic and psychiatric evaluations are undertaken when necessary. Each patient's treatment is directed by a physician experienced in the treatment of eating disorders.

The eating disorders Program includes: individual and group therapy, nutritional guidance and management of attendant medical or psychological problems.

Other Activities

REHABILITATION. The Registrant has owned 100% of RehabCare Corporation ("RehabCare") since April 1986, when it acquired the 50% interest previously held by Basic American Medical, Inc. RehabCare, originally formed in 1983, is engaged in the development, marketing and management of programs for patients with spinal cord injuries, strokes, closed head injuries and other dysfunctions of neurological or motor systems. The medically supervised treatment provided includes: nursing care; physical, occupational and speech therapy; and such other hospital services necessary to treat the individual patient's disorder.

As of May 31, 1986, RehabCare programs were offered solely in independent general hospitals under Contract RehabCare opened its first contract program in February 1984.

	Years Ended May 31,		
	1986	1985	1984
RehabCare Units at end of period	15	8	1
Available beds at end of period	310	201	20
Patient days served during period	33,036	5,680	1,035
Admissions	1,394	292	69
Average occupied beds per contract	7.6	5.4	8.1
Average occupancy rate for period	32.9%	27.3%	28.3%

RehabCare operations accounted for less than 2% of the Registrant's total revenues in fiscal 1986.

LONG TERM CARE. The Registrant leases and operates a 99-bed intermediate care facility. This facility provides nursing, rehabilitative and sustaining care over extended periods of time to persons who do not require the extensive care provided in a general hospital. For the fiscal year ended May 31, 1986, the intermediate care facility accounted for less than 1% of the Registrant's total revenues.

PUBLISHING ACTIVITIES. Since 1976, the Registrant (under the name CompCare Publications) has been engaged in the publication, distribution and sale of books, pamphlets and brochures relating to the Registrant's health care activities and to other life-style management subjects such as weight and smoking control. The primary purpose of these activities is to support the Registrant's treatment, training and marketing programs. Literature distributed by the Registrant is sold to patients participating in a program both by contracting hospitals and facilities operated by the Registrant. Such literature is also sold to the general public and educational institutions. The Registrant does not own or operate the printing facilities used in the publication of its literature. Publishing activities accounted for approximately 2% of the Registrant's total revenues in fiscal 1986.

SMOKING CESSATION. In fiscal 1985, the Registrant entered into a license agreement with SmokEnders Inc. The license agreement granted the Registrant the right to operate smoking cessation seminars using the name and materials of SmokEnders Inc. The license agreement, which has an eight year life, requires the Registrant to pay a royalty to SmokEnders Inc. based upon revenues derived from operation of the seminars. In fiscal 1986, the Registrant determined that there had been a permanent impairment in the value of the license agreement due to continued losses from the operation of seminars. Accordingly, the unamortized balance of the license consideration of $1.4 million was charged to earnings in fiscal 1986. Smoking cessation programs accounted for less than 2% of the Registrant's total revenues in fiscal 1986.

WEIGHT CONTROL. On February 14, 1986, the Registrant purchased the assets of a weight loss center located in Orange County, California. The Registrant subsequently began operation of a weight control program under the name CareFast.

CareFast is a protein-sparing modified fasting program directed toward individuals who exceed ideal body weight by 20% or more. Each CareFast participant is seen weekly by a physician and participates in group or individual therapy sessions directed by a trained behaviorist. Prior to admission to the program, potential participants receive a physical examination including an electrocardiogram and blood tests. Repeat tests are ordered by the physician during the fast as appropriate for each individual.

Registrant charges participants in CareFast a monthly fee. In addition, participants purchase a protein supplement which contains vitamins and minerals necessary to maintain health. Insurance coverage varies but generally excludes the cost of the protein supplement.

CANADIAN OPERATIONS. After several years of marketing effort the Registrant opened a Contract in Canada in fiscal 1985. In fiscal 1986, after the provincial government failed to provide funds to continue operation of the Program, the Registrant elected to cease participation in the operation of the unit. The Registrant is not presently marketing programs in Canada.

Competition

The Registrant competes first for the development and implementation of freestanding or Contract Programs and subsequently for patients who utilize these Programs. With respect to both of these areas of competition, the Registrant's primary competitors are hospitals and hospital management companies (both not-for-profit and investor owned) which offer programs similar to those of the Registrant. The Registrant also faces competition from health maintenance organizations ("HMOs") and preferred provider organizations ("PPOs"). The Registrant has faced generally increasing competition in the last few years as a result of the increasing development of competitive programs and the growth of HMOs and PPOs.

Both HMOs and PPOs attempt to control the cost of health services by directing their enrollees to participating physicians and institutions. Careful utilization review and limitations on access to physician specialists are used to further limit the cost of service delivery. Such organizations have typically developed on a regional basis where an appropriate enrollee population and mix of participating physicians and institutions can be developed. To the extent that these organizations have been successful in a given locale, the Registrant may be faced with a decreased population base (to the extent of the enrolled population) to support its programs. In certain instances the Registrant has elected to participate with the HMO or PPO, in which case the Registrant may discount its charges for service.

Factors to be considered in the development of successful programs include population base and demographic characteristics, community pricing standards, state licensure and rate control issues and

Certificate of Need ("CON") requirements (See "Governmental Regulation"). The Registrant either markets Contract Programs or develops freestanding Programs accordingly. The Registrant has a 23 person marketing staff which identifies potential sites and develops Programs.

With respect to contract programs, the Registrant believes that experience, reputation for quality programs, the availability of program support services and price are the principal factors in a hospital's decision to utilize a contract program. While a number of competing companies are offering contract programs at prices lower than those of the Registrant, the Registrant believes that its experience, reputation, and program support are superior to that of its competitors. The Registrant's experience with CON issues and program implementation often results in a reduced start-up period. Risk to the hospital is also reduced because the Registrant's compensation is based primarily on bed occupancy.

The primary competitive factors in attracting referral sources, patients and physicians are marketing, reputation, success record, quality of care and location and scope of services offered by a facility. The Registrant has an active promotional program, described below, and believes it is competitive in reputation and other factors necessary for patient attraction. Some of the hospitals which compete with the Registrant are either owned or supported by governmental agencies or are owned by non-profit corporations supported by endowments and charitable contributions which enable some of these hospitals to provide a wider range of services regardless of cost-effectiveness.

Promotion

The Registrant has an active public relations program designed to increase public awareness of the treatment Programs offered by the Registrant. During fiscal 1986, the Registrant spent $15,232,000 for all forms of advertising. Media advertising (television, radio and print) was $13,586,000 in fiscal 1986 (7% of operating revenues). The Registrant's advertising program includes a series of television commercials advertising the Registrant's Programs. The forms of media used are specifically geared to the geographic area in which the marketing efforts are directed. Accordingly, the focal point in the Registrant's public relations program is the Program Manager whose role in the local community is to identify referral sources and to carry out all marketing activities, including promotional campaigns, media coverage, conferences and distribution of literature, necessary to make the local community aware of the Program. Each Program Manager is assisted on an ongoing basis by the Registrant's various support services.

Other aspects of the Registrant's public awareness program include a nationwide telephone hot line which is staffed by counselors who provide referral advice and help on a 24-hour basis; a Crisis Intervention Program which assists relatives of chemically dependent or emotionally disturbed individuals in motivating a potential patient to seek professional help through an appropriate Program; and CareInstitute conferences which are alcoholism educational programs designed for health professionals.

Joint Ventures

The Registrant has developed several joint venture partnerships for the management of behavioral medicine programs. In 1972, the Registrant entered into its first joint venture to operate two hospitals in California.

In June 1983, the Registrant entered into a joint venture with a subsidiary of Voluntary Hospitals of America, Inc. ("VHA"), one of the largest associations of not-for-profit hospitals in the United States. The Registrant has a 70% interest in the joint venture which is called Behavioral Medical Care ("BMC"). BMC markets the Registrant's Programs to the VHA network of hospitals. As of May 31, 1986, BMC was operating 45 Contracts consisting of 1,200 beds.

In May 1984, the Registrant entered into a joint venture with a subsidiary of The Health Central System, a non-profit, multi-hospital management and service organization headquartered in Minneapolis, Minnesota. The Registrant manages the joint venture and has a 50% interest in it. As of May 31, 1986, the joint venture owned and operated a 258-bed behavioral medicine hospital and five Contract units.

Sources of Revenues

During fiscal 1986, approximately 96% of the Registrant's operating revenue was received from private sources (private health insurers or directly from patients or hospitals in which the Registrant has Contracts) and the balance from Medicare, Medicaid and other governmental programs.

Private health insurers offer plans which typically include coverage for chemical dependency or psychiatric treatment. In some instances, the level of coverage for chemical dependency or psychiatric benefits is less than that provided for medical-surgical services. Lower coverage levels result in higher co-payments by the patient who is often unable to meet his or her commitment in its entirety or is unable to pay as rapidly as the insurance company. In the case of the Registrant's freestanding facilities these factors tend to increase bad debts and days outstanding in receivables.

Private insurance plans vary significantly in their methods of payment, including: cost, cost plus, prospective rate, negotiated rate, percentage of charges, and billed charges. Blue Cross and other commercial insurance plans have adopted a number of payment mechanisms for the primary purpose of decreasing the amounts paid to hospitals (including the Registrant's) for services rendered. These mechanisms include various forms of utilization review, preferred provider arrangements where use of participating hospitals is encouraged in exchange for a discount, and payment limitations which are based on community standards. The Registrant is unable to predict the impact of changing payment mechanisms in future years.

The Medicare program provides hospitalization, physicians, diagnostic and certain other services to eligible persons 65 years of age and over and others considered disabled. Providers of service are paid by the federal government in accordance with regulations promulgated by the United States Department of Health and Human Services ("HHS") and accept said payment, with nominal co-insurance amounts required of the service recipient, as payment in full. Payments under the Medicare program are generally less than billed charges. Regulations governing the Medicare program are subject to change due to modifications in the enabling statutes, changes in administrative policy and interpretation, and in response to certain court actions. These changes may increase or decrease payment by the Medicare program to Registrant's facilities.

