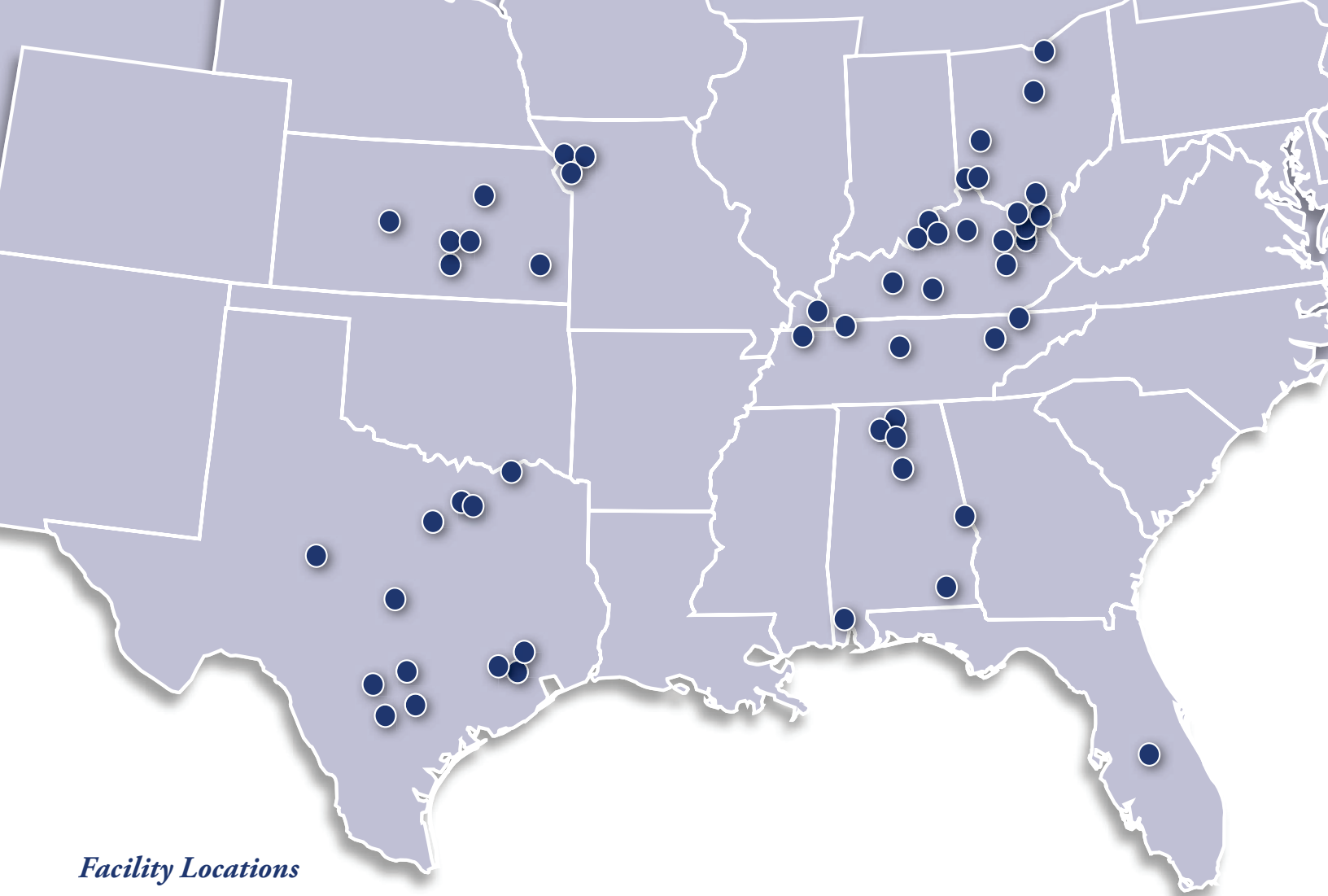




*A Trusted Name • Decades of Quality Care*

**2014**  
*Annual Report*



## ***Facility Locations***

### ***Alabama***

Brookshire Healthcare Center  
Canterbury Healthcare Facility  
Diversicare of Big Springs  
Hartford Health Care  
Lynwood Nursing Home  
Northside Healthcare  
Windsor House

### ***Florida***

Hardee Manor Healthcare Center

### ***Indiana***

Diversicare of Providence

### ***Kansas***

Diversicare of Chanute  
Diversicare of Council Grove  
Diversicare of Haysville  
Diversicare of Hutchinson\*  
Diversicare of Larned  
Diversicare of Sedgwick

### ***Missouri***

Diversicare of St. Joseph  
Riverside Place  
St. Joseph Chateau

### ***Kentucky***

Boyd Nursing & Rehab Center  
Diversicare of Glasgow\*  
Diversicare of Greenville  
Diversicare of Nicholasville  
Diversicare of Seneca Place  
Carter Nursing & Rehab Center  
Clinton Place  
Elliott Nursing & Rehab Center  
Highlands Health & Rehab Center  
South Shore Nursing & Rehab Center  
West Liberty Nursing & Rehab Center  
Wurtland Nursing & Rehab Center

### ***Ohio***

Avon Place  
Best Care Nursing & Rehab Center  
Diversicare of Bradford Place  
Diversicare of Siena Woods  
Diversicare of St. Theresa  
Ontario Pointe

### ***Tennessee***

Diversicare of Claiborne  
Diversicare of Dover  
Diversicare of Martin  
Diversicare of Oak Ridge  
Diversicare of Smyrna

### ***Texas***

Afton Oaks Nursing & Rehab Center  
Ballinger Healthcare & Rehab Center  
Brentwood Terrace Healthcare & Rehab Center  
Chisolm Trail Nursing & Rehab Center  
Doctors Healthcare & Rehab Center  
Estates Healthcare & Rehab Center  
Hillcrest Manor Nursing & Rehab Center  
Lampasas Nursing & Rehab Center  
Normandy Terrace Healthcare & Rehab Center  
Oakmont Healthcare & Rehab Center of Humble  
Oakmont Healthcare & Rehab Center of Katy  
Treemont Healthcare & Rehab Center  
Yorktown Nursing & Rehab Center

*\*Acquired 02/01/2015*

## LETTER TO SHAREHOLDERS

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Dear Shareholder:

Last year we commented that we had turned the corner as an organization with the belief that the strategic investments we made over the preceding 3 years were showing results. Now a full year later, we can decidedly say that we have turned the corner, having produced 2014 revenue growth of 32%. Therefore, we are pleased to say that we have entered into a new and exciting chapter for the Company.

What we are most proud of is that we have demonstrated our unwavering commitment to follow the strategic plan we developed in late 2010. We continue to believe as we did in 2010, that we had developed a roadmap to return the Company to profitability in preparation for long-term growth. Our goal during this time has been to become a demonstrated leader in the industry. Now with 2014 behind us, we have the ability to evaluate and fully assess the outcome of our strategic activities. Based upon our performance last year, we believe our efforts have produced significant results and we are delighted to share our story with you.

It is most appropriate to begin our evaluation by examining our results of our quality improvement initiatives. Our Mission Statement is to **Improve Every Life We Touch By Providing Exceptional Healthcare And Exceeding Expectations**. This statement is not just a phrase we evaluate periodically; rather, we discuss these ideals on a daily basis. We do this as a reminder of what our purpose is and to help guide every decision we make to improve and grow the Company. Quality clinical outcomes and appropriate financial results go hand in hand and maintaining a balance of these metrics is reflective of our plans and expectations as a leadership team.

Our strategic plan to improve the quality of our clinical outcomes called for considerable investments to upgrade and improve upon our operating platform, particularly our information technology systems. The investments we made in electronic medical records and other support services were designed to modernize our capabilities, which are required in such a technical and data intensive industry. This also helps to streamline clinical work flow thus enabling our care providers more time at the bedside of our patients and residents. We also invested in improving the composition of our staffing of clinical providers such as nurses, therapists and other essential personnel. We have refined our processes to leverage our technical capabilities and ongoing development of best practices that ultimately positively impact care delivery.

The quest to improve our clinical outcomes is continuous, and this focus has produced impressive results that benefit the residents and patients entrusted to us. As evidence of the effectiveness of our efforts and our unwavering commitment to industry-leading quality outcomes, we are proud that our national quality rankings have improved steadily. The 5 Star evaluation system was recently updated by CMS to include new data subsequent to year end 2014. Even with the new changes, which include additional measurement criteria, we continue to see positive results in that over 63% of our facilities rank at either a 4 or 5 Star on Quality Measures as compared to 48% for our profit peer group, with a vast majority of our facilities rated as 5 Star. On a national comparative basis, our composite Quality Measure rating is roughly 3.72 on the same comparable basis of 3.27 for our for-profit peer group. Keeping in mind that roughly half of our portfolio was acquired one or two years ago, the results of these quality improvements are particularly rewarding and we will continue to dedicate ourselves to meeting or exceeding national quality standards through our focus on continuous quality process improvement initiatives.

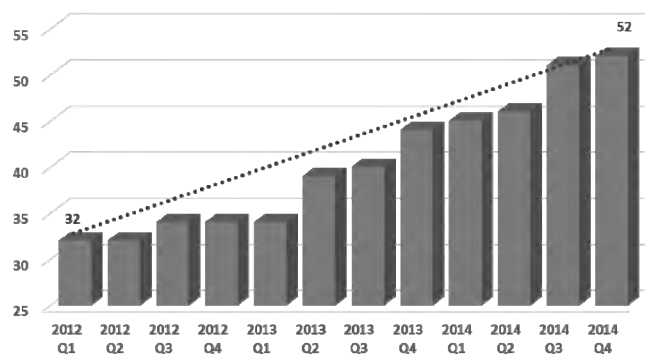
In the past, we have articulated our long-term vision for the Company where the investments we made over the past few years were designed to support a multi-year growth plan through acquisitions. We also said that we were committed to preparing ourselves first by making sure the investments we made into our operating platform were performing as intended. Since initially embarking up our acquisition program, we have acquired 23 Skilled Nursing Facilities (“SNF”) and 1 Assisted Living Facility (“ALF”), the majority of which were added since the second quarter of 2013. These acquisitions were made through a combination of fee simple acquisitions and step-into leases with individual property owners and REITs. Taking into consideration our strategic exit of 12 facilities in Arkansas and 3 facilities in West Virginia, we have now realized net positive growth for the Company not only in the number of facilities that we operate, but also in improved revenue and profitability per occupied bed.

The steps we have taken to reshape our portfolio also reflect our goals of expanding our overall facility count with enhanced profitability and with geographic diversification. We have grown our portfolio by over 60% and, consequently, believe we are demonstrating our ability to cultivate a robust development pipeline as well as our ability to close on meaningful numbers of accretive transactions. We are also validating our roadmap of

## LETTER TO SHAREHOLDERS

investment methods which allow us to accomplish this growth by utilizing the assumption of operations through step-into leases, which do not require the use of equity growth capital as well as the execution of fee simple purchases as capital is available through enhanced earnings over time.

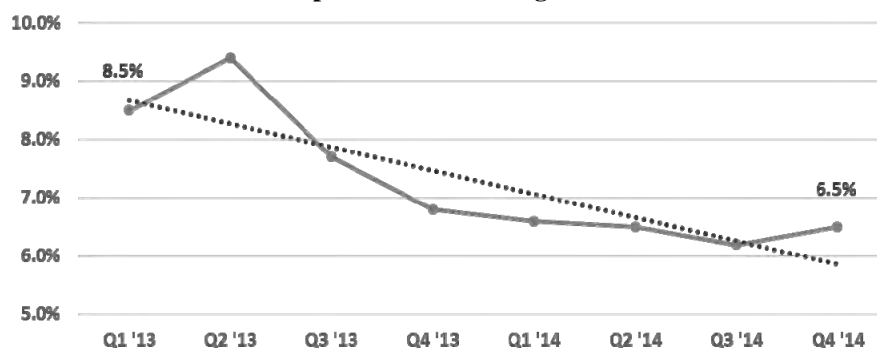
### Growth in Operating Facilities



Today, we operate 53 SNFs and 1 standalone ALF and we continue to cultivate our development pipeline for new acquisitions. We are pleased that we have already added two additional facilities to our portfolio in the first quarter of 2015. This demonstrated growth also showcases the viability and scalability of our operating platform. Our extensive use of our fully deployed electronic medical records system provides us with better tools to help improve the quality of care we provide to our residents and patients, and it provides us with considerable flexibility and confidence to move into new markets. As such, we have been able to expand our portfolio into three new states with the addition of 6 facilities in Kansas, 3 in Missouri and 1 in Indiana. The balance of our growth has been within our existing footprint, which also drives significant leverage into our existing general and administrative (“G&A”) expenses.