The Medicare program had previously paid hospitals the lesser of reasonable cost, as defined by regulation, or the hospital's billed charges. The Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA") required the Secretary of HHS ("Secretary") to promulgate regulations substantially limiting payments and increases in payments for hospital operating costs. Regulations established under TEFRA limit annual increases in payment from historical costs to a "target rate." The target rate is calculated from regional and national wage and price indices. Hospitals with operating costs less than the target rate may under certain circumstances be entitled to a bonus, hospitals that exceed the limit are penalized. TEFRA also required the Secretary to propose a prospective payment system to Congress by December 31, 1982. Under a prospective payment system a hospital is paid a predetermined fee without regard to the direct costs of providing the service. In response to the Secretary's proposal, Congress passed and the President signed P.L. 98-21 into law in April 1983. This law requires prospective payment for hospitals effective October 1, 1983 but provides temporary exclusion for certain psychiatric and alcoholism treatment facilities.

The Secretary intends to implement prospective payment for psychiatric services at an unspecified date. The exclusion from prospective payment for qualified providers of alcohol and drug services is afforded on a temporary basis until October 1, 1987. The Registrant is unable to predict the impact of prospective payment for psychiatric or chemical dependency services should it be implemented.

Eleven of the Registrant's hospitals participate in the Medicare program. Of these, ten are currently excluded from prospective payment (TEFRA target rate limits are applicable to these facilities.) Medicare utilization at those facilities participating in the program averaged approximately 4% in fiscal 1986. The Registrant does not believe that the imposition of TEFRA limits or prospective payment have had a material adverse impact on its business at freestanding facilities. Loss of exclusion would also not materially impact the Registrant's business. Substantially all of the hospitals contracting with the

Registrant for Programs participate in the Medicare program. The Registrant believes that these changes will not have a material adverse impact on its Contract operations; however, until the exclusions for alcoholism and psychiatric services are eliminated, the Registrant is unable to predict their impact.

Hospitals participating in the Medicare program are required to retain the services of a Medical Review Entity ("MRE"). The MRE is responsible for determining the medical necessity, appropriateness and quality of care given program patients. In instances where the medical necessity of an admission or procedure is challenged by the MRE, payment may be delayed, reduced or denied in its entirety. Amounts denied because of medical review may not be charged to the service recipient, they are absorbed by the hospital. In non-emergency admissions (which encompass most of the Registrant's admissions) review is performed prior to the patient's arrival at the hospital. In the event that the MRE does not approve the admission, the patient is referred to an alternative treatment provider such as an outpatient program or sent home. The Registrant believes that the existence of MRE's has had a negative impact on census growth in certain owned and Contract units, but is unable to measure the magnitude because the primary impact is in lost admissions.

The Medicaid program is a combined federal and state program providing coverage for low income persons. The specific services offered and reimbursement methods vary from state to state. In the majority of states Medicaid reimbursement is patterned after the Medicare program. Less than 2% of the Registrant's operating revenue is derived from the Medicaid program. Accordingly, changes in reimbursement are not expected to have a material adverse impact on the Registrant.

Governmental Regulation

The development and operation of health care facilities is subject to compliance with various federal, state and local statutes and regulations. Hospitals and other health care facilities operated by the Registrant as well as hospitals under contract for Programs must comply with the licensing requirements of the federal, state and local health agencies, with state mandated rate control initiatives and with the requirements of municipal building codes, health codes and local fire departments. State licensing of facilities is a prerequisite to participation in the Medicare and Medicaid programs.

Pursuant to the requirements of federal law, most states have enacted CON laws to curtail the proliferation of unnecessary health care services. Thus, prior to the introduction of new facilities, the expansion of old facilities or the introduction of major new services (such as the Registrant's Contract Programs) in existing facilities, the Registrant (in the case of its facilities), or the contracting hospital for a Contract Program, must demonstrate to either state or local authorities, or both, that it is in compliance with the plan adopted by such agencies. The Registrant, because of its experience in the processing of the CON documentation required for such Programs, usually prepares such documentation on behalf of the contracting hospital, with the assistance of the hospital. The CON application process ordinarily takes from six to 18 months, and may in some instances take two years or more, depending upon the state involved and whether the application is contested by a competitor or the health agency. As of May 31, 1986, the Registrant had entered into, but not yet opened nine CareUnit Contracts, eight CarePsychCenter Contracts, one EDU Contract and six RehabCare Contracts with general hospitals, 12 of which are awaiting governmental approval. Some states have enacted or have under legislative consideration "sunset" provisions which require the review, modification or deletion of statutes when no longer needed. CON legislation is under review in a number of states under these provisions. The Registrant is unable to predict the outcome of these deliberations but believes that the elimination of CON requirements would positively impact its business.

The Joint Commission on the Accreditation of Hospitals ("JCAH"), at a facility's request, will participate in the periodic surveys which are conducted by state and local health agencies to insure continuous compliance with all licensing requirements by health care facilities. JCAH accreditation satisfies certain of the certification requirements for participation in Medicare and Medicaid programs. A facility found substantially to comply with JCAH standards receives accreditation. A patient's choice of a treatment facility may be affected by JCAH accreditation considerations because most major third-party payors limit coverage to services provided by an accredited facility. The Registrant believes that all of the facilities operated by it and hospitals under contract have received or, in the case of new facilities, applied for, such accreditation.

The laws of various states in which the Registrant operates generally prevent corporations from engaging in the practice of medicine or other professions. Although the Registrant believes that its operations do not violate these prohibitions, recent legal precedents in this area are unclear and there can be no assurance that state authorities or courts will not determine that the Registrant is engaged in unauthorized professional practice. In the event of an unfavorable determination, the Registrant could be required to modify its method of operation or could be restrained from the continuation of certain of its operations, the result of which could be materially adverse to the Registrant.

Both Medicare and Medicaid programs contain specific physical plant, safety, patient care and other requirements which must be satisfied by health care facilities in order to qualify under said programs. The Registrant believes that the facilities it owns or leases are in substantial compliance with the various Medicare and Medicaid regulatory requirements applicable to them.

Administration and Employees

The Registrant's executive and administrative offices are located in Irvine, California, where management controls operations, marketing, accounting, medical insurance claims, governmental and statistical reporting, advertising and public relations, research and treatment program evaluation.

At May 31, 1986, the Registrant employed approximately 210 persons in its corporate and administrative offices, 2,900 persons in the hospital and long-term health care facilities operated by it, and 950 persons assigned to its Contract units. The physicians and psychiatrists who are the medical directors of the Registrant's Contract units, the psychologists serving on treatment teams, and the doctors utilizing the facilities operated by the Registrant are not employed by the Registrant.

The Registrant has not encountered any work stoppages due to labor disputes with its employees. Although the Registrant has expanded rapidly in the last five years, it has not experienced any significant difficulty in attracting competent employees.

Item 2. PROPERTIES.

The following table sets forth certain information regarding the properties owned or leased by the Registrant at May 31, 1986:

Name and Location	Owned or Leased	Lease Expires(1)	Monthly Rental(2)
Chemical Dependency Treatment Facilities			
CareUnit Hospital, Fort Worth, Texas	Owned(3)	—	—
Crossroads Hospital(4), Van Nuys, California	Leased	1997	$5,577
CareUnit Hospital, Orange, California	Owned(3)	—	—
CareUnit Hospital, Los Angeles, California	Owned(3)	—	—
CareUnit Hospital, Kirkland, Washington	Leased	2035	12,000(5)
CareUnit Facility, Jacksonville Beach, Florida	Owned(3)	—	—
CareUnit Hospital, Cincinnati, Ohio	Owned	—	—
CareUnit Hospital, St. Louis, Missouri	Owned	—	—
Starting Point, Oak Avenue, Orangevale, California	Owned	—	—
Starting Point, Orange County, Costa Mesa, California	Owned(3)	—	—
Starting Point, Grand Avenue, Sacramento, California	Owned(3)	—	—
CareUnit Hospital, Albuquerque, New Mexico	Leased(6)	2012	4,049
CareUnit Hospital, Las Vegas, Nevada	Owned	—	—
CareUnit Facility, Coral Springs, Florida	Owned(3)	—	—
CareUnit Facility, Grand Rapids, Michigan	Leased	1990	12,417
CareUnit Hospital(4), Portland, Oregon	Leased	1989	35,000
Psychiatric Treatment Facilities			
Brea Neuropsychiatric Center, Brea, California	Owned	—	—
Woodview-Calabasas Hospital(7), Calabasas, California	Leased	1996	19,227(8)(9)
Golden Valley Health Center(10), Golden Valley, Minnesota	Owned	—	—
Other Operating Facilities			
Tustin Manor, Tustin, California (Intermediate Care Facility)	Leased	1995	7,754(8)
CompCare Publications, Minneapolis, Minnesota	Leased	1986	4,879

(Table continued on following page)

Name and Location	Owned or Leased	Lease Expires(1)	Monthly Rental(2)
Administrative Facilities			
Corporate Headquarters(11) Newport Beach, California	Leased	1986	21,702
Corporate Headquarters(12) Irvine, California	Owned	—	—
Regional Headquarters Tampa, Florida	Leased	1989	8,623

(1) Assumes all options to renew will be exercised.

(2) All leases, other than those relating to the Registrant's administrative facilities, are triple net leases under which the Registrant bears all costs of operations, including insurance, taxes and utilities. The Registrant is responsible for specified percentages of increases in taxes, assessments and operating costs relating to its administrative facilities.

(3) Subject to encumbrances. For information concerning the Registrant's long-term debt, see Note 4 to the Registrant's Consolidated Financial Statements contained in this report.

(4) Leased by a joint venture and managed by the Registrant.

(5) Subject to increase every three years based upon increases in the Consumer Price Index, not to exceed 10%.

(6) The Registrant has a 30 year land lease for the facility which includes 182,200 square feet of land.

(7) Leased by the Registrant and managed by the Registrant's partner in a joint venture.

(8) Subject to increase every five years based upon the Consumer Price Index.

(9) Subject to legal action commenced in December 1979 in Superior Court, State of California, by the lessor. The lessor contends that a 1971 amendment to the lease, which reduced the amount of basic rent subject to five-year increases based upon the Consumer Price Index from $177,600 to $47,600, is void for lack of consideration. The amount of rent in dispute was approximately $4,000 per month from June 1976 to May 1981 and increased to approximately $13,000 per month in June 1981. In April 1985, the case was dismissed for failure to commence trial within the five-year statute of limitations. The lessor is appealing this dismissal.

(10) Owned by a joint venture and managed by the Registrant.

(11) Former Headquarters, lease expires in November 1986.

(12) Purchased by the Registrant in May 1985.

Item 3. LEGAL PROCEEDINGS.

The Registrant is routinely engaged in the defense of lawsuits arising out of the ordinary course and conduct of its business and has insurance policies covering such potential insurable losses where such coverage is cost effective. Management believes that the outcome of such lawsuits will not have a material adverse impact on its business.

Item 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS.

Inapplicable.

EXECUTIVE OFFICERS OF THE REGISTRANT

Executive

B. LEE KARNS, age 56. Mr. Karns has been a director of the Registrant since 1972 and served as President of the Registrant from May 1972 until February 1985. Mr. Karns presently serves as Chairman of the Board and Chief Executive Officer of the Registrant and on July 14, 1986 he was reappointed President.

W. JAMES NICOL, age 42. Mr. Nicol has been a director of the Registrant since February 1985. He has been employed by the Registrant since 1973. He has been its Secretary since 1973 and was a Vice President and the Company's Treasurer from 1974 through 1983. He became a Senior Vice President in April 1983, Executive Vice President—November 1983 and Vice Chairman of the Registrant in February 1985. He was also reappointed Treasurer on June 6, 1986.

Operations

ROBERT L. KASSELMANN, age 50. Mr. Kasselmann has been employed by the Registrant since 1974. He was President of RehabCare Corporation, a subsidiary of the Registrant from June 1984 until September 1985. He became Executive Vice President—Special Services of the Registrant in September 1985, and Executive Vice President—Operations on July 14, 1986.

JAMES P. CARMANY, age 47. Mr. Carmany has been employed by the Registrant since 1978 and has been a Vice President of the Registrant since 1982. He was Senior Vice President—National Client Services from June 1985 until he became Senior Vice President—Operations on July 14, 1986.

DAVID G. COMERZAN, age 42. Mr. Comerzan has been employed by the Registrant since 1975 and was a Vice President—Operations of the Registrant from 1984 until June 1985 when he became Senior Vice President—Operations.

DONALD G. SIMPSON, age 42. Mr. Simpson has been employed by the Registrant since 1980 and was Vice President—Operations of the Registrant from June 1985 until he became Senior Vice President—Operations on July 17, 1986.

LAURENCE J. STEUDLE, age 39. Mr. Steudle has been employed by the Registrant since 1970. He was Vice President—BMC Operations of the Registrant from 1984 until he became Senior Vice President—Operations in November 1985.

EARL E. WILLIAMS, age 51. Mr. Williams has been employed by the Registrant since 1984. He was Vice President—Marketing from June 1985 until November 1985 when he became Senior Vice President—Operations. Prior to his employment with the Registrant, Mr. Williams was a health care consultant from 1982 to 1984 and Executive Vice President of Advanced Health Systems, Inc. (a health care management company) from 1969 to 1982.

Special Services

RICHARD A. SANTONI, Ph.D., age 44. Dr. Santoni has been employed by the Registrant since 1975. He was a Vice President of the Registrant from 1978 until he became an Executive Vice President in 1983. He was President of the Registrant from February 1985 through July 14, 1986, at which time he became Executive Vice President—Special Services.

EDWARD A. CARELS, Ph.D., age 43. Dr. Carels has been employed by the Registrant since 1979. He was a Vice President of the Registrant from 1980 until he became an Executive Vice President in 1983. He became Senior Vice President—National Client Services on July 14, 1986.

Business Development

JAMES E. PARKHURST, age 46. Mr. Parkhurst has been employed by the Registrant since March 1985. He was Vice President—Marketing until he became Senior Vice President—Business Development in November 1985. Prior to his employment with the Registrant Mr. Parkhurst was Vice President—

Acquisitions for Medical Care International (a health care management company) from 1983 to February 1985. He served as Vice President—Corporate Development LifeMark Corporation (a health care management company) from 1978 to 1983.

Finance

STEPHEN R. MUNROE, age 41. Mr. Munroe has been employed by the Registrant since 1977 and was a Vice President from 1983 until 1984 when he became Chief Financial Officer. He became a Senior Vice President in February 1985.

MARK A. EDWARDS, age 32. Mr. Edwards has been employed by the Registrant since 1977. He has been Corporate Controller of the Registrant since 1983. He became a Vice President of the Registrant in February 1985.

Law

MARILYN U. MACNIVEN-YOUNG, age 35. Ms. MacNiven-Young joined the Registrant in December 1985 as Vice President, General Counsel and Assistant Secretary. Prior to her employment with the Registrant, Ms. MacNiven-Young served as Senior Counsel for Fluor Corporation, an engineering and construction and natural resources company from 1978 through October 1985.

PART II

Item 5. MARKET FOR REGISTRANT'S COMMON EQUITY AND RELATED STOCKHOLDER MATTERS.

(a) The Registrant's Common Stock is traded on the national over-the-counter market and is quoted on the NASDAQ National Market System under the symbol CMPH. The following table sets forth the range of high and low bid prices for the Common Stock for the fiscal quarters indicated. All quotations have been adjusted to give effect to a 33⅓% stock dividend (which had the effect of a four-for-three stock split) effected on July 16, 1985 and are rounded to the nearest one-eighth. Such prices represent inter dealer prices, without retail markup, markdown or commission and do not necessarily represent actual transactions.

	Bid Price	
Fiscal Year	High	Low
1986:		
First Quarter	$25⅜	$17⅞
Second Quarter	18⅝	14¾
Third Quarter	23¼	17
Fourth Quarter	19¼	13⅛
1985:		
First Quarter	$18	$12⅞
Second Quarter	18½	15⅝
Third Quarter	22⅜	16
Fourth Quarter	22⅞	19⅝

(b) As of July 31, 1986, the Registrant had 3,028 stockholders of record.

(c) The Registrant paid $.08 and $.075 per share cash dividends on a quarterly basis during the fiscal years ended May 31, 1986 and May 31, 1985, respectively, or an aggregate of $.32 and $.30 per share for those years. The Registrant intends to continue to pay regular cash dividends in the future, although the payment of such dividends will be dependent upon the earnings, financial position and cash requirements of the Registrant and other relevant factors existing at the time. On June 6, 1986, the Registrant's Board of Directors declared a quarterly dividend of $.09 per share payable August 21, 1986, to stockholders of record July 31, 1986.

Item 6. SELECTED FINANCIAL DATA.

The following tables summarize selected consolidated financial data and should be read in conjunction with the more detailed consolidated financial statements and notes thereto appearing at page 18 of this report.

	Years Ended May 31,				
	1986	1985	1984	1983	1982
	(Amounts in thousands, except per share data)				
Income Statement Data					
Revenues:					
Operating	$187,022	$153,035	$107,913	$86,126	$68,709
Interest	4,812	4,637	5,416	2,845	4,610
Other	1,102	864	353	412	166
	192,936	158,536	113,682	89,383	73,485
Cost and Expenses:					
Operating	108,894	84,912	58,817	46,619	39,349
General and administrative	43,012	32,926	22,742	18,574	16,930
Depreciation and amortization	5,775	4,240	2,781	1,952	1,448
Interest	4,135	1,577	783	660	603
Loss on write-down of assets	5,701	—	—	—	—
	167,517	123,655	85,123	67,805	58,330
Earnings before taxes on income and extraordinary items	25,419	34,881	28,559	21,578	15,155
Net earnings(1)	13,102	17,226	14,058	10,767	7,586
Earnings per common and common equivalent share(1)					
Primary	.87	1.13	.93	.81	.63
Fully diluted	.87	1.13	.93	.81	.62
Cash dividends per share	.32	.30	.24	.18	.12
Weighted average common and common equivalent shares outstanding	16,987	15,315	15,160	13,367	12,680

(1) Excludes extraordinary gain of $231,000 ($.02 per share) recorded in fiscal 1982. Amounts per share have been adjusted to effect a four-for-three stock split effected July 16, 1985.