In 2013 and at the height of our internal strategic operating development program, our G&A expense as a percentage of revenue peaked at just over 9%. However, the graph below demonstrates that once we had completed our strategic activities and realized the considerable growth in revenue through acquisitions, overall leverage of our overhead expenses has consistently declined to its current range at just over 6%, where we expect it to generally normalize. Once again, we believe this is a significant indicator of the viability and scalability of our operating platform which is a direct result of our strategic investments.

### G&A Expense as a Percentage of Revenue



When evaluating our financial results for 2014, we encourage our Shareholders to bear in mind that nearly half of our portfolio is new to the Company with roughly 11 facilities acquired 1 to 2 years ago and an equal number of facilities for 12 months or less. With this being said, we believe this perspective makes an evaluation of our financial results all the more impressive.

Incremental revenue growth in 2014 from newly acquired facilities was \$45.9 million and \$26.1 million for facilities acquired in 2013 and 2014, respectively. The facilities acquired in 2013 contributed total revenue in 2014 of \$74 million. The 2014 facility level contribution from the 2013 and 2014 acquisitions was \$17.8 million,

## LETTER TO SHAREHOLDERS

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which clearly demonstrates the accretive contribution from newly acquired facilities. We believe these results support our investment premise that there are a number of underperforming facilities in the market to be acquired. Additionally, the skill of our operations team and the capabilities of our operating platform provide us with the ability to drive improved financial performance into newly acquired facilities. While these results cannot be guaranteed in every instance, we are nonetheless pleased with the financial performance of our newly acquired facilities since embarking upon our growth campaign.

While we have demonstrated the accretive contribution from our new centers, we also saw organic growth from our Same Store facilities. Revenue growth from same store facilities was \$12 million for 2014 over 2013. The facility level contribution and operating margin was \$50.7 million and 20.8%, respectively, which clearly demonstrates our ability to remain focused on improving the performance of our legacy facilities as well.

### **Key Financial Highlights for 2014**

- Revenue increased in each quarter of 2014 from \$77.8 million in the first quarter to \$93.7 million for the fourth quarter.
- Operating expenses decreased as a percentage of revenue from 80.8% for the first quarter to 80.1% for the fourth quarter.
- General and administrative expenses decreased from 8.0% of revenue in 2013 to 6.4% of revenue in 2014.
- Since the implementation of our strategic plan in 2010, our skilled mix has increased from 13.6% to 16.0% and our Medicare average rate per day has increased from \$394.23 to \$454.94.
- Our quarterly dividend, which has been \$0.22 annually, combined with our demonstrated execution of our strategic objectives in 2014, and our growth plans for 2015 and beyond should continue to offer a strong footing for shareholder returns.

### **Our strategy going forward**

Clearly we are pleased with the financial results of both our same store facilities and our newly acquired centers. We are also confident that we are on the right track with both our operational approach to our business and our strategic growth activities. As we enter 2015, we remain focused on the significant areas that matter. We will maintain our efforts on continuous improvement of our quality of care and expansion of our clinical-care delivery capabilities consistent with our overall goal towards being at the forefront of healthcare reform, believing as we do that the Long Term Care Industry is well-positioned to be the leader in the delivery of the highest quality / low cost services across the post-acute spectrum of care.

In summary, we are extremely pleased to have accomplished so much during the year and we truly have started a new chapter for the Company. However, we remain mindful that our work has really just begun. We're building upon the significant momentum we have towards achieving our goals. With the opportunities and the challenges of healthcare reform now upon us, we are pleased that we've prepared ourselves so well relative to the rest of the industry. We see a clear path ahead and we are excited and eager to move forward to meet those challenges to deliver the best possible return to our shareholders. Today, the management team, along with our 6,500+ loyal and dedicated Diversicare employees, all proudly share a commitment to our Core Values which are **Integrity, Excellence, Compassion, Teamwork, and Stewardship**. All of us at Diversicare take these responsibilities seriously and we maintain our commitment to these important principles.

Thank you for your trust and confidence in us. We greatly appreciate your support and continued investment in Diversicare.



Chad A. McCurdy  
Chairman of the Board



Kelly J. Gill  
President and Chief Executive Officer

## Operating and Growth Strategy

Our operating objective is to optimize market position in the delivery of health care and related services to the patients and residents in need of post-acute care in the communities in which we operate. Our strategic operations development plan focuses on (i) providing a broad range of high quality, cost-effective post-acute care services; (ii) improving skilled mix in our nursing centers via enhanced capabilities for rehabilitation and transitional care; (iii) building clinical competencies and programs consistent with marketplace needs; and (iv) clustering our operations on a regional basis. Interwoven into our objectives and operating strategy is our mission:

- Improve Every Life We Touch
- Provide Exceptional Healthcare
- Exceed Expectations
- Increase Shareholder Value

*Strategic operating initiatives.* Our key strategic operating initiatives include improving skilled mix in our nursing centers by enhancing our staffing complement to address the increased medical complexity of certain patients, increasing clinical competencies, and adding clinical programs. The investments in nursing and clinical care have been implemented in concert with additional investments in nursing center-based sales representatives to cultivate referral and Managed Care relationships. These investments have positioned us and are expected to continue to position us to be a destination for patients covered by Medicare and Managed Care as well as certain private pay individuals. These enhancements and investments have positioned us to admit higher acuity patients.

Another strategic operating initiative was to implement an Electronic Medical Records (“EMR”) platform. See description of our EMR implementation below. We completed the implementation of Electronic Medical Records in all our nursing centers in December 2011, and implement EMR at all new facilities near the time operations commence.

As part of our strategic operating initiatives, we have continued our program for improving our physical plants. Since 2005, we have been completing strategic renovations of certain facilities that improve quality of care and profitability. We plan to continue these nursing center renovation projects and accelerate this strategy using the knowledge obtained in the first few years of this program. Our strategic operating initiatives will also include pursuing and investigating opportunities to acquire, lease or develop new facilities, focusing primarily on opportunities within our existing geographic areas of operation.

To achieve our objectives, we:

*Provide a broad range of quality cost-effective services.* Our objective is to provide a variety of services to meet the needs of the increasing post-acute care population requiring skilled nursing and rehabilitation care. Our service offerings currently include skilled nursing, comprehensive rehabilitation services, programming for Life Steps and Memory Care units (described below) and other specialty programming. By addressing varying levels of acuity, we work to meet the needs of the population we serve. We seek to establish a reputation as the provider of choice in each of our markets. Furthermore, we believe we are able to deliver quality services cost-effectively, compared to other healthcare providers along the spectrum of care, thereby expanding the population base that can benefit from our services.

*Improve skilled mix in our nursing centers.* By enhancing our registered nurse coverage and adding specialized clinical care, we believe we can admit patients with more medically complex conditions, thereby improving skilled mix and reimbursement. The investments in nursing and clinical care are being conducted in concert with additional investments in nursing center-based sales representatives to develop referral and Managed Care relationships. These investments will better attract quality payor sources for patients covered by Medicare, Managed Care and Medicare replacement payors as well as certain private pay individuals. We will also continue our program for the renovation and improvement of our nursing centers to attract and retain patients and residents.

*Cluster operations on a regional basis.* We have developed regional concentrations of operations in order to achieve operating efficiencies, generate economies of scale and capitalize on marketing opportunities created by having multiple operations in a regional market area.

Key elements of our growth strategy are to:

*Increase revenues and profitability at existing facilities.* Our strategy includes increasing center revenues and profitability through improving payor mix, providing an increasing level of higher acuity care, obtaining appropriate reimbursement for the care we provide, and providing high quality patient care. In addition to our nursing center renovation program, ongoing investments are being made in expanded nursing and clinical care. We continue to enhance center-based marketing initiatives to promote higher occupancy levels and improved skilled mix at our nursing centers.

*Improve physical plants.* Our nursing centers have an average age of approximately 39 years as of December 31, 2014. During 2005, we began an initiative to complete strategic renovations of certain facilities to improve occupancy, quality of care and profitability. We developed a plan to identify those facilities with the greatest potential for benefit and began the renovation program during the third quarter of 2005. Major renovations result in significant cosmetic upgrades, including new flooring, wall coverings, lighting, ceilings and furniture throughout the nursing center. Renovations also usually include certain external work to improve curb appeal, such as concrete work, landscaping, roof and signage enhancements. Many of our renovation projects will include adding functionality and space for our rehabilitation therapy offerings.

*Development of additional specialty services.* Our strategy includes the development of additional specialty units and programming in facilities that could benefit from these services. The specialty programming will vary depending on the needs of the specific market, and may include complex medical and rehabilitation services, as well as memory care units and other specialty programming. These services allow our facilities to meet market needs while improving census and payor mix. A center specific assessment of the market and the current programming being offered is conducted related to specialty programming to determine if unmet needs exist as a predictor of the success of particular niche offerings and services.

*Acquisition, leasing and development of new centers.* We continue to pursue and investigate opportunities to acquire, lease or develop new facilities, focusing primarily on opportunities that can leverage our existing infrastructure.

## **Nursing Centers and Services**

Diversicare provides a broad range of post-acute care services to patients and residents including skilled nursing, ancillary health care services and assisted living. In addition to the nursing and social services usually provided in long-term care centers, we offer a variety of rehabilitative, nutritional, respiratory, and other specialized ancillary services. As of December 31, 2014, our continuing operations consist of 52 nursing centers with 5,825 licensed nursing beds. Our nursing centers range in size from 48 to 320 licensed nursing beds. The licensed nursing bed count does not include 496 licensed assisted living beds. Our continuing operations include centers in Alabama, Florida, Indiana, Kansas, Kentucky, Missouri, Ohio, Tennessee, and Texas.



## MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

The following table summarizes certain information with respect to the nursing centers we own or lease as of December 31, 2014:

	Number of Centers	Licensed Nursing Beds <sup>(1)</sup>	Available Nursing Beds <sup>(1)</sup>
<b>Operating Locations:</b>			
Alabama	7	846	838
Florida	1	79	79
Indiana	1	158	158
Kansas	5	418	413
Kentucky	11	973	969
Missouri	3	339	339
Ohio	6	546	536
Tennessee	5	617	563
Texas	13	1,849	1,726
	<u>52</u>	<u>5,825</u>	<u>5,621</u>
<b>Classification:</b>			
Owned	13	1,220	1,188
Leased	39	4,605	4,433
Total	<u>52</u>	<u>5,825</u>	<u>5,621</u>

<sup>(1)</sup> The number of Licensed Nursing Beds is based on the regulatory licenses for the nursing center. The Company reports its occupancy based on licensed nursing beds. The number of Available Nursing Beds represents Licensed Nursing Beds reduced by beds removed from service. Available Nursing Beds is subject to change based upon the needs of the facilities, including configuration of patient rooms, common usage areas and offices, status of beds (private, semi-private, ward, etc.) and renovations. The number of Licensed and Available Nursing Beds does not include 496 Licensed Assisted Living/Residential Beds, all of which are also available. These beds are excluded from the bed counts as our operating statistics such as occupancy are calculated using Nursing Beds only.

Our nursing centers provide skilled nursing health care services, including nutrition services, recreational therapy, social services, housekeeping and laundry services. Skilled nursing care is provided for post-acute patients and residents with comorbidities. This care includes assessment using evidence based tools; individualized care plan development based on identified areas of risk and care needs; and skilled interventions such as IV services. We also provide for the delivery of ancillary medical services at the nursing centers we operate. These specialty services include rehabilitation therapy services, such as audiology, speech, occupational and physical therapies, which are provided through licensed therapists and registered nurses, and the provision of medical supplies, nutritional support, infusion therapies and related clinical services. The majority of these services are provided using our internal resources and clinicians.

Within the framework of a nursing center, we may provide other specialty care, including:

*Transitional Care Unit.* Many of our nursing centers have units designated as transitional care units, our designation for patients requiring transitional care following an acute stay in the hospital. These units specialize in short-term nursing and rehabilitation with the goal of returning the patient to their highest potential level of functionality. These units provide enhanced services with emphasis on upgraded amenities. The design and programming of the units generally appeal to the clinical and hospitality needs of individuals as they progress to the next appropriate level of care. Specialized therapeutic treatment regimens include orthopedic rehabilitation, neurological rehabilitation and complex medical rehabilitation. While these patients generally have a shorter length of stay, the intensive level of nursing and rehabilitation required by these patients typically results in higher levels of reimbursement.