	At May 31,				
	1986	1985	1984	1983	1982
	(Dollars in thousands)				
Balance Sheet Data					
Working capital	$ 79,145	$ 92,852	$ 55,481	$ 59,691	$30,934
Total assets	220,469	216,397	144,290	119,491	69,073
Long-term debt	59,377	64,522	15,493	6,446	5,291
Stockholders' equity	132,180	123,745	110,910	100,489	53,561

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

The following table sets forth for the periods indicated (i) percentages which certain items reflected in the financial data bear to total revenues and (ii) the percentage increase of such items as compared to the indicated prior period:

	Relationship to Total Revenues			Period-to-Period Increase	
	Years Ended May 31,			Years Ended May 31,	
	1986	1985	1984	1985-86	1984-85
Revenues:					
Operating	96.9%	96.6%	94.9%	22.2%	41.8%
Interest	2.5	2.9	4.8	3.8	(14.4)
Other	.6	.5	.3	27.5	144.8
	100.0	100.0	100.0	21.7	39.5
Costs and Expenses:					
Operating	56.4	53.5	51.8	28.2	44.4
General and administrative	22.3	20.8	20.0	30.6	44.8
Depreciation and amortization	3.0	2.7	2.4	36.2	52.5
Interest	2.1	1.0	.7	162.2	101.4
Loss on write-down of assets	3.0	—	—	—	—
Earnings before taxes on income	13.2	22.0	25.1	(27.1)	22.1
Taxes on income	6.4	11.1	12.7	(30.2)	21.7
Net earnings	6.8%	10.9%	12.4%	(23.9)%	22.5%

Results of Operations

The Registrant's revenues have increased from approximately $159,000,000 in fiscal 1985 to $193,000,000 in fiscal 1986. These gains are the result of increases in the utilization of the Registrant's existing Programs, the addition of new Programs and price increases. Program utilization varies as to its impact on revenues depending on the type of services provided and the method of delivery employed. Increased utilization at the Registrant's freestanding chemical dependency or psychiatric facilities has a proportionately greater effect on revenues than does increased utilization of contract operations. The difference is attributable to the higher fees charged for each day of service rendered in freestanding facilities where a broader range of services are provided. From the beginning of fiscal 1984 through fiscal 1986 the Registrant has opened eight such freestanding facilities. Reflecting these facts, the contribution to operating revenues of the Registrant's freestanding facilities has ranged from approximately 60% in fiscal 1984, to 63% in fiscal 1985 and 61% in fiscal 1986. Contract operations represented approximately 37% in fiscal 1984, 34% in fiscal 1985 and 33% in fiscal 1986. Revenues from the Registrant's other operating activities rose to 6% in fiscal 1986 from 3% in fiscal 1985.

Operating and other revenues for fiscal 1986 and fiscal 1985 increased by 23% and 42%, respectively, over the previous periods. The new freestanding facilities and new contracts, net of units closed, accounted for approximately 40% of the increase in fiscal 1985, while they accounted for only 15% in fiscal 1986. Fiscal 1985 was positively impacted by the addition of approximately 370 freestanding beds in May and June 1984, while CareUnit of Coral Springs, which opened in October 1985, was the only material addition as a source of freestanding revenue in fiscal 1986. Other operations, principally RehabCare, outpatient programs and SmokEnders, accounted for approximately 15% of the increase in fiscal 1986, but had a negligible effect on fiscal 1985. Improvement in utilization of existing freestanding facilities and contracts had a much greater impact on fiscal 1985, accounting for approximately 45% of the increase, while in fiscal 1986 they accounted for approximately 30%. A decline in average length of stay was a factor in moderating utilization gains. The increase in fiscal 1986 was also affected by the purchase or exchange of the Registrant's interest in certain joint ventures. The change in ownership interests accounted for approximately 10% of the increase in revenue. Price increases accounted for the remaining 30% of the increase in fiscal 1986 and 15% in fiscal 1985.

Cost and expenses increased approximately 35% when comparing fiscal 1986 to 1985, and 45% when comparing fiscal 1985 to 1984. Major factors in the increase from fiscal 1985 to 1986 were the write-down of the value of the Registrant's Brea, California psychiatric facility of $4.3 million and the write-off of the license agreement the Registrant has with SmokEnders, Inc. of $1.4 million. Without these two items costs and expenses would have increased approximately 31% from fiscal 1985 to 1986. Media advertising expenditures rose from approximately $8.9 million in fiscal 1985 (6% of operating revenues) to $13.6 million in fiscal 1986 (7% of operating revenues). During fiscal 1986, in addition to the increase in operating and general administrative expenses caused by the addition of new freestanding facilities and contracts, and general inflationary pressures, the Registrant added several new services including departments to provide in-house legal services, to package the Registrant's services for national organizations, to provide construction management and other systems support. This year also showed a marked increase in expenditures for the development of new programs and facilities which was generally offset by a decrease in the Registrant's executive bonus plan. The Registrant accrued approximately $1.2 million for this plan in fiscal 1985. Nothing was accrued for fiscal 1986 as the Registrant did not meet its internal operating goals.

Depreciation and amortization expenses increased in fiscal 1986 as a result of the Registrant's acquisition of interests in certain joint venture facilities, the opening of freestanding facilities and its new corporate headquarters, and additional amortization of deferred costs. The addition of new facilities and the remodeling and expansion of existing facilities were principally responsible for the increase in fiscal 1985. The increase in interest expense in fiscal 1986 was due primarily to interest associated with the convertible debentures the Registrant issued in April 1985. This was partially offset by capitalized interest associated with the Registrant's new corporate headquarters building (which it occupied in December 1985) of approximately $610,000.

As a result of the above factors, pretax earnings for fiscal 1986 decreased by approximately $9.5 million when compared to fiscal 1985. Earnings from operations, calculated by excluding write-downs, interest income and interest expense, decreased approximately $1.4 million or 4%. Operating margins declined from 21% to 16%. In addition to increased media costs, this decline in margins was also influenced by declining occupancy trends in the third and fourth quarters that was not offset by decreased costs. Much of the revenue gain can also be attributed to lower margin operating units and programs such as SmokEnders, RehabCare and outpatient services. Operating margins declined from approximately 22% in fiscal 1984 to 21% in fiscal 1985. Start-up losses and lower than average margins in newer freestanding facilities inhibited improved margin performance. Margins were also negatively impacted by the increase in start-up losses associated with the Registrant's Canadian operations and its RehabCare subsidiary.

Revenues for the fourth quarter of fiscal 1986 increased approximately $4.2 million (8.6%) over the third quarter, principally as a result of increased utilization of the Registrant's freestanding facilities and contracts. Also significant to this increase is the comparable length in calendar days of the fourth quarter (92 days) compared to the third quarter (90 days). Although the Registrant did experience gross gains in patient days of service rendered through its contract operations it continued to experience the unfavorable occupancy trends first reported in the third quarter and as reflected in the following table:

	Hospital Utilization		Contract Utilization	
Fourth Quarter	Patient Days	Avg. Daily Occupancy	Patient Days	Avg. Occupied Bed Per Contract
Fiscal 1986	115,917	75.8%	232,938	15.7
Fiscal 1985	119,781	80.9%	198,137	16.8

Costs and expenses in the fourth quarter excluding the loss on write-down of assets, increased approximately $5.0 million over the third quarter. Increased media expenditures accounted for nearly 30% of this increase. In addition to costs associated with increased utilization, costs associated with personnel reductions and increased business development costs contributed to the increase for the quarter.

Liquidity and Capital Resources

The Registrant's current ratio decreased from approximately 4.3:1 at May 31, 1985 to 3.7:1 at May 31, 1986. Accounts receivable days outstanding decreased from 86 days at May 31, 1985 to 79 days at May 31, 1986. This decrease is principally a result of improved collection systems and procedures put in place throughout fiscal 1985 and 1986.

The Registrant has committed or plans to commit approximately $46,000,000 for purchase or construction of new freestanding facilities in Chicago, Illinois; Orlando, Florida; San Diego, California; and Norman, Oklahoma; replacement of the existing facility in Brea, California; and the expansion of existing facilities in Sacramento, California; and Cincinnati, Ohio.

Because of its present cash on hand, expected cash flow from earnings, and ability to obtain outside financing, the Registrant believes it will have no difficulty in meeting its obligations during the coming fiscal year. The Registrant had a $10,000,000 bank line of credit which it allowed to expire on September 30, 1985.

Impact of Inflation

Although inflation has become less of a significant factor in the nation's economy, to cope with its effect of increasing expenses, the Registrant regularly raises prices charged at freestanding facilities. The Registrant's Contracts provide for annual price increases to reflect increases in the Consumer Price Index. To date, these price increases have been adequate to offset the Registrant's increases in costs.

Item 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA.

COMPREHENSIVE CARE CORPORATION

Index to Consolidated Financial Statements

Years Ended May 31, 1986, 1985 and 1984

REPORT OF INDEPENDENT CERTIFIED PUBLIC ACCOUNTANTS

To the Stockholders and Board of Directors
Comprehensive Care Corporation

We have examined the consolidated balance sheets of Comprehensive Care Corporation and subsidiaries as of May 31, 1986 and 1985 and the related consolidated statements of earnings, stockholders' equity and changes in financial position for the years then ended. Our examinations were made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances. The consolidated financial statements for the year ended May 31, 1984 were examined by other accountants whose report dated July 20, 1984 expressed an unqualified opinion on those statements.

In our opinion, the accompanying 1986 and 1985 consolidated financial statements present fairly the financial position of Comprehensive Care Corporation and subsidiaries at May 31, 1986 and 1985 and the results of their operations and the changes in their financial position for the years then ended, in conformity with generally accepted accounting principles applied on a consistent basis.

Peat, Marwick, Mitchell & Co.

Orange County, California
July 18, 1986

REPORT OF INDEPENDENT CERTIFIED PUBLIC ACCOUNTANTS

To the Stockholders and Board of Directors
Comprehensive Care Corporation

We have examined the consolidated statements of earnings, stockholders' equity and changes in financial position of Comprehensive Care Corporation and subsidiaries for the year ended May 31, 1984. Our examination was made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, the accompanying consolidated financial statements present fairly the results of operations and the changes in financial position of Comprehensive Care Corporation for the year ended May 31, 1984, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

Newport Beach, California
July 20, 1984

Lesley, Thomas, Schwarz & Postma

COMPREHENSIVE CARE CORPORATION AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

ASSETS

	May 31, 1986	May 31, 1985
	(Dollars in thousands)	
Current assets:		
Cash, including short-term investments of $31,332 and $58,197	$ 42,834	$ 62,228
Accounts and notes receivable, less allowance for doubtful accounts of $7,553 and $6,674 (Note 3)	55,923	47,903
Prepaid taxes (Note 8)	2,986	4,531
Other current assets	6,314	6,320
Total current assets	108,057	120,982
Property and equipment, at cost (Notes 4, 6 and 14)	100,574	84,216
Less accumulated depreciation and amortization	15,429	11,711
Total property and equipment	85,145	72,505
Other assets:		
Intangible assets (Notes 2 and 9)	9,308	4,774
Notes receivable	1,312	1,158
Investments	4,863	4,548
Deferred contract costs	3,284	3,218
Other	8,500	9,212
Total other assets	27,267	22,910
	$220,469	$216,397

LIABILITIES AND STOCKHOLDERS' EQUITY

	1986	1985
Current liabilities:		
Note payable, accounts payable and accrued liabilities (Note 10)	$ 18,794	$ 19,611
Long-term debt payable within one year (Note 4)	1,091	1,183
Deferred income taxes (Note 8)	8,628	7,001
Income taxes payable	399	335
Total current liabilities	28,912	28,130
Long-term debt due after one year (Note 4)	55,711	59,233
Other liabilities	3,666	2,076
Deferred income taxes (Note 8)	—	3,213
Commitments and contingencies (Notes 6 and 12)		
Stockholders' equity (Note 5):		
Common stock, $.10 par value; authorized 30,000,000 shares; issued and outstanding 15,178,668 and 15,169,183 shares	1,518	1,138
Additional paid-in capital	75,830	76,021
Retained earnings	54,832	46,586
Total stockholders' equity	132,180	123,745
	$220,469	$216,397

See notes to consolidated financial statements.

COMPREHENSIVE CARE CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF EARNINGS

	Years Ended May 31,		
	1986	1985	1984
	(Dollars in thousands, except per share amounts)		
Revenues:			
Operating	$187,022	$153,035	$107,913
Interest	4,812	4,637	5,416
Other	1,102	864	353
	192,936	158,536	113,682
Costs and Expenses:			
Operating	108,894	84,912	58,817
General and administrative	43,012	32,926	22,742
Depreciation and amortization	5,775	4,240	2,781
Interest	4,135	1,577	783
Loss on write-down of assets (Note 13)	5,701	—	—
	167,517	123,655	85,123
Earnings before taxes on income	25,419	34,881	28,559
Taxes on income (Note 8)	12,317	17,655	14,501
Net earnings	$ 13,102	$ 17,226	$ 14,058
Earnings per common and common equivalent share (Note 1):			
Primary and fully diluted	$ .87	$ 1.13	$ .93
Dividends per common share	$ .32	$ .30	$ .24

See notes to consolidated financial statements.

COMPREHENSIVE CARE CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY

	Common Stock		Additional Paid-In Capital	Retained Earnings
	Shares	Amount		
		(Amounts in thousands)		
Balances, May 31, 1983	15,160	$1,137	$75,862	$23,490
Net earnings	—	—	—	14,058
Dividends	—	—	—	(3,637)
Balances, May 31, 1984	15,160	1,137	75,862	33,911
Net earnings	—	—	—	17,226
Exercise of stock options (Note 5)	9	1	159	—
Dividends	—	—	—	(4,551)
Balances, May 31, 1985	15,169	1,138	76,021	46,586
Stock split effected July 16, 1985	(1)	379	(379)	—
Net earnings	—	—	—	13,102
Exercise of stock options (Note 5)	11	1	188	—
Dividends	—	—	—	(4,856)
Balances, May 31, 1986	15,179	$1,518	$75,830	$54,832

See notes to consolidated financial statements.

COMPREHENSIVE CARE CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CHANGES IN FINANCIAL POSITION

	Years Ended May 31,		
	1986	1985	1984
	(Dollars in thousands)		
Financial resources provided by			
Operations:			
Net earnings	$ 13,102	$17,226	$14,058
Items not requiring outlay of working capital:			
Depreciation and amortization of property and equipment	4,501	3,878	2,614
Deferred income taxes	(3,608)	2,378	451
Annuity income	(315)	(347)	(362)
Amortization of intangible and other assets	1,274	362	167
Working capital provided by operations	14,954	23,497	16,928
Loss on write-down of assets	5,701	—	—
Disposal of property and equipment	2,050	299	4,109
Additional long-term debt	3,152	48,076	10,129
Decrease in notes receivable	361	3,518	882
Issuance of common stock	189	160	—
Decrease in other assets	1,732	—	183
	28,139	75,550	32,231
Financial resources used for			
Acquisition of property and equipment	23,492	21,196	25,179
Reduction of long-term debt	6,674	1,425	1,533
Increase in notes receivable	515	84	3,570
Dividends	4,856	4,551	3,637
Deferred contract costs	593	2,599	845
Increase in intangible assets	4,853	—	68
Investments	—	1,250	817
Other applications	863	7,074	792
	41,846	38,179	36,441
Increase (decrease) in working capital	$(13,707)	$37,371	$(4,210)
Summary of changes in components of working capital			
Increase (decrease) in current assets:			
Cash	$(19,394)	$20,467	$(6,987)
Accounts and notes receivable	8,020	20,633	6,389
Prepaid taxes	(1,545)	4,531	—
Other current assets	(6)	1,983	1,719
	(12,925)	47,614	1,121
Increase (decrease) in current liabilities:			
Note payable, accounts payable and accrued liabilities	(817)	7,286	2,590
Long-term debt payable within one year	(92)	20	684
Deferred income taxes	1,627	3,701	1,731
Income taxes payable	64	(764)	326
	782	10,243	5,331
Increase (decrease) in working capital	$(13,707)	$37,371	$(4,210)

See notes to consolidated financial statements.

Note 1—Summary of Significant Accounting Policies

The consolidated financial statements include the accounts of the Registrant, its subsidiaries and the Registrant's interest in the accounts of joint venture partnerships (see Note 2). All intercompany accounts and transactions have been eliminated in consolidation. Certain reclassifications of prior year amounts have been made to conform with current year classifications.

Revenue Recognition

Approximately 96% of the Registrant's operating revenues is received from private sources; the remainder from Medicare and Medicaid. The latter are governmental programs which provide for payments at rates generally less than the established billing rates. Payments are subject to audit by intermediaries administering these programs. Revenues from these programs are recorded under reimbursement principles applicable under the circumstances. Although management believes estimated provisions currently recorded properly reflect these revenues, any differences between final settlement and these estimated provisions are reflected in operating revenues in the year finalized.

Property and Equipment

Depreciation and amortization of property and equipment are computed on the straight-line method over the estimated useful lives of the related assets, principally: buildings and improvements—5 to 40 years; furniture and equipment—3 to 12 years; leasehold improvements—life of lease or life of asset, whichever is less.

Intangible Assets

Intangible assets include costs in excess of net assets of businesses purchased (goodwill), licenses, and similar rights. Costs in excess of net assets purchased are amortized over 25 to 40 years. The costs of other intangible assets are amortized over the period of benefit. The amounts on the consolidated balance sheets are net of accumulated amortization of $703,000 and $384,000 at May 31, 1986 and 1985, respectively.

Capitalized Interest

Interest incurred during the construction of freestanding facilities is capitalized and subsequently charged to depreciation expense over the life of the related asset. The interest rate utilized is either the rate of the specific borrowing associated with the project or the Registrant's average interest rate on borrowings where there is no specific borrowing associated with the project. The amount of interest capitalized was $654,000, $161,000 and $330,000 in fiscal 1986, 1985 and 1984, respectively.

Deferred Contract Costs

The Registrant has entered into a limited number of contracts with independent general hospitals whereby it will provide services over a period in excess of the standard two year agreement. In recognition of the hospital's long-term commitment, the Registrant has paid certain amounts to them. These amounts may be used by the hospital for capital improvements or as otherwise determined by the hospital. The Registrant is entitled to a pro rata refund in the event that the hospital terminates the contract before its scheduled termination date: accordingly, these amounts are charged to expense over the life of the contract.

Investment Tax Credits

Investment tax credits are accounted for under the "flow through" method.

Note 1—Summary of Significant Accounting Policies (continued)

Earnings Per Share

Primarily and fully diluted earnings per common and common equivalent share have been computed by dividing net earnings, after giving effect to the elimination of interest expense applicable to the convertible debentures less income tax effect, by the weighted average number of common and common equivalent shares outstanding during the period. The convertible debentures issued in April 1985 are considered to be common stock equivalents from the time of issuance. The weighted average of the number of shares issuable on conversion of the convertible debentures and exercise of stock options was added to the number of common shares outstanding.

The weighted average number of shares outstanding used to compute primary and fully diluted earnings per share has been restated to reflect a four-for-three stock split effected July 16, 1985, as have all share and per share information. The weighted average number of shares used to calculate earnings per share was 16,987,000, 15,315,000, and 15,160,000 in 1986, 1985 and 1984, respectively.

Note 2—Accounting for Interests in Joint Venture Partnerships

In 1972, the Registrant entered into a joint venture partnership, Neuro Affiliates Company, with another corporation for the purpose of operating two hospitals. Under the terms of the joint venture agreement, the Registrant manages one of the hospitals and its partner manages the other. Each of the partners in the joint venture receives a management fee for the hospital it manages, and they share equally in the profits or losses.

In May 1981, the Registrant entered into two joint venture partnerships in Florida organized for the purpose of owning and operating 84-bed and 120-bed chemical dependency treatment facilities in Jacksonville Beach and Tampa on properties owned by the joint ventures. In July 1983, a third joint venture was formed to operate a 100-bed chemical dependency treatment facility in Coral Springs. The facility opened on October 1, 1985. On November 13, 1985, the Registrant exchanged its interests in the CareUnit of Tampa joint venture for its partners' interests in the CareUnit of Coral Springs and CareUnit of Jacksonville Beach ventures. As a result, the three Florida joint ventures in which the Registrant participated were terminated.