*Memory Care Unit.* Like our transitional care units, many of our nursing centers have memory care units, our designation for advanced care for dementia related disorders including Alzheimer's disease. The goal of the units is to provide a safe, homelike and supportive environment for cognitively impaired patients, utilizing an interdisciplinary team approach. Family and community involvement compliment structured programming in the secure environment instrumental in fostering as much resident independence and purposeful quality of life as long as possible despite diminished capacity.

*Enhanced Therapy Services.* We have complimented our traditional therapy services with programs that provide electrotherapy, vital stimulation, ultrasound and shortwave diathermy therapy treatments that promote pain management, wound healing, muscle strengthening, and/or contractures management, improving outcomes for our patients and residents receiving therapy treatments.



## MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

*Other Specialty Programming.* We implement other specialty programming based on a center's specific needs. We have developed two adult day care centers on nursing center campuses. We have developed specialty programming for bariatric patients (generally, patients weighing more than 350 pounds) at one of these facilities as these individuals have unique psychosocial and equipment needs.

***Quality Assurance and Performance Improvement.*** We have in place a Quality Assurance and Performance Improvement ("QAPI") program, which is focused on monitoring and improving all aspects of the care provided in a center by identifying outcomes and acting on areas of improvement. The QAPI program in our centers addresses all systems of care and management practices. Key quality indicators are determined and performance goals and benchmarks are established based on industry research standards via a Balanced Scorecard. Gaps and opportunities in performance versus benchmarks are addressed with analysis and performance improvement plans. Outcomes from each center in the areas of quality, employee workplace, customer satisfaction, and stewardship are collected monthly and overseen by regional and company quality committees.

***Implement Electronic Medical Records.*** We completed the initial implementation of EMR in our nursing centers in December 2011. EMR improves our ability to accurately record the care provided to our patients and quickly respond to areas of need. We now implement the use of EMR near the time of acquisition for new centers. EMR improves customer and employee satisfaction, nursing center regulatory compliance and provides real-time monitoring and scheduling of care delivery. We believe our EMR system supports our quality initiatives and positions us for higher acuity service offerings. Our EMR system is comprehensive in its functionality, providing key components, such as:

- *Tracking Activities of Daily Living ("ADLs").* ADLs are the functions that each person must perform on a daily basis including, but not limited to, getting dressed, bathing, and eating. ADL tracking allows us to capture the provision of care provided by our nursing, dietary and housekeeping staff in assisting with ADLs quickly, efficiently and electronically.
- *Progress Notes.* Progress notes are an important component of our medical records. Licensed nursing professionals provide documentation reflecting assessment of each patient's condition and intervention of skilled care provided. The EMR system provides means for a comprehensive chronological record resulting in improved capture, monitoring and review of documentation of condition and care provided.
- *Medications.* Our patients receive a number of daily medications. This module assists with electronic tracking and documenting of required medications and treatments. This provides a more accurate and efficient care system for our nurses and patients.
- *Wound Module.* This allows for an evidence-based risk assessment to drive patient specific interventions to prevent skin breakdown. When skin abnormalities are present, it provides for accurate depiction of anatomical location and description which drives individualized care treatments.
- *Incident Module.* Allows for capturing any event, such as a fall, and provides quality assurance steps for root cause and patient-specific care plans.

For all modules, the EMR system provides a dashboard that can be reviewed at a number of kiosks throughout the nursing center, allowing our staff to securely access a list of upcoming patient care tasks and providing supervisors a tool to help manage and monitor staff performance. We believe the EMR system provides better support, efficiency, and improves the quality of care for our patients. Our deployment schedule resulted in full EMR in 8 centers and ADL tracking in 13 others during 2010 and the remaining implementations were completed during 2011, at a rate of approximately five to six centers every two months. We invested approximately \$112,000 per nursing center to deploy EMR in all our facilities at the time of implementation. We currently implement EMR at each of the facilities we acquire or at which time we assume operations during the transition process.

***Organization.*** Our nursing centers are currently organized into eight regions, each of which is supervised by a regional vice president. The regional vice president is generally supported by specialists in several functions, including clinical, human resources, marketing, revenue cycle management and administration, all of whom are employed by us. The day-to-day operations of each of our nursing centers are led by an on-site, licensed administrator. The administrator of each nursing center is supported by other professional personnel, including a medical director, who assists in the medical management of the nursing center, and a director of nursing, who supervises a team of registered nurses, licensed practical nurses and nurse aides. Other personnel include those providing therapy, dietary, activities and social service, housekeeping, laundry and maintenance and office services. The majority of personnel at our nursing centers, including the administrators, are our employees.

## MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

*Market Information.* Our common stock is traded on the NASDAQ Capital Market and began trading there on September 12, 2006 under the symbol “AVCA.” Effective March 15, 2013, the Company changed its name from Advocat Inc. to Diversicare Healthcare Services, Inc. as a result of a merger of the Company and a wholly-owned subsidiary. In connection with the name change, the Company changed its NASDAQ ticker symbol from “AVCA” to “DVCR” effective with the market open on Monday, March 18, 2013.

The following table sets forth the high and low bid prices of our common stock, as reported by NASDAQ.com, for each quarter in 2014 and 2013:

	<b>Period</b>		<b>High</b>	<b>Low</b>	<b>Dividends</b>
2013	— 1 <sup>st</sup> Quarter	\$	5.91	\$ 4.87	\$ 0.055
2013	— 2 <sup>nd</sup> Quarter	\$	5.37	\$ 4.45	\$ 0.055
2013	— 3 <sup>rd</sup> Quarter	\$	5.74	\$ 4.67	\$ 0.055
2013	— 4 <sup>th</sup> Quarter	\$	5.30	\$ 4.56	\$ 0.055
2014	— 1 <sup>st</sup> Quarter	\$	6.33	\$ 4.61	\$ 0.055
2014	— 2 <sup>nd</sup> Quarter	\$	8.25	\$ 5.75	\$ 0.055
2014	— 3 <sup>rd</sup> Quarter	\$	13.32	\$ 6.41	\$ 0.055
2014	— 4 <sup>th</sup> Quarter	\$	12.80	\$ 8.50	\$ 0.055

Our common stock has been traded since May 10, 1994. On February 16, 2015, the closing price for our common stock was \$10.30, as reported by NASDAQ.com.

*Holders.* On February 16, 2015, there were approximately 284 holders of record. Most of our shareholders have their holdings in the street name of their broker/dealer.

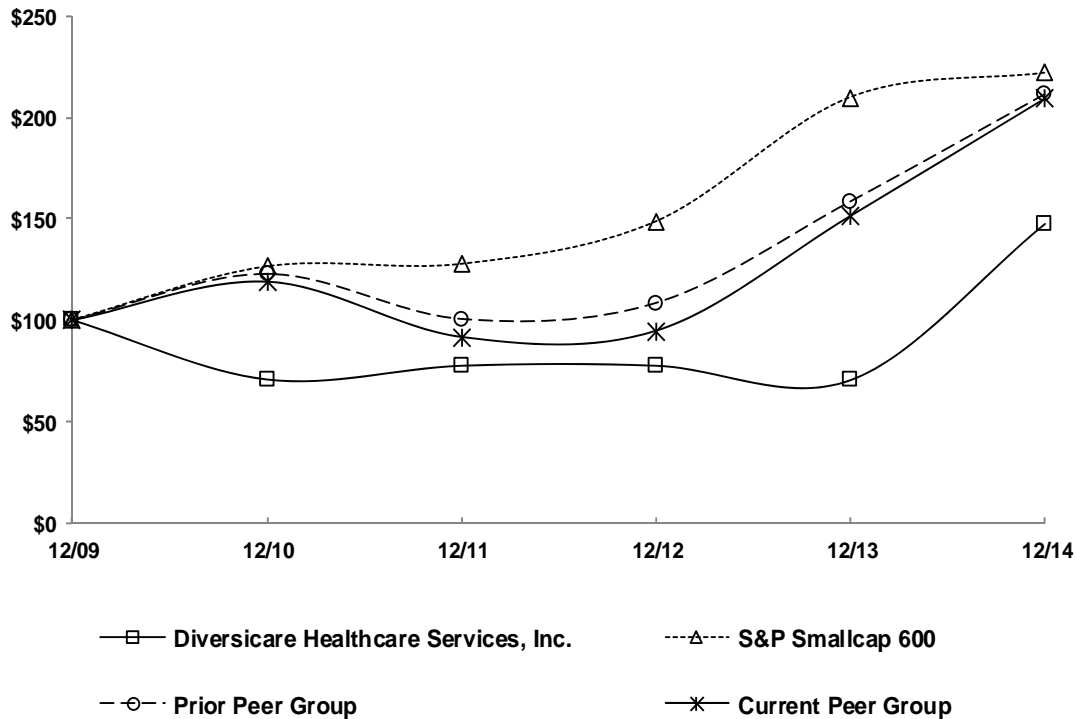
*Dividends.* For each of the two most recent fiscal years, we have paid a quarterly dividend of \$0.055 per common share. While the Board of Directors intends to continue to pay quarterly dividends, the Board will make the determination of the amount of future cash dividends, if any, to be declared and paid based on, among other things, the Company's financial condition, funds from operations, the level of its capital expenditures and its future business prospects. The Company is restricted by its debt agreements in its ability to pay dividends. Effective August 14, 2014, the Company redeemed all of its outstanding shares of Series C Preferred Stock for approximately \$4,918,000 from the holder. The redemption was affected as a result of Omega's exercise of its pre-existing option to require the Company to redeem the Preferred Stock as provided in the Company's Certificate of Designation. As a result of the redemption, the Company no longer has any Series C Preferred Stock outstanding. Prior to the redemption of the Preferred Stock, we were required to pay dividends at an annual rate of 7.0% of the stated value on our outstanding Series C Redeemable Preferred Stock, payable quarterly.

## MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

The graph below compares the cumulative 5-year total return of holders of Diversicare Healthcare Services, Inc.'s common stock with the cumulative total returns of the S & P Smallcap 600 index, and a customized peer group of four companies that includes Adcare Health Systems Inc., Ensign Group, Inc., Genesis Healthcare, Inc. and Kindred Healthcare Inc. The graph tracks the performance of a \$100 investment in our common stock, in the peer group, and the index (with the reinvestment of all dividends) from 12/31/2009 to 12/31/2014.

### COMPARISON OF 5 YEAR CUMULATIVE TOTAL RETURN\*

Among Diversicare Healthcare Services, Inc., the S&P Smallcap 600 Index,  
Prior Peer Group and Current Peer Group



\*\$100 invested on 12/31/09 in stock or index, including reinvestment of dividends.  
Fiscal year ending December 31.

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*The stock price performance included in this graph is not necessarily indicative of future stock price performance.*