In July 1981, the Registrant entered into a joint venture partnership in Ohio for the purpose of owning and operating an 84-bed chemical dependency hospital. The Registrant's partners loaned the joint venture $4,000,000 (at 10% interest) which was used to purchase the building and equipment necessary for operation of the hospital. On December 19, 1985 the Registrant purchased the interest of its partners in the venture for $4,600,000. The Registrant also repaid the loan owed by the joint venture. The purchase price exceeded the fair market value of net assets purchased by approximately $1.2 million. This amount is included in intangible assets in the consolidated balance sheet.

In May 1984, the Registrant entered into a joint venture agreement with a subsidiary of The Health Central System ("HCS"). The joint venture owns and operates Golden Valley Health Center, a 258-bed behavioral medicine hospital located in a suburb of Minneapolis. The joint venture is marketing the Registrant's behavioral medicine services to HCS affiliate hospitals. The Registrant serves as managing partner of the joint venture for which it earns a fee based on profitability. The Registrant has a 50% interest in the joint venture.

Note 2—Accounting for Interests in Joint Venture Partnerships (continued)

The Registrant consolidates its interest in the assets, liabilities, income and expenses of the joint ventures. The assets and liabilities of the joint ventures included in the consolidated balance sheets are as follows:

	May 31,	
	1986	1985
	(Dollars in thousands)	
Assets		
Current assets	$ 6,989	$ 8,144
Property and equipment (net)	9,863	18,367
Other assets	113	233
	$16,965	$26,744
Liabilities and partners' equity		
Current liabilities	$ 1,699	$ 1,991
Note payable(1)	—	1,753
Long-term liabilities	—	5,365
Partners' equity	15,266	17,635
	$16,965	$26,744

(1) This amount was offset against the Registrant's notes receivable of $3,506,000 at May 31, 1985 in the consolidated balance sheet.

The Registrant's proportionate share of the operating results of the joint ventures included in the consolidated statements of earnings is as follows:

	Years Ended May 31,		
	1986	1985	1984
	(Dollars in thousands)		
Revenues	$23,407	$25,354	$14,557
Costs and expenses:			
Operating, general and administrative	16,931	18,135	10,924
Depreciation and amortization	743	841	317
Interest	215	608	451
	17,889	19,584	11,692
Earnings before taxes on income	$ 5,518	$ 5,770	$ 2,865

Note 3—Accounts and Notes Receivable

Accounts and notes receivable include current notes receivable of $8,062,000 and $5,590,000 at May 31, 1986 and 1985, respectively.

Note 4—Long-Term Debt

Long-term debt consists of the following:

	May 31, 1986	May 31, 1985
	(Dollars in thousands)	
7% to 10% notes, payable in monthly installments with maturity dates through 1996. Collateralized by real and personal property having a net book value of $7,025	$ 2,115	$ 2,360
Note payable bearing interest at 72% of prime through 1988, and at 74% of prime for years 1989 through 1994, payable quarterly maturing in 1994. Collateralized by real and personal property having a net book value of $6,802	4,750	2,625
Note payable bearing interest at 70% of prime through June 1986, and at 74% of prime from July 1986 through 1995, payable quarterly maturing in 1995. Collateralized by real and personal property having a net book value of $7,827. Retired in fiscal 1986	—	4,315
Note payable bearing interest at 10%, payable quarterly with level payments of principal and interest based upon a twenty year amortization schedule, with unpaid principal and interest due in 1995. Collateralized by real and personal property having a net book value of $2,463. Retired in fiscal 1986	—	1,881
Note payable bearing interest at 65% of prime, payable monthly maturing in 1994. Collateralized by real property having a net book value of $2,980	1,619	859
7½% convertible subordinated debentures due 2010	46,000	46,000
Capital lease obligations (Note 6)	1,890	1,980
Other	428	396
	56,802	60,416
Less amounts due within one year	1,091	1,183
	$55,711	$59,233

As of May 31, 1986, the annual maturities of long-term debt for the next five years amounted to $1,091 in 1987, $1,084 in 1988, $1,109 in 1989, $1,164 in 1990, and $1,204 in 1991.

In April 1985, the Registrant issued $46,000,000 in convertible subordinated debentures. These debentures require that the Registrant make semi-annual interest payments in April and October at an interest rate of 7½%. The debentures are due in 2010 but may be converted to common stock of the Registrant at the option of the holder at a conversion price of $25.97 per share, subject to adjustment in certain events. The debentures are also redeemable, at the option of the Registrant, in certain circumstances. Mandatory annual sinking fund payments sufficient to retire 5% of the aggregate principal amount of the debentures are required to be made on each April 15 commencing in April 1996 to and including April 15, 2009.

Note 5—Stock Option Plans

In November 1973, the Registrant adopted a non-qualified stock option plan which expired May 31, 1983. At the beginning of fiscal 1986, options for 9,200 shares of common stock were outstanding. The options were exercised in fiscal 1986 at $10.88 per share.

Note 5—Stock Option Plans (continued)

On June 24, 1983, the Registrant adopted a stock option plan which was approved at the stockholders annual meeting held in September, 1983. The total number of shares of common stock which may be granted under this plan cannot exceed 333,333 shares. The Plan is intended to qualify as an Incentive Stock Option Plan. At the time of granting an option under the plan, "stock appreciation rights" and "cash appreciation rights" may be concurrently granted. The Plan provides that options must be exercised within 10 years of the date of grant and that no options may be granted under the Plan subsequent to May 31, 1993.

The following table sets forth the options granted under this Plan:

		Option Price		Market Price When Granted	
	Number of Shares	Per Share	Aggregate	Per Share	Aggregate
		(Dollars in thousands, except per share amounts)			
Options granted in fiscal 1985	140,345	$13.78-18.38	$1,959	$13.78-18.38	$1,959
Options forfeited in fiscal 1985	(5,802)	13.78	(80)	13.78	(80)
Options granted in fiscal 1986	74,000	18.00	1,332	18.00	1,332
Options forfeited in fiscal 1986	(14,418)	13.78	(199)	13.78	(199)
Options exercised in fiscal 1986	(1,088)	13.78	(15)	13.78	(15)
	193,037	$13.78-18.38	$2,997	$13.78-18.38	$2,997

During fiscal 1984, the Registrant authorized the issuance of non-statutory options for 33,333 common shares at $15.56-16.88 per share. The non-statutory options become exercisable at the rate of 25% per year following the date of grant and must be exercised within five years after the date of grant. At May 31, 1986, options for 16,666 shares were exercisable.

Note 6—Lease Commitments

The Registrant and the Neuro Affiliates joint venture partnership lease facilities, furniture and equipment. The facility leases contain escalation clauses based on the Consumer Price Index and provisions for payment of real estate taxes, insurance, maintenance and repair expenses.

Total rental expenses for all operating leases were as follows:

	Years Ended May 31,		
	1986	1985	1984
	(Dollars in thousands)		
Minimum rentals	$ 935	$603	$637
Contingent rentals	126	71	78
Total rentals	$1,061	$674	$715

Assets under capital leases are capitalized using interest rates appropriate at the inception of each lease; contingent rents associated with capital leases in fiscal 1986, 1985 and 1984 were $129,000, $123,000 and $122,000, respectively. The net book value of capital leases at May 31, 1986 and 1985, was $1,300,000 and $1,416,000, respectively.

Note 6—Lease Commitments (continued)

Future minimum payments, by year and in the aggregate, under capital leases and non-cancellable operating leases with initial or remaining terms of one year or more consisted of the following at May 31, 1986:

	Capital Leases			
	Registrant	Joint Venture	Total	Operating Leases
	(Dollars in thousands)			
1987	$ 204	$122	$ 326	$1,180
1988	204	100	304	1,168
1989	204	89	293	951
1990	204	89	293	218
1991	204	89	293	222
Later years	2,276	444	2,720	1,049
Total minimum lease payments	$3,296	$933	4,229	$4,788
Less amounts representing interest			2,339	
Present value of net minimum lease payments			$1,890	

Note 7—Deferred Compensation Plans

The Registrant has a deferred compensation plan for its Chairman. The vested unfunded benefits at May 31, 1986 and 1985 ($1,374,000 and $901,000), have been accrued by the Registrant. The Registrant utilized an 8% discount rate in determining the present value of vested unfunded past service cost. The total charges to earnings for fiscal 1986, 1985 and 1984 amounted to $463,000, $136,000 and $146,000, respectively.

The Registrant has deferred compensation plans for its key executives and medical directors. Under provisions of these plans, participants may elect to defer a portion of their current compensation to future periods.

Note 8—Taxes on Income

Taxes on income consist of the following:

	Years Ended May 31,		
	1986	1985	1984
	(Dollars in thousands)		
Currently payable:			
Federal income taxes	$12,303	$10,264	$10,336
State income taxes	2,584	1,974	1,984
	14,887	12,238	12,320
Deferred:			
Federal income taxes	(1,946)	4,518	1,824
State income taxes	(624)	899	357
	(2,570)	5,417	2,181
	$12,317	$17,655	$14,501

Note 8—Taxes on Income (continued)

A reconciliation between taxes on income and the amount computed by applying the statutory federal income tax rate (46%) to earnings before taxes on income is as follows:

	Years Ended May 31,		
	1986	1985	1984
	(Dollars in thousands)		
Income taxes at the statutory tax rate	$11,692	$16,045	$13,137
State income taxes net of federal tax benefit	1,058	1,540	1,279
Investment tax credit	(517)	(303)	(270)
Loss from unconsolidated subsidiary	144	312	118
Amortization of goodwill	127	65	77
Other	(187)	(4)	160
	$12,317	$17,655	$14,501

Total taxes on income differs from taxes currently payable as a result of differences in the recognition of revenue and expense for tax and financial statement purposes. The sources of these differences and the tax effect of each are as follows:

	Years Ended May 31,		
	1986	1985	1984
	(Dollars in thousands)		
Excess tax over book depreciation	$ 969	$ 572	$ 406
Cash basis accounting and different reporting period for tax purposes by joint ventures	272	2,312	481
State income taxes not currently deductible	124	(462)	(197)
Deferred compensation expense not currently deductible	(768)	(351)	(403)
Cash basis accounting by subsidiaries	1,173	1,363	1,378
Employee benefit expenses not currently recorded for book purposes	(1,509)	2,405	407
Write-down of Brea Hospital facility not currently deductible	(2,307)	—	—
Partnership exchange recognized as income for tax purposes	(863)	—	—
Other	339	(422)	109
	$(2,570)	$5,417	$2,181

Note 9—Acquisitions and Dispositions

In February 1986, the Registrant purchased the assets of a weight control clinic located in Orange County, California. The purchase price of $460,000 exceeded the fair market value of the assets by approximately $425,000. This amount is included in intangible assets in the consolidated balance sheets.