# SELECTED CONSOLIDATED FINANCIAL DATA

	Year Ended December 31,				
	2014	2013	2012	2011	2010
<b>Statement of Operations Data</b>	(in thousands, except per share amounts)				
<b>REVENUES:</b>					
Patient revenues, net	\$ 344,192	\$ 260,221	\$ 231,047	\$ 233,844	\$ 214,159
<b>EXPENSES:</b>					
Operating	275,605	213,064	186,958	185,638	173,994
Lease	26,151	20,396	18,018	17,031	16,703
Professional liability	7,216	5,666	4,304	3,237	1,810
General and administrative	22,133	20,940	19,515	21,024	15,892
Depreciation and amortization	7,078	6,363	5,758	5,454	4,899
Asset Impairment	—	—	—	344	—
Restructuring	—	1,446	—	—	—
	<u>338,183</u>	<u>267,875</u>	<u>234,553</u>	<u>232,728</u>	<u>213,298</u>
<b>OPERATING INCOME (LOSS)</b>	<u>6,009</u>	<u>(7,654)</u>	<u>(3,506)</u>	<u>1,116</u>	<u>861</u>
<b>OTHER INCOME (EXPENSE):</b>					
Equity in net losses of unconsolidated affiliate	(5)	(183)	(280)	—	—
Interest expense, net	(3,697)	(3,032)	(2,232)	(2,180)	(1,632)
Debt retirement costs	—	(320)	—	(112)	(127)
	<u>(3,702)</u>	<u>(3,535)</u>	<u>(2,512)</u>	<u>(2,292)</u>	<u>(1,759)</u>
<b>INCOME (LOSS) FROM CONTINUING OPERATIONS BEFORE INCOME TAXES</b>	<u>2,307</u>	<u>(11,189)</u>	<u>(6,018)</u>	<u>(1,176)</u>	<u>(898)</u>
<b>BENEFIT (PROVISION) FOR INCOME TAXES</b>	<u>(857)</u>	<u>4,196</u>	<u>2,147</u>	<u>316</u>	<u>286</u>
<b>INCOME (LOSS) FROM CONTINUING OPERATIONS</b>	<u>1,450</u>	<u>(6,993)</u>	<u>(3,871)</u>	<u>(860)</u>	<u>(612)</u>
<b>DISCONTINUED OPERATIONS, net of taxes</b>	<u>3,258</u>	<u>(1,469)</u>	<u>951</u>	<u>2,227</u>	<u>4,461</u>
<b>NET INCOME (LOSS)</b>	<u>\$ 4,708</u>	<u>\$ (8,462)</u>	<u>\$ (2,920)</u>	<u>\$ 1,367</u>	<u>\$ 3,849</u>
<b>INCOME (LOSS) PER COMMON SHARE:</b>					
<b>Basic</b>					
Continuing operations	\$ 0.21	\$ (1.26)	\$ (0.74)	\$ (0.21)	\$ (0.38)
Discontinued operations	0.54	(0.25)	0.16	0.39	0.78
Net income (loss) per common share	<u>\$ 0.75</u>	<u>\$ (1.51)</u>	<u>\$ (0.58)</u>	<u>\$ 0.18</u>	<u>\$ 0.40</u>
<b>Diluted</b>					
Continuing operations	\$ 0.20	\$ (1.26)	\$ (0.74)	(0.20)	(0.37)
Discontinued operations	0.52	(0.25)	0.16	0.38	0.76
Net income (loss) per common share	<u>\$ 0.72</u>	<u>\$ (1.51)</u>	<u>\$ (0.58)</u>	<u>\$ 0.18</u>	<u>\$ 0.39</u>
<b>CASH DIVIDENDS DECLARED PER COMMON SHARE</b>	<u>\$ 0.22</u>	<u>\$ 0.22</u>	<u>\$ 0.22</u>	<u>\$ 0.22</u>	<u>\$ 0.22</u>
<b>WEIGHTED AVERAGE COMMON SHARES OUTSTANDING:</b>					
Basic	<u>6,011</u>	<u>5,899</u>	<u>5,821</u>	<u>5,774</u>	<u>5,732</u>
Diluted	<u>6,197</u>	<u>5,899</u>	<u>5,821</u>	<u>5,906</u>	<u>5,854</u>

# **SELECTED CONSOLIDATED FINANCIAL DATA**

	<b>December 31,</b>				
	<b>2014</b>	<b>2013</b>	<b>2012</b>	<b>2011</b>	<b>2010</b>
<b>Balance Sheet Data</b>	<b>(in thousands)</b>				
Working capital	\$ 8,797	\$ 8,044	\$ 15,663	\$ 15,435	\$ 16,228
Total assets	\$ 129,089	\$ 137,744	\$ 114,963	\$ 116,744	\$ 105,596
Long-term debt and capitalized lease obligations, including current portion	\$ 48,265	\$ 53,577	\$ 29,462	\$ 29,899	\$ 24,401
Preferred Stock - Series C	\$ —	\$ 4,918	\$ 4,918	\$ 4,918	\$ 4,918
Total Shareholders' Equity of Diversicare Healthcare Services, Inc.	\$ 11,754	\$ 8,129	\$ 17,178	\$ 21,315	\$ 22,205
Total Shareholders' Equity	\$ 11,754	\$ 9,566	\$ 18,751	\$ 22,969	\$ 22,205

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

### Overview

Diversicare Healthcare Services, Inc. provides long-term care services to nursing center patients in nine states, primarily in the Southeast and Southwest. Our centers provide a range of health care services to their patients and residents. In addition to the nursing, personal care and social services usually provided in long-term care centers, we offer a variety of comprehensive rehabilitation services as well as nutritional support services. As of December 31, 2014, our continuing operations consist of 52 nursing centers with 5,825 licensed nursing beds and 496 assisted-living and other residential beds. We own 13 and lease 39 of our nursing centers included in continuing operations. The Company's continuing operations include centers in Alabama, Florida, Indiana, Kansas, Kentucky, Missouri, Ohio, Tennessee, and Texas.

### Divestitures

Effective April 3, 2014, the Company entered into an asset purchase agreement with Rose Terrace Acq., LLC to sell its skilled nursing facility in Culloden, West Virginia. The original asset purchase agreement was subject to a number of conditions including an amendment to the Master Lease with Omega Health Investors, Inc. ("Omega") to terminate the lease only with respect to two other skilled nursing facilities in West Virginia, state licensure and regulatory approval.

Effective July 1, 2014, the Company completed the transaction with Rose Terrace Acq., LLC to sell Rose Terrace, a 90-bed skilled nursing facility in Culloden, West Virginia for a sales price of \$16,500,000. The Company also entered into the Fifteenth Amendment to Consolidated Amended and Restated Master Lease with Omega to terminate the lease only with respect to two other skilled nursing facilities in West Virginia, and concurrently entered into an operations transfer agreement with American Health Care Management, LLC, an affiliate of the purchaser with respect to two other skilled nursing facilities located in Danville and Ivydale, West Virginia. The amendment effectively reduced the annual rent payments due under the Master Lease by \$1,900,000. Upon completion of the transaction, Diversicare no longer operates any skilled nursing centers in the state of West Virginia. In conjunction with the closing of the sale, the Company paid the balance of the \$8,000,000 mortgage loan outstanding on the Rose Terrace facility.

Effective September 1, 2013, the Company entered into an agreement with Omega to terminate its lease with respect to eleven nursing centers and 1,181 licensed beds located in the state of Arkansas, and concurrently entered into operation transfer agreements to transfer the operations of each of those eleven centers to an operator selected by Omega. Upon the completion of the transaction, the Company no longer operates any skilled nursing centers in the State of Arkansas. As a result of this transaction, the Company has reclassified the operations of these centers as discontinued operations for all periods presented in the accompanying consolidated financial statements. These centers contributed revenues of \$0.0 million, \$40.2 million, and \$61.8 million, during the twelve months ended December 31, 2014, 2013, and 2012, respectively. Further, these centers contributed net loss of \$1.1 million and \$2.9 million during the twelve months ended December 31, 2014 and 2013, respectively, and net income of \$0.5 million during the twelve months ended December 31, 2012. The net income or loss for the nursing centers included in discontinued operations does not reflect any allocation of corporate general and administrative expense or any allocation of corporate interest expense. The Company considered these additional costs along with the centers' future prospects based upon operating history when determining the contribution of the skilled nursing centers to its operations. In addition to the expenses associated with the discontinued operations, the Company also incurred \$1.4 million in restructuring expenses in 2013 that represent corporate expenses and exit costs associated with the Arkansas lease termination, but not classified as discontinued operations. The Company will continue to defend, and make cash payments related to, professional liability claims asserted against these nursing centers for events occurring prior to September 1, 2013.

### Strategic Operating Initiatives

During the third quarter of 2010, we identified several key strategic objectives to increase shareholder value through improved operations and business development. These strategic operating initiatives included: improving skilled mix in our nursing centers, improving our average Medicare rate, implementing Electronic Medical Records ("EMR") to improve Medicaid capture, accelerating center renovations and completing strategic acquisitions. We have experienced success in these initiatives and expect to continue to build on these improvements.

#### *Improving skilled mix and average Medicare rate:*

Our strategic operating initiatives of improving our skilled mix and our average Medicare rate required investing in nursing and clinical care to treat more acute patients along with nursing center-based marketing representatives to attract these patients. These initiatives developed referral and Managed Care relationships that have attracted and are expected to continue to attract payor sources for patients covered by Medicare and Managed Care. A comparison of our most recent quarter versus the third quarter of 2010, the quarter before we embarked on our strategic operating initiatives, reflects our success with these strategic operating initiatives:

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

	Three Months Ended	
	December 31, 2014	September 30, 2010
As a percent of total census:		
Medicare census	12.3%	12.3%
Managed Care census	3.7%	1.3%
Total skilled mix census	16.0%	13.6%
As a percent of total revenues:		
Medicare revenues	29.2%	29.3%
Managed Care revenues	7.0%	2.8%
Total skilled mix revenues	36.2%	32.1%
Medicare average rate per day:	\$ 454.94	\$ 394.23

### *Implementing Electronic Medical Records to improve Medicaid acuity capture:*

As another part of our strategic operating initiatives, we implemented EMR to improve Medicaid acuity capture, primarily in our states where the Medicaid payments are acuity based. We completed the implementation of Electronic Medical Records in all our nursing centers in December 2011, on time and under budget, and since implementation, have increased our average Medicaid rate despite rate cuts in certain acuity based states by accurately and timely capture of care delivery. A comparison of our most recent quarter versus the third quarter of 2010 reflects our success with increasing our average Medicaid rate per day:

	Three Months Ended	
	December 31, 2014	September 30, 2010
Medicaid average rate per day:	\$ 163.49	\$ 147.93

### *Accelerating center renovations:*

As part of our strategic operating initiatives we have accelerated our program for improving our physical plants. Since 2005, we have been completing strategic renovations of certain facilities that improve quality of care and profitability. We plan to continue these nursing center renovation projects and accelerate this strategy using the knowledge obtained in the first few years of this program. A comparison of our most recent quarter versus the third quarter of 2010 reflects our success with accelerating center renovations:

	December 31, 2014*	September 30, 2010
Renovated nursing centers	17	14
Amounts expended on renovations (in millions) \$	29.1	\$ 20.9

\*The amounts above include renovations which were performed on six homes within the state of Arkansas that have since been disposed of and recorded within discontinued operations. Renovation spending on these facilities totaled \$7.3 million.

### *Completing strategic acquisitions:*

Our strategic operating initiatives include a renewed focus on completing strategic acquisitions. We continue to pursue and investigate opportunities to acquire, lease or develop new centers, focusing primarily on opportunities within our existing geographic areas of operation. We expect to announce additional development projects in the near future. We have added five skilled nursing centers in Kentucky, three in Missouri, five in Kansas, one in Indiana, one in Alabama, and five in Ohio.

As part of our strategic efforts, we have also performed thorough analysis on our existing centers in order to determine whether continuing operations within certain markets or regions was in line with the short-term and long-term strategy of the business. As a result, we disposed of an owned building in Arkansas in 2012, and reached an agreement to terminate our lease for eleven other facilities in Arkansas in 2013. Additionally, in 2014, the Company disposed of all operations within the state of West Virginia, including the sale of Rose Terrace.



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

## Selected Financial and Operating Data

The following table summarizes the Diversicare statements of continuing operations for the years ended December 31, 2014, 2013 and 2012, and sets forth this data as a percentage of revenues for the same year:

	Year Ended December 31,					
	(Dollars in thousands)					
	2014		2013		2012	
Revenues:						
Patient revenues, net	\$ 344,192	100.0 %	\$ 260,221	100.0 %	\$ 231,047	100.0 %
Expenses:						
Operating	275,605	80.1 %	213,064	81.9 %	186,958	80.9 %
Lease	26,151	7.6 %	20,396	7.8 %	18,018	7.8 %
Professional liability	7,216	2.1 %	5,666	2.2 %	4,304	1.9 %
General & administrative	22,133	6.4 %	20,940	8.0 %	19,515	8.4 %
Depreciation and amortization	7,078	2.1 %	6,363	2.4 %	5,758	2.5 %
Restructuring	—	— %	1,446	0.6 %	—	— %
	338,183	98.3 %	267,875	102.9 %	234,553	101.5 %
Operating income (loss)	6,009	1.7 %	(7,654)	(2.9)%	(3,506)	(1.5)%
Other income (expense):						
Equity in net losses of unconsolidated affiliate	(5)	— %	(183)	(0.1)%	(280)	(0.1)%
Interest expense, net	(3,697)	(1.1)%	(3,032)	(1.2)%	(2,232)	(1.0)%
Debt retirement costs	—	— %	(320)	(0.1)%	—	— %
	(3,702)	(1.1)%	(3,535)	(1.4)%	(2,512)	(1.1)%
Income (loss) from continuing operations before income taxes	2,307	0.6 %	(11,189)	(4.3)%	(6,018)	(2.6)%
Benefit (provision) for income taxes	(857)	(0.2)%	4,196	1.6 %	2,147	0.9 %
Income (loss) from continuing operations	\$ 1,450	0.4 %	\$ (6,993)	(2.7)%	\$ (3,871)	(1.7)%

The following table presents data about the facilities we operated as part of our continuing operations as of the dates:

	December 31,		
	2014	2013	2012
Licensed Nursing Center Beds:			
Owned	1,220	1,224	806
Leased	4,605	3,854	3,311
Total	5,825	5,078	4,117
Facilities:			
Owned	13	13	7
Leased	39	31	27
Total	52	44	34

## Critical Accounting Policies and Judgments

A “critical accounting policy” is one which is both important to the understanding of our financial condition and results of operations and requires management's most difficult, subjective or complex judgments, often of the need to make estimates about the effect of matters that are inherently uncertain. Actual results could differ from those estimates and cause our reported net income (loss) to vary significantly from period to period. Our accounting policies that fit this definition include the following:

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

### **Revenues**

#### ***Patient Revenues, Net***

The fees we charge patients in our nursing centers are recorded on an accrual basis. These rates are contractually adjusted with respect to individuals receiving benefits under federal and state-funded programs and other third-party payors. Our net revenues are derived substantially from Medicare, Medicaid and other government programs (approximately 78.0%, 80.3% and 82.9% for 2014, 2013, and 2012, respectively). Medicare intermediaries make retroactive adjustments based on changes in allowed claims. In addition, certain of the states in which we operate require complicated detailed cost reports which are subject to review and adjustments. In the opinion of management, adequate provision has been made for adjustments that may result from such reviews. Retroactive adjustments, if any, are recorded when objectively determinable, generally within three years of the close of a reimbursement year depending upon the timing of appeals and third-party settlement reviews or audits.

#### ***Allowance for Doubtful Accounts***

We evaluate the collectibility of our accounts receivable by reviewing current aging summaries of accounts receivable, historical collections data and other factors. As a percentage of revenue, our provision for doubtful accounts was approximately 1.7%, 1.6%, and 1.2% for 2014, 2013, and 2012, respectively. Historical bad debts have generally resulted from uncollectible private pay balances, some uncollectible coinsurance and deductibles and other factors. Receivables that are deemed to be uncollectible are written off.

### **Professional Liability and Other Self-Insurance Reserves**

#### ***Accrual for Professional and General Liability Claims***

The Company has professional liability insurance coverage for its nursing centers that, based on historical claims experience, is likely to be substantially less than the claims that are expected to be incurred. Effective July 1, 2013, the Company established a wholly-owned, consolidated offshore limited purpose insurance subsidiary, SHC Risk Carriers, Inc. ("SHC"), which has issued a policy insuring claims made against all of the Company's nursing centers in Florida and Tennessee, the Company's formerly operated Arkansas and West Virginia facilities, and several of the Company's nursing centers in Alabama, Kentucky, Ohio, and Texas. The insurance coverage provided for these centers under the SHC policy include coverage limits of \$500,000 or \$1,000,000 per medical incident with a sublimit per center of \$1,000,000 and total annual aggregate policy limits of \$5,000,000. All other centers within the Company's portfolio are covered through various commercial insurance policies which provide coverage limits of \$1,000,000 per claim and have sublimits of \$3,000,000 per center, with varying aggregate policy limits and deductibles.

Because our actual liability for existing and anticipated professional liability and general liability claims will exceed our limited insurance coverage, we have recorded total liabilities for reported professional liability claims and estimates for incurred but unreported claims of \$25.2 million as of December 31, 2014, including \$5.3 million for settlements that are expected to be paid in 2015, estimates of liability for incurred but not reported claims, estimates of liability for reported but unresolved claims, and estimates of related legal costs incurred and expected to be incurred. All losses are projected on an undiscounted basis.

The Company evaluates the adequacy of this liability on a quarterly basis. Semi-annually, the Company retains a third-party actuarial firm to assist in the evaluation of this reserve. Since May 2012, Merlinos & Associates, Inc. ("Merlinos") has assisted management in the preparation of the appropriate accrual for incurred but not reported general and professional liability claims based on data furnished as of May 31 and November 30 of each year. Merlinos primarily utilizes historical data regarding the frequency and cost of the Company's past claims over a multi-year period, industry data and information regarding the number of occupied beds to develop its estimates of the Company's ultimate professional liability cost for current periods. The Actuarial Division of Willis of Tennessee, Inc. assisted the Company with all estimates prior to May 2012.

On a quarterly basis, we obtain reports of asserted claims and lawsuits from our insurers and a third party claims administrator. These reports contain information relevant to the liability actually incurred to date with that claim as well as the third-party administrator's estimate of the anticipated total cost of the claim. This information is reviewed by us quarterly and provided to the actuary semi-annually. We use this information to determine the timing of claims reporting and the development of reserves and compare the information obtained to our previously recorded estimates of liability. Based on the actual claim information obtained, the semi-annual estimates received from the actuary and on estimates regarding the number and cost of additional claims anticipated in the future, the reserve estimate for a particular period may be revised upward or downward on a quarterly basis. Final determination of our actual liability for claims incurred in any given period is a process that takes years.

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

The Company's cash expenditures for self-insured professional liability costs from continuing operations were \$4.8 million, \$4.5 million and \$1.8 million for the years ended December 31, 2014, 2013 and 2012, respectively.

Although we retain a third-party actuarial firm to assist us, professional and general liability claims are inherently uncertain, and the liability associated with anticipated claims is very difficult to estimate. Professional liability cases have a long cycle from the date of an incident to the date a case is resolved, and final determination of our actual liability for claims incurred in any given period is a process that takes years. As a result, our actual liabilities may vary significantly from the accrual, and the amount of the accrual has and may continue to fluctuate by a material amount in any given quarter.

Professional liability costs are material to our financial position, and changes in estimates, as well as differences between estimates and the ultimate amount of loss, may cause a material fluctuation in our reported results of operations. Our professional liability expense was \$7.2 million, \$5.7 million and \$4.3 million for the years ended December 31, 2014, 2013 and 2012, respectively. These amounts are material in relation to our reported income (loss) from continuing operations for the related periods of \$1.5 million, \$(7.0) million and \$(3.9) million, respectively. The total liability recorded at December 31, 2014 was \$25.2 million, compared to current assets of \$55.9 million and total assets of \$129.1 million.

### ***Accrual for Other Self-Insured Claims***

With respect to workers' compensation insurance, substantially all of our employees became covered under either an indemnity insurance plan or state-sponsored programs in May 1997. We are completely self-insured for workers' compensation exposures prior to May 1997. We have been and remain a non-subscriber to the Texas workers' compensation system and are, therefore, completely self-insured for employee injuries with respect to our Texas operations. From June 30, 2003 until June 30, 2007, our workers' compensation insurance programs provided coverage for claims incurred with premium adjustments depending on incurred losses. For the period from July 1, 2008 through December 31, 2014, we are covered by a prefunded deductible policy. Under this policy, we are self-insured for the first \$500,000 per claim, subject to an aggregate maximum of \$3,000,000. We fund a loss fund account with the insurer to pay for claims below the deductible. We account for premium expense under this policy based on its estimate of the level of claims subject to the policy deductibles expected to be incurred.

We are self-insured for health insurance benefits for certain employees and dependents for amounts up to \$175,000 per individual annually. We provide reserves for the settlement of outstanding self-insured health claims at amounts believed to be adequate, based on known claims and estimates of unknown claims based on historical information. The differences between actual settlements and reserves are included in expense in the period finalized. Our reserves for health insurance benefits can fluctuate materially from one year to the next depending on the number of significant health issues of our covered employees and their dependents.

### **Asset Impairment**

We evaluate our property, equipment and other long-lived assets on a quarterly basis to determine if facts and circumstances suggest that the assets may be impaired or that the estimated depreciable life of the asset may need to be changed for significant physical changes in the property, or significant adverse changes in general economic conditions, and significant deteriorations of the underlying cash flows or fair values of the property. The need to recognize impairment is based on estimated undiscounted future cash flows from a property compared to the carrying value of that property. If recognition of impairment is necessary, it is measured as the amount by which the carrying amount of the property exceeds the fair value of the property. Our asset impairment analysis is consistent with the fair value measurements described in the accounting guidance for "*Fair Value Measurements and Disclosures*."

No impairment of long lived assets was recognized during 2014, 2013, or 2012. If our estimates or assumptions with respect to a property change in the future, we may be required to record additional impairment charges for our assets.

### **Business Combinations**

For business combination transactions, we recognize and measure the identifiable assets acquired, the liabilities assumed, any noncontrolling interest in the acquiree, as well as the goodwill acquired or gain recognized in a bargain purchase, and we make certain valuations to determine the fair value of assets acquired and the liabilities assumed. These valuations are subject to retroactive adjustment during the twelve-month period subsequent to the acquisition date. Such valuations require us to make significant estimates, judgments and assumptions, including projections of future events and operating performance.

### **Stock-Based Compensation**

We recognize compensation cost for all share-based payments granted after January 1, 2006, on a straight-line basis over the vesting period. We calculated the recognized and unrecognized stock-based compensation for options and SOSARs using the

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

Black-Scholes-Merton option valuation method, which requires us to use certain key assumptions to develop the fair value estimates. These key assumptions include expected volatility, risk-free interest rate, expected dividends and expected term. For restricted shares, we utilize an intrinsic valuation method based on market price at the grant date in order to calculate the stock-based compensation expense to be recognized during the vesting period. During the years ended December 31, 2014, 2013, and 2012, we recorded charges of approximately \$0.6 million, \$1.0 million and \$0.6 million in stock-based compensation, respectively. Stock-based compensation expense is a non-cash expense and such amounts are included as a component of general and administrative expense or operating expense based upon the classification of cash compensation paid to the related employees.

### **Income Taxes**

We determine deferred tax assets and liabilities based upon differences between financial reporting and tax bases of assets and liabilities and measure them using the enacted tax laws that will be in effect when the differences are expected to reverse. We maintain a valuation allowance of approximately \$1.1 million to reduce the deferred tax assets to amounts we believe can be realized on a more likely than not basis in accordance with generally accepted accounting principles. In future periods, we will continue to assess the need for and adequacy of the remaining valuation allowance. We follow the relevant guidance found in the FASB codification, *ASC 740: Accounting for Uncertainty in Income Taxes*. The guidance provides information and procedures for financial statement recognition and measurement of tax positions taken, or expected to be taken, in tax returns.

### **Contractual Obligations and Commercial Commitments**

We have certain contractual obligations of continuing operations as of December 31, 2014, summarized by the period in which payment is due, as follows (dollar amounts in thousands):

<b>Contractual Obligations</b>	<b>Total</b>	<b>Less than 1 year</b>	<b>1 to 3 Years</b>	<b>3 to 5 Years</b>	<b>After 5 Years</b>
Long-term debt obligations <sup>(1)</sup>	\$ 57,757	\$ 8,540	\$ 8,086	\$ 41,131	\$ —
Settlement obligations <sup>(2)</sup>	5,348	5,348	—	—	—
Elimination of Preferred Stock Conversion feature <sup>(3)</sup>	2,576	687	1,374	515	—
Operating leases <sup>(4)</sup>	592,131	31,140	63,215	65,638	432,138
Required capital expenditures under operating leases <sup>(5)</sup>	4,563	238	476	476	3,373
<b>Total</b>	<b>\$ 662,375</b>	<b>\$ 45,953</b>	<b>\$ 73,151</b>	<b>\$ 107,760</b>	<b>\$ 435,511</b>

- (1) Long-term debt obligations include scheduled future payments of principal and interest of long-term debt and amounts outstanding on our capital lease obligations.
- (2) Settlement obligations relate to professional liability cases that are expected to be paid within the next twelve months. The professional liabilities are included in our current portion of self-insurance reserves.
- (3) Payments to Omega Health Investors ("Omega"), from whom we lease 23 nursing centers, for the elimination of the preferred stock conversion feature in connection with restructuring the preferred stock and master lease agreements. Monthly payments of approximately \$57,000 will be made through the end of the initial lease period that ends in September 2018.
- (4) Represents lease payments under our operating lease agreements. Assumes all renewals periods.
- (5) Includes annual expenditure requirements under operating leases.

We have employment agreements with certain members of management that provide for the payment to these members of amounts up to two times their annual salary in the event of a termination without cause, a constructive discharge (as defined), or upon a change of control of the Company (as defined). The maximum contingent liability under these agreements is approximately \$1.8 million as of December 31, 2014. The terms of such agreements are for one year and automatically renew for one year if not terminated by us or the employee. In addition, upon the occurrence of any triggering event, those certain members of management may elect to require that we purchase equity awards granted to them for a purchase price equal to the difference in the fair market value of our common stock at the date of termination versus the stated equity award exercise price. Based on the closing price of our common stock on December 31, 2014, there is \$366,000 in contingent liabilities for the repurchase of the equity grants. No amounts have been accrued for these contingent liabilities.