In April 1986, the Registrant entered into a joint venture agreement to operate a 160-bed chemical dependency treatment facility in Portland, Oregon. The Registrant has a 66⅔% interest in the venture and manages it for a fee based on revenue.

In May 1986, the Registrant purchased the remaining 50% of its partially owned subsidiary, RehabCare Corporation. The purchase price of $3.6 million exceeded the fair market value of net assets purchased by $3.1 million. This amount is included in intangible assets in the consolidated balance sheets.

COMPREHENSIVE CARE CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

May 31, 1986, 1985 and 1984

Note 9—Acquisitions and Dispositions (continued)

In July 1986, the Registrant purchased a hospital in San Diego, California for $4.0 million which the Registrant intends to operate as a 92-bed chemical dependency treatment facility.

Note 2 includes a further description of acquisitions and dispositions of joint venture interests.

Note 10—Note Payable, Accounts Payable and Accrued Liabilities

Note payable, accounts payable and accrued liabilities consist of the following:

	At May 31,	
	1986	1985
	(Dollars in thousands)	
Note payable	$ —	$ 1,410
Accounts payable and accrued liabilities	12,311	10,690
Accrued salaries and wages	4,435	5,930
Payable to third-party intermediaries	2,048	1,581
	$18,794	$19,611

Note 11—Quarterly Results (unaudited): Years Ended May 31, 1986 and 1985

	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
	(Dollars in thousands, except per share amounts)			
1986				
Revenues	$44,207	$46,697	$48,914	$53,118
Earnings before taxes on income	$ 9,304	$ 9,399	$ 6,634	$ 82
Taxes on income	4,643	4,671	3,305	(302)
Net earnings	$ 4,661	$ 4,728	$ 3,329	$ 384
Per share:				
Earnings—primary and fully diluted	$ .30	$ .30	$ .22	$ .05
Dividend declared	$ .08	$ .08	$ .08	$ .08
Stock Price:				
High	$ 25⅜	$ 18⅝	$ 23¼	$ 19¼
Low	$ 17⅞	$ 14¾	$ 17	$ 13⅛
1985				
Revenues	$33,882	$37,208	$39,736	$47,710
Earnings before taxes on income	$ 8,214	$ 8,797	$ 8,020	$ 9,850
Taxes on income	4,132	4,492	4,242	4,789
Net earnings	$ 4,082	$ 4,305	$ 3,778	$ 5,061
Per share:				
Earnings—primary and fully diluted	$ .27	$ .28	$ .25	$ .33
Dividend declared	$ .075	$ .075	$ .075	$ .075
Stock Price:				
High	$ 18	$ 18½	$ 22⅝	$ 22⅞
Low	$ 12⅞	$ 15⅝	$ 16	$ 1[illegible]⅝

Note 12—Contingencies

The Registrant is routinely engaged in the defense of lawsuits arising out of the ordinary course and conduct of its business and has insurance policies covering such potential insurable losses where such coverage is cost effective. Management believes that the outcome of such lawsuits will not have a material adverse effect on the consolidated financial statements.

Note 13—Loss On Write-Down Of Assets

In May 1986, the Registrant determined that its psychiatric hospital in Brea, California required physical plant replacement. The hospital, which was constructed in 1966, requires continuing heavy maintenance expenditures despite several renovation and refurbishment projects undertaken during the past decade. The Registrant commissioned an engineering report in March 1986, to assess the options available to correct deficiencies in the building's major systems. The report revealed that the level of renovation that would be necessary would, under California law, also require that the physical plant be brought current with seismic safety standards. The engineering report further indicated that such a renovation would not be cost effective.

The Registrant has begun development of a replacement facility to be constructed at the same site. Upon completion of the new structure, the existing facilities will be razed. The Registrant incurred in fiscal 1986 a charge to earnings of $4.3 million related to the write-down of the facilities.

In fiscal 1985, the Registrant entered into a license agreement with SmokEnders, Inc. The license agreement granted the Registrant the right to operate smoking cessation seminars using the name and materials of SmokEnders, Inc. The license agreement, which has an eight year life, requires the Registrant to pay a royalty to SmokEnders, Inc. based upon revenues derived from operation of the seminars. In fiscal 1986, the Registrant determined that there had been a permanent impairment in the value of the license agreement due to continued losses on the operation of seminars. Accordingly, the unamortized balance of license consideration of $1.4 million was charged to earnings in fiscal 1986.

Note 14—Property and Equipment

Property and equipment consists of the following:

	At May 31,	
	1986	1985
	(Dollars in thousands)	
Land and improvements	$ 15,464	$14,267
Buildings and improvements	64,063	53,819
Furniture and equipment	18,139	12,912
Leasehold improvements	204	514
Capitalized leases	2,704	2,704
	$100,574	$84,216

Item 9. DISAGREEMENTS ON ACCOUNTING AND FINANCIAL DISCLOSURE.

None.

PART III

Item 10. DIRECTORS AND EXECUTIVE OFFICERS OF THE REGISTRANT.

The information required by this item has been omitted (except certain information regarding executive officers contained in Part I) because the Registrant will file with the Securities and Exchange Commission a definitive proxy statement pursuant to Regulation 14A, involving the election of directors, not later than 120 days after the close of the Registrant's fiscal year ended May 31, 1986, relating to the Registrant's annual meeting of stockholders to be held on September 25, 1986.

Item 11. EXECUTIVE COMPENSATION.

This item has been omitted because the Registrant will file with the Securities and Exchange Commission a definitive proxy statement pursuant to Regulation 14A, involving the election of directors, not later than 120 days after the close of the Registrant's fiscal year ended May 31, 1986.

Item 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT.

This item has been omitted because the Registrant will file with the Securities and Exchange Commission a definitive proxy statement pursuant to Regulation 14A, involving the election of directors, not later than 120 days after the close of the Registrant's fiscal year ended May 31, 1986.

Item 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS.

This item has been omitted because the Registrant will file with the Securities and Exchange Commission a definitive proxy statement pursuant to Regulation 14A, involving the election of directors, not later than 120 days after the close of the Registrant's fiscal year ended May 31, 1986.

PART IV

Item 14. EXHIBITS, FINANCIAL STATEMENT SCHEDULES AND REPORTS ON FORM 8-K.

(a) 1. FINANCIAL STATEMENTS

Included in Part II of this report:

Reports of Independent Certified Public Accountants

Consolidated Balance Sheets at May 31, 1986 and 1985

Consolidated Statements of Earnings for years ended May 31, 1986, 1985 and 1984

Consolidated Statements of Stockholders' Equity for years ended May 31, 1986, 1985 and 1984

Consolidated Statements of Changes in Financial Position for years ended May 31, 1986, 1985 and 1984

Notes to Consolidated Financial Statements

2. FINANCIAL STATEMENT SCHEDULES

V. Property and Equipment
VI. Accumulated Depreciation and Amortization of Property and Equipment
VIII. Valuation and Qualifying Accounts
X. Supplementary Statement of Earnings Information

3. EXHIBITS

Exhibit Number	Description and Reference
3.1	Restated Certificate of Incorporation(1)
3.2	Amendment to Restated Certificate of Incorporation(7)
3.3	Restated Bylaws of the Registrant as amended July 14, 1986(filed herewith)
4.1	Indenture dated April 25, 1985, between the Registrant and Bank of America, NT&SA relating to Convertible Subordinated Debentures(8)
10.1	Standard form of CareUnit Contract(1)
10.2	Standard form of CarePsychCenter Contract(1)
10.3	Stock Bonus Plan of the Registrant, including pamphlet describing such Plan(2)
10.4	The Registrant's Employee Savings Plan(10)
10.5	Deferred Compensation Agreement dated April 6, 1982, between the Registrant and B. Lee Karns(4)
10.6	Amendment No. 1 to Deferred Compensation Agreement between the Registrant and B. Lee Karns(7)
10.7	Amendment No. 2 to Deferred Compensation Agreement between the Registrant and B. Lee Karns (filed herewith)
10.8	The Registrant's Amended and Restated 1983 Incentive Stock Option Plan(9)
10.9	Form of Individual Benefit Agreement(7)
10.10	Deferred Compensation Plan for executive management(9)
10.11	Form of Non-Statutory Stock Option Agreement(9)
10.12	Form of Incentive Stock Option Agreement (filed herewith)
10.13	Description of Executive Bonus Plan(9)
10.14	Agreement for Exchange of Ownership Interests dated November 13, 1985, between the Registrant and Alloa? Inc., Wonlar Inc., Trallow Inc. and Carter LaPrade and

(3) Filed as an exhibit to the Registrant's Form 10-K for the fiscal year ended May 31, 1981.

(4) Filed as an exhibit to the Registrant's Form 10-K for the fiscal year ended May 31, 1982.

(5) Filed as an exhibit to the Registrant's Form 10-Q for the quarter ended February 28, 1983.

(6) Filed as an exhibit to the Registrant's Form 10-K for the fiscal year ended May 31, 1983.

(7) Filed as an exhibit to the Registrant's Form 10-K for the fiscal year ended May 31, 1984.

(8) Filed as an exhibit to the Registrant's Form S-3 Registration Statement No. 2-97160.