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

### Revenue Sources

We classify our revenues from patients and residents into four major categories: Medicaid, Medicare, Managed Care, and private pay and other. Medicaid revenues are composed of the traditional Medicaid program established to provide benefits to those in need of financial assistance in the securing of medical services. Medicare revenues include revenues received under both Part A and Part B of the Medicare program. Managed Care revenues include payments for patients who are insured by a third-party entity or are Medicare beneficiaries who assign their Medicare benefits to a Managed Care replacement plan often referred to as Medicare replacement products. The private pay and other revenues are composed primarily of individuals or parties who directly pay for their services. Included in the private pay and other are patients who are hospice beneficiaries as well as the recipients of Veterans Administration benefits. Veterans Administration payments are made pursuant to renewable contracts negotiated with these payors.

The following table sets forth net patient revenues related to our continuing operations by payor source for the periods presented (dollar amounts in thousands):

	Year Ended December 31,					
	2014		2013		2012	
Medicaid	\$ 166,497	48.4%	\$ 137,388	52.8%	\$ 121,280	52.5%
Medicare	101,806	29.6%	71,662	27.5%	70,235	30.4%
Managed Care	23,178	6.7%	15,580	6.0%	11,863	5.1%
Private Pay and other	52,711	15.3%	35,591	13.7%	27,669	12.0%
Total	\$ 344,192	100.0%	\$ 260,221	100.0%	\$ 231,047	100.0%

The following table sets forth average daily skilled nursing census by payor source for our continuing operations for the periods presented:

	Year Ended December 31,					
	2014		2013		2012	
Medicaid	2,844	67.0%	2,392	69.6%	2,160	69.7%
Medicare	540	12.7%	395	11.5%	394	12.7%
Managed Care	151	3.6%	103	3.0%	79	2.5%
Private Pay and other	709	16.7%	548	15.9%	466	15.1%
Total	4,244	100.0%	3,438	100.0%	3,099	100.0%

Consistent with the nursing center industry in general, changes in the mix of a nursing center's patient population among Medicaid, Medicare, Managed Care and private pay can significantly affect the profitability of the center's operations.

### Results of Operations

As discussed in the overview at the beginning of Management's Discussion and Analysis of Financial Condition and Results of Operations, we have completed certain divestitures, acquisitions and entered several new lease agreements. We have reclassified our Consolidated Financial Statements to present certain divestitures as discontinued operations for all periods presented.

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

(in thousands)	Year Ended December 31,			
	2014	2013	Change	%
PATIENT REVENUES, net	\$ 344,192	\$260,221	\$ 83,971	32.3 %
EXPENSES:				
Operating	275,605	213,064	62,541	29.4 %
Lease	26,151	20,396	5,755	28.2 %
Professional liability	7,216	5,666	1,550	27.4 %
General and administrative	22,133	20,940	1,193	5.7 %
Depreciation and amortization	7,078	6,363	715	11.2 %
Restructuring	—	1,446	(1,446)	(100.0)%
Total expenses	338,183	267,875	70,308	26.2 %
OPERATING INCOME (LOSS)	6,009	(7,654)	13,663	(178.5)%
OTHER INCOME (EXPENSE):				
Equity in net losses of unconsolidated affiliate	(5)	(183)	178	(97.3)%
Interest expense, net	(3,697)	(3,032)	(665)	21.9 %
Debt retirement costs	—	(320)	320	100.0 %
	(3,702)	(3,535)	(167)	4.7 %
INCOME (LOSS) FROM CONTINUING OPERATIONS BEFORE INCOME TAXES	2,307	(11,189)	13,496	120.6 %
BENEFIT (PROVISION) FOR INCOME TAXES	(857)	4,196	(5,053)	(120.4)%
INCOME (LOSS) FROM CONTINUING OPERATIONS	\$ 1,450	\$ (6,993)	\$ 8,443	120.7 %

(in thousands)	Year Ended December 31,			
	2013	2012	Change	%
PATIENT REVENUES, net	\$ 260,221	\$ 231,047	\$ 29,174	12.6 %
EXPENSES:				
Operating	213,064	186,958	26,106	14.0 %
Lease	20,396	18,018	2,378	13.2 %
Professional liability	5,666	4,304	1,362	31.6 %
General and administrative	20,940	19,515	1,425	7.3 %
Depreciation and amortization	6,363	5,758	605	10.5 %
Restructuring	1,446	—	1,446	100.0 %
Total expenses	267,875	234,553	33,322	14.2 %
OPERATING INCOME (LOSS)	(7,654)	(3,506)	(4,148)	(118.3)%
OTHER INCOME (EXPENSE):				
Equity in net losses of investee	(183)	(280)	97	34.6 %
Interest expense, net	(3,032)	(2,232)	(800)	35.8 %
Debt retirement costs	(320)	—	(320)	(100)%
	(3,535)	(2,512)	(1,023)	40.7 %
LOSS FROM CONTINUING OPERATIONS BEFORE INCOME TAXES	(11,189)	(6,018)	(5,171)	(85.9)%
BENEFIT FOR INCOME TAXES	4,196	2,147	2,049	95.4 %
LOSS FROM CONTINUING OPERATIONS	\$ (6,993)	\$ (3,871)	\$ (3,122)	(80.7)%

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

## Year Ended December 31, 2014 Compared With Year Ended December 31, 2013

### *Patient Revenues*

Patient revenues were \$344.2 million in 2014 and \$260.2 million in 2013, an increase of \$84.0 million or 32.3%. This increase is primarily attributable to the acquisition of new operations during the period. The following table summarizes the revenue increases attributable to our portfolio growth (in thousands):

	Year Ended December 31,		
	2014	2013	Change
Same-store revenue	\$ 244,063	\$ 232,069	\$ 11,994
2013 acquisition revenue	74,033	28,152	45,881
2014 acquisition revenue	26,096	—	26,096
Total revenue	<u>\$ 344,192</u>	<u>\$ 260,221</u>	<u>83,971</u>

The overall increase in revenue of \$84.0 million is primarily attributable to revenue contributions from acquisition activity in 2014 of \$26.1 million, as well as an incremental increase in revenues from 2013 acquisitions of \$45.9 million as a result of having a full year in operation during 2014. The balance of the increase in revenues year-over-year is attributable to increases in same-store revenue of \$12.0 million which is explained in more detail below.

The following table summarizes key revenue and census statistics for continuing operations for each period:

	Year Ended December 31,	
	2014	2013
Skilled nursing occupancy	77.5%	75.5%
As a percent of total census:		
Medicare census	12.7%	11.5%
Managed Care census	3.6%	3.0%
As a percent of total revenues:		
Medicaid revenues	48.4%	52.8%
Medicare revenues	29.6%	27.5%
Managed Care revenues	6.7%	6.0%
Average rate per day:		
Medicare	\$ 444.63	\$ 432.06
Medicaid	\$ 160.43	\$ 157.07
Managed Care	\$ 383.44	\$ 379.11

The average Medicaid rate per patient day for same-store nursing centers in 2014 increased 1.7% compared to 2013, resulting in an increase in revenue of \$2.2 million. This average rate per day for Medicaid patients is the result of rate increases in certain states and increasing patient acuity levels. The average Medicare rate per patient day for same-store nursing centers in 2014 increased 2.3% compared to 2013, resulting in an increase in revenue of \$1.4 million also related to our ability to attract and provide care for patients with increased acuity levels. Same-store Managed Care rate per patient day for 2014 also experienced favorable results compared to 2013 resulting in a \$0.4 million increase in revenue.

Our total average daily census increased by approximately 23.4% compared to 2013 on a consolidated basis, but was primarily attributable to the aforementioned acquisition activity. On a same-store basis, our Medicare, Medicaid, and Managed Care average daily census for 2014 increased compared to 2013, resulting in an increases in revenue of \$3.6 million, \$0.8 million, and \$2.1 million, respectively.



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

### *Operating Expense*

Operating expense increased to \$275.6 million in 2014 from \$213.1 million in 2013, driven primarily by the \$20.8 million in operating costs at the nursing centers added in 2014, and a \$37.1 million incremental increase from the centers acquired in 2013 due to a full year of operation. Operating expense decreased to 80.1% of revenue in 2014, compared to 81.9% of revenue in 2013.

	<b>Year Ended December 31,</b>		
	<b>2014</b>	<b>2013</b>	<b>Change</b>
Same-store operating expenses	\$ 193,316	\$ 188,697	\$ 4,619
2013 acquisition operating expenses	61,453	24,367	37,086
2014 acquisition operating expenses	20,836	—	20,836
Total revenue	<u>\$ 275,605</u>	<u>\$ 213,064</u>	<u>62,541</u>

The largest component of operating expenses is wages, which increased to \$160.4 million in 2014 from \$126.2 million in 2013, an increase of \$34.2 million, or 27.1%. We continued to see improvements in our labor costs as a percentage of revenues as this decreased to 46.6% in 2014, an improvement from 48.5% in 2013. On a same-store basis, wages remained relatively flat increasing by \$0.7 million to \$112.8 million in 2014 from \$112.1 million in 2013, reflecting general wage increases.

Other factors driving the increase in operating expenses at the same-store nursing centers include bad debt expense and increases in provider taxes. Bad debt expense increased approximately \$1.6 million in 2014 compared to 2013 driven significantly by the growth in Medicaid patients undergoing the initial qualification process. Provider taxes increased \$0.6 million in 2014 compared to 2013 primarily driven by rate increases in Tennessee and Kentucky.

### *Lease Expense*

Lease expense increased to \$26.2 million in 2014 from \$20.4 million in 2013. The increase in lease expense was primarily driven by \$2.7 million in combined lease expense for the newly leased nursing centers acquired in 2014. We also incurred an incremental increase in lease expense of \$3.3 million over the prior year associated leases for nursing centers for which we assumed leases in 2013. The remaining increase was the result of regular rent adjustments at existing facilities.

### *Professional Liability*

Professional liability expense was \$7.2 million in 2014 compared to \$5.7 million in 2013, an increase of \$1.5 million. As centers have been acquired in 2013 and 2014, the Company has accessed commercial insurance markets, which accounts for a significant portion of the growth in professional liability expense in the current year. We were engaged in 51 professional liability lawsuits as of December 31, 2014, compared to 54 as of December 31, 2013. Our cash expenditures for professional liability costs of continuing operations were \$4.8 million and \$4.5 million for 2014 and 2013, respectively. Professional liability expense and cash expenditures fluctuate from year to year based respectively on the results of our third-party professional liability actuarial studies, the premium costs of purchased insurance, and on the costs incurred in defending and settling existing claims. See "Liquidity and Capital Resources" for further discussion of the accrual for professional liability.

### *General and Administrative Expense*

General and administrative expenses were approximately \$22.1 million in 2014 compared to \$20.9 million in 2013, an increase of \$1.2 million. The overall increase in general and administrative expenses were attributable to a \$0.7 million increase in bonus and stock-based incentive expenses, and a \$0.6 million increase in expense related to the expansion of the Ohio and Kansas regions.

### *Depreciation and Amortization*

Depreciation and amortization expense was approximately \$7.1 million in 2014 and \$6.4 million in 2013. The increase in 2014 is primarily due to an incremental increase of \$0.3 million in depreciation and amortization expenses related to the Kansas facilities acquired in 2013. The incremental increase is the result of four additional months of expense in 2014.

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

### *Restructuring*

We incurred certain charges in connection with the termination of our existing lease for 11 Arkansas nursing centers, including one-time separation costs of \$0.3 million in 2013. These expenses were classified as restructuring expenses on the consolidated statement of operations. As these expenses related to the transaction which occurred in 2013, the \$1.4 million in restructuring expense represents a decrease from the same period in 2013.

### *Interest Expense, Net*

Interest expense has increased to \$3.7 million in 2014 compared to \$3.0 million in 2013, an increase of \$0.7 million. The increase was primarily attributable to higher debt balances in 2014 on the Revolver as a result of on-going change in ownership processes for newly acquired nursing centers.

### *Income (Loss) from Continuing Operations before Income Taxes; Income (Loss) from Continuing Operations per Common Share*

As a result of the above, continuing operations reported income before taxes of \$2.3 million in 2014, as compared to a loss before taxes of \$11.2 million in 2013. The provision for income taxes was \$(0.9) million in 2014, an effective rate of 37.1% and a benefit of \$4.2 million in 2013, an effective rate of 37.5%. The basic and diluted income per common share from continuing operations were \$0.21 and \$0.20 in 2014, respectively, compared to a basic and diluted loss per common share of \$1.26 in 2013.

## **Year Ended December 31, 2013 Compared With Year Ended December 31, 2012**

### *Patient Revenues*

Patient revenues were \$260.2 million in 2013 and \$231.0 million in 2012, an increase of \$29.2 million, or 12.6%.

	<b>Year Ended December 31,</b>		
	<b>2013</b>	<b>2012</b>	<b>Change</b>
Same-store revenue	\$ 219,161	\$ 228,256	\$ (9,095)
2012 acquisition revenue	12,908	2,791	10,117
2013 acquisition revenue	28,152	—	28,152
Total revenue	<u>\$ 260,221</u>	<u>231,047</u>	<u>29,174</u>

The overall increase in revenue of \$29.2 million is primarily attributable to revenue contributions from acquisition activity in 2013 of \$28.2 million, as well as an incremental increase in revenues from 2012 acquisitions of \$10.1 million as a result of having a full year in operation during 2013. These increases in revenue from acquisitions were partially offset by a decrease in same-store revenue of \$9.1 million which is explained in more detail below.

The following table summarizes key revenue and census statistics for continuing operations for each period:

	<b>Year Ended December 31,</b>	
	<b>2013</b>	<b>2012</b>
Skilled nursing occupancy	75.5%	78.0%
As a percent of total census:		
Medicare census	11.5%	12.7%
Managed Care census	3.0%	2.5%
As a percent of total revenues:		
Medicare revenues	27.5%	30.4%
Medicaid revenues	52.8%	52.5%
Managed Care revenues	6.0%	5.1%
Average rate per day:		
Medicare	\$ 432.06	\$ 429.42
Medicaid	\$ 157.07	\$ 153.73
Managed Care	\$ 379.11	\$ 376.45

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

The decrease in same-store revenue is primarily driven by decreased census. The primary driver for the decrease in same-store revenue is our Medicare average daily census, which decreased in 2013 resulting in a decrease in revenue of \$8.0 million. Additionally, our Medicaid average daily census decreased in 2013 compared to 2012, resulting in a decrease in revenue of \$1.9 million. Our Hospice census in our same-store group also declined in 2013, resulting in a decrease of \$0.9 million. These decreases in census were partially offset by a 22.5% increase in Managed Care census in 2013, which resulted in a revenue increase of \$2.6 million.

The average Medicaid rate per patient day for same-store nursing centers in 2013 increased 2.7% compared to 2012, resulting in an increase in revenue of \$3.5 million. This average rate per day for Medicaid patients is the result of rate increases in certain states and increasing patient acuity levels. The average Medicare rate per patient day for same-store nursing centers in 2013 increased 1.2% compared to 2012, resulting in an increase in revenue of \$0.7 million as a result of increased patient acuity levels, offset by a 2% reduction in rates as a result of sequestration effective April 1, 2013.

### *Operating Expense*

Operating expense increased to \$213.1 million in 2013 from \$187.0 million in 2012, an increase of \$26.1 million, or 14.0%, driven primarily by the \$24.4 million in operating costs at the nursing centers added in 2013, and a \$7.3 million incremental increase from the facilities acquired in 2012 due to a full year of operation. Operating expense increased to 81.9% of revenue in 2013, compared to 80.9% of revenue in 2012. The increases in operating expenses resulting from acquisitive activity was offset by a decrease in operating expenses at same-store nursing centers of \$5.5 million.

	<b>Year Ended December 31,</b>		
	<b>2013</b>	<b>2012</b>	<b>Change</b>
Same-store operating expenses	\$ 178,395	\$ 183,932	\$ (5,537)
2012 acquisition operating expenses	10,302	3,026	7,276
2013 acquisition operating expenses	24,367	—	24,367
Total revenue	<u>213,064</u>	<u>186,958</u>	<u>26,106</u>

The largest component of operating expenses is wages, which increased to \$126.2 million in 2013 from \$116.8 million in 2012, an increase of \$9.4 million, or 8.1%. We continued to see improvements in our labor costs as a percentage of revenues as this decreased to 48.5% in 2013, an improvement from 50.6% in 2012. On a same-store basis, salaries decreased by \$7.6 million due to decreased census and other operating initiatives, which include outsourcing housekeeping and laundry services, as well as centralizing certain business office responsibilities creating efficiencies. The same-store decrease in salaries was partially offset by an increase of \$5.8 million in external housekeeping and laundry services as a result of the aforementioned outsourcing effort. The decrease in salaries was accompanied by a decrease in payroll taxes of \$0.7 million.

Employee health insurance costs were approximately \$1.4 million higher in 2013 compared to 2012. The Company is self-insured for the first \$175,000 in claims per employee each year. Employee health insurance costs can vary significantly from year to year, and we continually evaluate the provisions of these plans.

Bad debt expense increased approximately \$1.1 million in 2013 compared to 2012 driven significantly by the growth in Medicaid patients undergoing the initial qualification process.

### *Lease Expense*

Lease expense increased to \$20.4 million in 2013 from \$18.0 million in 2012. The increase in lease expense was primarily driven by \$1.3 million in combined lease expense for the newly leased nursing center in Louisville, Kentucky and the four recently leased nursing centers in the Ohio region, three in Ohio and one in Indiana. We also incurred an incremental increase in lease expense of \$0.9 million over the prior year associated with the Louisville, Kentucky facility and the facility in Clinton, Kentucky, both of which we leased in 2012. The remaining increase was the result of regular rent adjustments at existing facilities.

### *Professional Liability*

Professional liability expense was \$5.7 million in 2013 and \$4.3 million in 2012. We were engaged in 54 professional liability lawsuits as of December 31, 2013, compared to 49 as of December 31, 2012. Our cash expenditures for professional liability costs of continuing operations were \$4.5 million and \$1.8 million for 2013 and 2012, respectively. Professional liability expense and cash expenditures fluctuate from year to year based respectively on the results of our third-party professional liability actuarial

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

studies and on the costs incurred in defending and settling existing claims. See "Liquidity and Capital Resources" for further discussion of the accrual for professional liability.

### *General and Administrative Expense*

General and administrative expenses were approximately \$20.9 million in 2013 compared to \$19.5 million in 2012, an increase of \$1.4 million. The overall increase in general and administrative expenses were primarily attributable to a \$0.5 million in wages. We also experienced a \$0.4 million increase in stock-based incentive expense, and a \$0.3 million increase in legal and consulting expenses related to our acquisition activities.

### *Depreciation and Amortization*

Depreciation and amortization expense was approximately \$6.4 million in 2013 and \$5.8 million in 2012. The increase in 2013 is primarily due to \$0.5 million in depreciation and amortization expenses related to the newly acquired Kansas facilities.

### *Restructuring*

We incurred certain charges in connection with the termination of our existing lease for 11 Arkansas nursing centers, including one-time separation costs of \$0.3 million. These expenses were classified as restructuring expenses on the consolidated statement of operations. As these expenses related to the transaction which occurred in 2013, the \$1.4 million in restructuring expense represents an increase from the same period in 2012.

### *Interest Expense, Net*

Interest expense increased to \$3.0 million in 2013 compared to \$2.2 million in 2012. The increase was primarily attributable to higher debt balances in 2013 as a result of the amended Mortgage Loan, which increased the balance of outstanding debt as a result of the acquisition of the Kansas centers.

### *Loss from Continuing Operations before Income Taxes; Loss from Continuing Operations per Common Share*

As a result of the above, continuing operations reported loss before taxes of \$11.2 million and \$6.0 million in 2013 and 2012, respectively. The benefit for income taxes was \$4.2 million in 2013, an effective rate of 37.5% and a benefit of \$2.1 million in 2012, an effective rate of 35.7%. The basic and diluted loss per common share from continuing operations were both \$1.26 in 2013 compared to loss per common share from continuing operations of \$0.74 for both basic and diluted in 2012.

## **Liquidity and Capital Resources**

### *Liquidity*

Our primary source of liquidity is the net cash flow provided by the operating activities of our facilities. We believe that these internally generated cash flows will be adequate to service existing debt obligations, fund required capital expenditures as well as provide cash flows for investing opportunities. In determining priorities for our cash flow, we evaluate alternatives available to us and select the ones that we believe will most benefit us over the long term. Options for our cash include, but are not limited to, capital improvements, dividends, repurchase of additional shares of our common stock, acquisitions, and payment of existing debt obligations, as well as initiatives to improve nursing center performance. We review these potential uses and align them to our cash flows with a goal of achieving long-term success.

Net cash provided by operating activities of continuing operations totaled \$6.0 million in 2014, compared to net cash used in operating activities of continuing operations of \$6.3 million in 2013, and minimal net cash provided by operating activities of continuing operations in 2012. One primary driver of the increase in cash provided by operating activities from continuing operations is the overall increase in income produced from operating activities during the year which increased \$8.1 million. Operating activities of discontinued operations used cash of \$3.0 million in 2014 as compared to cash provided of \$5.1 million and \$3.2 million in 2013 and 2012, respectively.

Our cash expenditures related to professional liability claims of continuing operations were \$4.8 million, \$4.5 million and \$1.8 million for 2014, 2013 and 2012, respectively. We also continue to experience cash expenditures related to professional liability claims of discontinued operations, primarily associated with the disposition of Arkansas and West Virginia. Our cash expenditures related to professional liability claims of discontinued operations were \$3.8 million, \$3.3 million, and \$5.6 million for 2014, 2013 and 2012, respectively. The Company will continue to defend, and make cash payments related to, professional liability claims asserted against discontinued operations. Although we work diligently to limit the cash required to settle and

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

defend professional liability claims, a significant judgment entered against us in one or more legal actions could have a material adverse impact on our cash flows and could result in our being unable to meet all of our cash needs as they become due.

Investing activities of continuing operations provided cash of \$11.6 million in 2014, as compared to cash used of \$23.4 million in 2013, and \$0.3 million cash provided in 2012. The cash provided in 2014 is primarily attributable to the sale of Rose Terrace and disposition of West Virginia operations which provided \$16.5 million, and was offset by cash used of \$5.5 million for the purchase of property and equipment. Additionally, the disposition of the Carolina Beach land in North Carolina provided cash of \$0.6 million in 2014. The cash used in 2013 was the result of \$14.7 million in cash used to purchase the five Kansas nursing facilities in May 2013. We have used between \$3.8 million and \$5.5 million for capital expenditures of continuing operations in each of the three calendar years ended December 31, 2014, with certain years experiencing higher expenditures as a result of renovation projects at our facilities. We used \$3.3 million in restricted cash during 2013 to fund capital improvements at the four owned nursing centers that secure the mortgage loan resulting in a net decrease in these restricted funds.

Financing activities of continuing operations used cash of \$8.5 million in 2014, provided cash of \$20.9 million in 2013, and used cash of \$3.5 million in 2012. Financing activities in 2014 reflect the proceeds received from refinancing our credit facility resulting in proceeds of \$21.8 million, offset by the repayment of the existing mortgage loan and other debt payments during the year of \$21.6 million for a minimal net impact from borrowings and repayments. Cash provided in 2013 primarily resulted from the refinancing of our mortgage loan facility resulting in \$54.5 million of proceeds offset by the payment of existing debt obligations of \$30.2 million and write-off of \$1.3 million of financing costs. Financing activities reflect \$1.5 million in common stock and preferred stock dividends in 2014, \$1.3 million in 2013, and \$1.6 million in 2012. Additionally, the Company used cash of \$4.9 million in the redemption of preferred stock in 2014.

### *Dividends*

On February 27, 2015, the Board of Directors declared a quarterly dividend on common shares of \$0.055 per share. While the Board of Directors intends to pay quarterly dividends, the Board will make the determination of the amount of future cash dividends, if any, to be declared and paid based on, among other things, the Company's financial condition, funds from operations, the level of its capital expenditures and its future business prospects and opportunities. The Company is restricted by its debt agreements in its ability to pay dividends.

### *Redeemable Preferred Stock*

Effective August 14, 2014, the Company redeemed all of its outstanding shares of Series C Preferred Stock ("Preferred Stock") from the holder, Omega. The redemption was affected as a result of Omega's exercise of its pre-existing option to require the Company to redeem the Preferred Stock as provided in the Company's Certificate of Designation. Following the redemption, the Company no longer has any Series C Preferred Stock outstanding.