(9) Filed as an exhibit to the Registrant's Form 10-K for the fiscal year ended May 31, 1985.

(10) Filed as an exhibit to the Registrant's Form S-8 Registration No. 33-6520.

(b) Reports on Form 8-K

No reports on Form 8-K were filed during the last quarter of the period covered by this report. However, in June 1986, the Registrant filed a report on Form 8-K relating to a news release dated June 6, 1986. The news release announced the loss on write-down of assets as described in Note 13 to the Consolidated Financial Statements included in Part II of this report.

SIGNATURES

Pursuant to the requirements of Sections 13 or 15(d) of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized, August 19, 1986.

COMPREHENSIVE CARE CORPORATION

By B. Lee Karns
B. Lee Karns
Chairman

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the Registrant and in the capacities and on the dates so indicated.

Signature	Title	Date
B. Lee Karns	Director, Chairman of the Board, and President (Chief Executive Officer)	August 19, 1986.
Stephen R. Munroe	Senior Vice President and Chief Financial Officer (Chief Financial Officer)	August 19, 1986
Mark A. Edwards	Vice President and Controller (Chief Accounting Officer)	August 19, 1986
Robert B. Hunter, M.D.	Director	August 19, 1986
Jack A. McLeod	Director	August 19, 1986
William J. Nicol	Director	August 19, 1986

SIGNATURES

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William J. Nicol	Director	August 19, 1986

COMPREHENSIVE CARE CORPORATION

SCHEDULE V—PROPERTY AND EQUIPMENT

For the Years Ended May 31, 1986, 1985 and 1984

	Balance at beginning of period	Additions at cost	Retirements	Other changes(a)	Balance at end of period
			(Dollars in thousands)		
Year ended May 31, 1986					
Land and improvements	$14,267	$ 1,348	$ 151	$ —	$ 15,464
Buildings and improvements	53,819	15,742	5,938	440	64,063
Furniture and equipment	12,912	6,328	666	(435)	18,139
Leasehold improvements	514	74	379	(5)	204
Capitalized building leases	2,704	—	—	—	2,704
	$84,216	$23,492	$7,134	$ —	$100,574
Year ended May 31, 1985					
Land and improvements	$ 7,476	$ 6,957	$ 147	$ (19)	$ 14,267
Buildings and improvements	42,607	11,359	18	(129)	53,819
Furniture and equipment	10,144	2,850	237	155	12,912
Leasehold improvements	501	30	10	(7)	514
Capitalized building leases	2,704	—	—	—	2,704
	$63,432	$21,196	$ 412	$ —	$ 84,216
Year ended May 31, 1984					
Land and improvements	$ 7,253	$ 1,725	$1,008	$(494)	$ 7,476
Buildings and improvements	25,315	20,121	3,146	317	42,607
Furniture and equipment	7,071	3,220	324	177	10,144
Leasehold improvements	891	113	503	—	501
Capitalized building leases	2,704	—	—	—	2,704
	$43,234	$25,179	$4,981	$ —	$ 63,432

(a) Reclassification.

COMPREHENSIVE CARE CORPORATION

SCHEDULE VI—ACCUMULATED DEPRECIATION AND AMORTIZATION OF PROPERTY AND EQUIPMENT

For the Years Ended May 31, 1986, 1985 and 1984

	Balance at beginning of period	Additions charged to expense	Retirements	Other changes(a)	Balance at end of period
	(Dollars in thousands)				
Year ended May 31, 1986					
Buildings and improvements	$ 5,027	$2,570	$118	$ 22	$ 7,501
Furniture and equipment	4,959	1,798	280	(22)	6,455
Leasehold improvements	436	17	384	—	69
Capitalized building leases	1,289	116	1	—	1,404
	$11,711	$4,501	$783	$ —	$15,429
Year ended May 31, 1985					
Buildings and improvements	$ 3,147	$1,882	$ 2	$ —	$ 5,027
Furniture and equipment	3,345	1,703	111	22	4,959
Leasehold improvements	281	177	—	(22)	436
Capitalized building leases	1,173	116	—	—	1,289
	$ 7,946	$3,878	$113	$ —	$11,711
Year ended May 31, 1984					
Buildings and improvements	$ 2,255	$1,154	$277	$ 15	$ 3,147
Furniture and equipment	2,503	1,095	238	(15)	3,345
Leasehold improvements	389	249	357	—	281
Capitalized building leases	1,057	116	—	—	1,173
	$ 6,204	$2,614	$872	$ —	$ 7,946

(a) Reclassification.

COMPREHENSIVE CARE CORPORATION

SCHEDULE VIII—VALUATION AND QUALIFYING ACCOUNTS

For the Years Ended May 31, 1986 and 1985

Description	Balance at beginning of period	Additions: Charged to revenue	Additions: Charged to other accounts	Deductions: Write-off of accounts	Balance at end of period
	(Dollars in thousands)				
Allowance for doubtful accounts					
Year ended May 31, 1986	$6,674	$14,959	$4,057(a)	$18,137	$7,553
Year ended May 31, 1985	$3,513	$12,398	$1,930(a)	$11,167	$6,674

(a) Amounts are recoveries on accounts previously charged to this allowance.

COMPREHENSIVE CARE CORPORATION

SCHEDULE X—SUPPLEMENTARY STATEMENT OF EARNINGS INFORMATION

For the Years Ended May 31, 1986, 1985 and 1984

	Years Ended May 31,		
	1986	1985	1984
	(Dollars in thousands)		
Advertising costs	$15,232	$10,075	$8,797

BECHTEL

Information Services

15740 Shady Grove Road
Gaithersburg, Maryland 20877-1454

EXHIBITS FOLLOW

EPD-33803 10/85

COMPREHENSIVE CARE CORPORATION

FORM 10-K

Exhibit Volume

COMPREHENSIVE CARE CORPORATION

FORM 10-K

Commission File No. 0-5751

For the fiscal year ended May 31, 1986

EXHIBIT INDEX

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10.15	Agreement for Sale and Purchase of Joint Venture Interests dated November 15, 1985, between the Registrant and FLA Realty Corp. and FKLA Realty Corp. (re: CareUnit of Cincinnati project)	118
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COMPREHENSIVE CARE CORPORATION
SCHEDULE OF SUBSIDIARIES

SUBSIDIARY NAME	STATE OF INCORPORATION
COMPREHENSIVE CARE CORPORATION (PARENT)	Delaware
N.P.H.S., INC.	California
CAREMANOR HOSPITAL OF WASHINGTON, INC.	Washington
TRINITY OAKS HOSPITAL, INC.	Texas
CAREMANOR HOSPITAL OF VIRGINIA, INC.	California
TERRACINA CONVALESCENT HOSPITAL & HOME, INC.	California
CAREUNIT, INC.	California
CAREUNIT HOSPITAL OF ST. LOUIS, INC.	Missouri
STARTING POINT, INC.	California
CAREUNIT HOSPITAL OF ALBUQUERQUE, INC.	New Mexico
CAREUNIT HOSPITAL OF NEVADA, INC.	Nevada
CAREINSTITUTE	California
CAREUNIT CLINIC OF WASHINGTON, INC.	Washington
CAREUNIT REDEVELOPMENT CORP.	Missouri
CAREUNIT HOSPITAL OF OHIO, INC.	Ohio
CAREUNIT OF FLORIDA, INC.	Florida
COMPREHENSIVE CARE CORPORATION (CANADA) LIMITED	Canada
REHABCARE CORPORATION	Delaware
TWELVE POINT RIDGE, INC.	Oklahoma

EXHIBIT 22

COMPREHENSIVE CARE CORPORATION
SCHEDULE OF JOINT VENTURES

JOINT VENTURES (CompCare is the partner in all except as noted)

NEUROAFFILIATES
(N.P.H.S., INC. IS THE PARTNER)

BEHAVIORAL MEDICAL CARE ("BMC")

SUTTER-BMC JOINT VENTURE
(BMC IS THE PARTNER)

GOLDEN VALLEY HEALTH CENTER

CAREUNIT HEALTHLINK

PEAT MARWICK

Peat, Marwick, Mitchell & Co.
Certified Public Accountants
Orange County Office
Center Tower
650 Town Center Drive
Costa Mesa, California 92626
714-850-4300

To the Stockholders and Board of Directors
Comprehensive Care Corporation

The examinations referred to in our report dated July 18, 1986 included the related financial statement schedules as of May 31, 1986 and for each of the years in the two-year period ended May 31, 1986 included in Form 10-K. In our opinion, such financial statement schedules, when considered in relation to the basic consolidated financial statements taken as a whole, present fairly in all material respects the information set forth therein.

We consent to the incorporation by referance in the Registration Statements (No's. 2-62410, 2-75129, 33-6520 and 33-3091) on Form S-8 of Comprehensive Care Corporation of our report dated July 18, 1986, relating to the consolidated balance sheets of Comprehensive Care Corporation and subsidiaries as of May 31, 1986 and 1985 and the related consolidated statements of earnings, stockholders' equity, and changes in financial position for the years then ended which report appears in the May 31, 1986 annual report on Form 10-K of Comprehensive Care Corporation.

Peat, Marwick, Mitchell & Co.

Orange County, California
August 19, 1986

EXHIBIT 24.1

Consent of Certified Public Accountants

We hereby consent to the incorporation by reference in the Prospectuses constituting part of the Registration Statements on Form S-8 (No's. 2-75129, 2-62410, 33-6520 and 33-3091) of Comprehensive Care Corporation of our report dated July 20, 1984 appearing in the Comprehensive Care Corporation Annual Report on Form 10-K for the year ended May 31, 1986.

Lesley, Thomas, Schwarz & Postma

LESLEY, THOMAS, SCHWARZ & POSTMA

Newport Beach, California
August 19, 1986

EXHIBIT 24.2

END

FILMED
AUGUST 1986

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