### *Professional Liability*

The Company has professional liability insurance coverage for its nursing centers that, based on historical claims experience, is likely to be substantially less than the claims that are expected to be incurred. Effective July 1, 2013, the Company established a wholly-owned, consolidated offshore limited purpose insurance subsidiary, SHC Risk Carriers, Inc. ("SHC"), which has issued a policy insuring claims made against all of the Company's nursing centers in Florida and Tennessee, the Company's formerly operated Arkansas and West Virginia facilities, and several of the Company's nursing centers in Alabama, Kentucky, Ohio, and Texas. The insurance coverage provided for these centers under the SHC policy include coverage limits of \$500,000 or \$1,000,000 per medical incident with a sublimit per center of \$1,000,000 and total annual aggregate policy limits of \$5,000,000. All other centers within the Company's portfolio are covered through various commercial insurance policies which provide coverage limits of \$1,000,000 per claim and have sublimits of \$3,000,000 per center, with varying aggregate policy limits and deductibles.

As of December 31, 2014, we have recorded total liabilities for reported professional liability claims and estimates for incurred, but unreported claims of \$25.2 million. Our calculation of this estimated liability is based on an assumption that the Company will not incur a severely adverse judgment with respect to any asserted claim; however, a significant judgment could be entered against us in one or more of these legal actions, and such a judgment could have a material adverse impact on our financial position and cash flows.

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

### *Capital Resources*

As of December 31, 2014, we had \$48.3 million of outstanding long-term debt and capital lease obligations. The \$48.3 million total includes \$0.3 million in capital lease obligations. The balance of the long-term debt is comprised of \$43.4 million owed on our collateralized mortgage debt and \$4.5 million currently outstanding on the revolving credit facility.

We have agreements with a syndicate of banks for a mortgage loan and our revolving credit facility. Under the terms of the agreements, the syndicate of banks provided mortgage debt ("Mortgage Loan") with an original balance of \$45.0 million with a five year maturity through March 2016 and a \$27.5 million revolving credit facility ("Revolver") through March 2016. The Mortgage Loan has a term of five years with principal and interest payable monthly based on a 25 year amortization. Interest is based on LIBOR plus 4.5% but a portion is fixed at 6.87% based on the interest rate swap described below. The Mortgage Loan is secured by 13 owned nursing centers, related equipment and a lien on the accounts receivable of these facilities. The Mortgage Loan and the Revolver are cross-collateralized.

The Revolver is secured by accounts receivable and is subject to limits on the maximum amount of loans that can be outstanding on the Revolver based on borrowing base restrictions. As of December 31, 2014, we had \$4.5 million outstanding on the Revolver. Annual fees for letters of credit issued on the Revolver are 3.0% of the amount outstanding. We have a letter of credit of \$4.6 million to serve as a security deposit for our Omega lease. We also have a \$1.0 million letter of credit outstanding related to the Company's wholly-owned captive insurance entity. Finally, we have nine letters of credit to serve as security deposits at certain facilities. Considering the balance of eligible accounts receivable at December 31, 2014, the letters of credit, the amounts outstanding under the revolving credit facility and the maximum loan amount of \$27.5 million, the balance available for borrowing on the Revolver was \$13.8 million as of December 31, 2014. Eligible accounts receivable are calculated as defined and consider 80% of certain net receivables while excluding receivables from private pay patients, those pending approval by Medicaid and receivables greater than 90 days. Our Revolver has an interest rate of LIBOR plus 4.5%.

Our lending agreements contain various financial covenants, the most restrictive of which relate to minimum cash deposits, cash flow and debt service coverage ratios. We are in compliance with all such covenants at December 31, 2014.

Our calculated compliance with financial covenants is presented below:

	<b>Requirement</b>	<b>Level at December 31, 2014</b>
Minimum fixed charge coverage ratio	1.10:1.00	1.20:1.00
Minimum adjusted EBITDA	10,000,000	22,519,000
EBITDAR (mortgaged facilities)	6,150,000	10,104,000

As part of the debt agreements entered into in March 2011 and amended May 2013, we entered into an interest rate swap agreement with a member of the bank syndicate as the counterparty. As part of the refinancing of the Mortgage Loan in 2013, we amended the existing swap agreement in order to ensure the terms of the swap agreement remained consistent with the underlying Mortgage Loan. The amended interest rate swap agreement has the same effective date and maturity date as the Mortgage Loan, and includes a notional amount of 50% of the outstanding balance on the Mortgage Loan. The interest rate swap agreement requires us to make fixed rate payments to the bank calculated on the applicable notional amount at an annual fixed rate of 6.87% while the bank is obligated to make payments to us based on LIBOR on the same notional amounts. We entered into the interest rate swap agreement to mitigate the variable interest rate risk on our outstanding mortgage borrowings.

### **Capitalized Lease Obligations**

During 2011, the Company entered into a series of lease agreements to finance the purchase of certain equipment primarily for the implementation of Electronic Medical Records ("EMR") in its nursing centers. Additionally, upon acquisition of certain facilities, we assume certain leases, primarily related to equipment, that constitute capital leases.

As a result of the lease agreements above, we have recorded the underlying lease assets and capitalized lease obligations of \$0.3 million, \$0.7 million, and \$1.5 million as of December 31, 2014, 2013, and 2012, respectively. These lease agreements provide terms of three to five years.

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

### **Receivables**

Our operations could be adversely affected if we experience significant delays in reimbursement from Medicare, Medicaid and other third-party revenue sources. Our future liquidity will continue to be dependent upon the relative amounts of current assets (principally cash, accounts receivable and inventories) and current liabilities (principally accounts payable and accrued expenses). In that regard, accounts receivable can have a significant impact on our liquidity. Continued efforts by governmental and third-party payors to contain or reduce the acceleration of costs by monitoring reimbursement rates, by increasing medical review of bills for services, or by negotiating reduced contract rates, as well as any delay by us in the processing of our invoices, could adversely affect our liquidity and financial position.

Accounts receivable attributable to patient services of continuing operations totaled \$47.3 million at December 31, 2014 compared to \$36.5 million at December 31, 2013, representing approximately 43 days revenue in accounts receivable at both dates. The increase in accounts receivable is due primarily to accounts associated with facilities still in the change in ownership process, which is addressed below. We have adjusted the days of revenue in the accounts receivable calculation to remove the impact of the receivables related to these change in ownerships.

Our accounts receivable at December 31, 2014 included approximately \$5.5 million of accounts for newly leased facilities including: the two leased facilities in Kentucky, three facilities in Missouri, and one in Ohio, for which we assumed operations in during 2014. During the change of ownership process, we are required to hold these accounts while waiting for final Medicare and Medicaid approvals. We expect these accounts to be collectible as soon as we are able to submit them for payment.

The allowance for bad debt was \$6.0 million and \$3.9 million at December 31, 2014 and 2013, respectively. We continually evaluate the adequacy of our bad debt reserves based on patient mix trends, aging of older balances, payment terms and delays with regard to third-party payors, collateral and deposit resources, as well as other factors. We continue to evaluate and implement additional procedures to strengthen our collection efforts and reduce the incidence of uncollectible accounts.

### **Inflation**

Based on contract pricing for food and other supplies and recent market conditions, we expect cost increases in 2015 to be relatively the same or slightly lower than the increases in 2014. We expect salary and wage increases for our skilled health care providers to continue to be higher than average salary and wage increases, as is common in the healthcare industry.

### **Off-Balance Sheet Arrangements**

We have eleven letters of credit outstanding totaling approximately \$8.1 million as of December 31, 2014. Ten of these letters of credit serve as a security deposits for certain facility leases, while one was issued in conjunction with the initial funding of our wholly-owned captive insurance company. The letters of credit were issued under our revolving credit facility. Our accounts receivable serve as the collateral for this revolving credit facility.



## **FORWARD-LOOKING STATEMENT AND QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

### **Forward-Looking Statements**

The foregoing discussion and analysis provides information deemed by management to be relevant to an assessment and understanding of our consolidated results of operations and financial condition. This discussion and analysis should be read in conjunction with our consolidated financial statements included herein. Certain statements made by or on behalf of us, including those contained in this “Management’s Discussion and Analysis of Financial Condition and Results of Operations” and elsewhere, are forward-looking statements as defined in the Private Securities Litigation Reform Act of 1995. Actual results could differ materially from those contemplated by the forward-looking statements made herein. In addition to any assumptions and other factors referred to specifically in connection with such statements, other factors, many of which are beyond our ability to control or predict, could cause our actual results to differ materially from the results expressed or implied in any forward-looking statements including, but not limited to, our ability to successfully operate the new nursing centers in Alabama, Kansas, Kentucky, Missouri, Ohio, and Indiana, our ability to increase census at our renovated centers, changes in governmental reimbursement, including the impact of the CMS final rule that has resulted in a reduction in Medicare reimbursement as of October 2012 and our ability to mitigate the impact of the revenue reduction, government regulation, the impact of the recently adopted federal health care reform or any future health care reform, any increases in the cost of borrowing under our credit agreements, our ability to comply with covenants contained in those credit agreements, the outcome of professional liability lawsuits and claims, our ability to control ultimate professional liability costs, the accuracy of our estimate of our anticipated professional liability expense, the impact of future licensing surveys, the outcome of proceedings alleging violations of state or Federal False Claims Acts, laws and regulations governing quality of care or other laws and regulations applicable to our business including laws governing reimbursement from government payors, impacts associated with the implementation of our electronic medical records plan, the costs of investing in our business initiatives and development, our ability to control costs, changes to our valuation of deferred tax assets, changes in occupancy rates in our centers, changing economic and competitive conditions, changes in anticipated revenue and cost growth, changes in the anticipated results of operations, the effect of changes in accounting policies as well as others. Investors also should refer to the risks identified in this “Management’s Discussion and Analysis of Financial Condition and Results of Operations” as well as risks identified in “Part I. Item 1A. Risk Factors” for a discussion of various risk factors of the Company and that are inherent in the health care industry. Given these risks and uncertainties, we can give no assurances that these forward-looking statements will, in fact, transpire and, therefore, caution investors not to place undue reliance on them. These assumptions may not materialize to the extent assumed, and risks and uncertainties may cause actual results to be different from anticipated results. These risks and uncertainties also may result in changes to the Company’s business plans and prospects. Such cautionary statements identify important factors that could cause our actual results to materially differ from those projected in forward-looking statements. In addition, we disclaim any intent or obligation to update these forward-looking statements.

### **QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

The chief market risk factor affecting our financial condition and operating results is interest rate risk. As of December 31, 2014, we had outstanding borrowings of approximately \$47.9 million, \$26.2 million of which were subject to variable interest rates. In connection with our May 2013 financing agreement, we entered into an interest rate swap with respect to one half of the Amended Mortgage Loan to mitigate the floating interest rate risk of such borrowing. In the event that interest rates were to change 1%, the impact on future pre-tax cash flows would be approximately \$262,000 annually, representing the impact of increased or decreased interest expense on variable rate debt.

## **MANAGEMENT'S REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING**

### **CONTROLS AND PROCEDURES**

Diversicare, with the participation of our principal executive and financial officers, has evaluated the effectiveness of our disclosure controls and procedures, as such term is defined under Rules 13a-15(e) and 15d-15(e) promulgated under the Securities Exchange Act of 1934, as amended, as of December 31, 2014. Based on this evaluation, the principal executive and financial officers have determined that such disclosure controls and procedures are effective to ensure that information required to be disclosed in our filings under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in the Securities Exchange Commission's rules and forms.

### **Management's Report on Internal Control over Financial Reporting**

Our management is responsible for establishing and maintaining adequate internal control over financial reporting (as defined in Rule 13a-15(f) under the Securities Exchange Act of 1934, as amended). Our management conducted an evaluation of the effectiveness of our internal control over financial reporting based on the framework in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (2013 framework). Based on this evaluation, management concluded that our internal control over financial reporting was effective as of December 31, 2014. Management reviewed the results of its assessment with our Audit Committee.

### **Changes in Internal Control over Financial Reporting**

There has been no change (including corrective actions with regard to significant deficiencies or material weaknesses) in our internal control over financial reporting that has occurred during our fiscal quarter ended December 31, 2014 that has materially affected, or is reasonably likely to materially affect our internal control over financial reporting.

Our management does not expect that our disclosure controls and procedures or our internal controls will prevent all errors and all fraud. A control system, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. Further, the design of a control system must reflect the fact that there are resource constraints, and the benefit of controls must be considered relative to their costs. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that misstatements due to error or fraud will not occur or that all control issues and instances of fraud, if any, have been detected. These inherent limitations include the realities that judgments in decision making can be faulty and that breakdowns can occur because of simple error or mistake. Controls can also be circumvented by the individual acts of some persons, by collusion of two or more people, or by management override of the controls. The design of any system of controls is based in part on certain assumptions about the likelihood of future events and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions.

## REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

Board of Directors and Shareholders  
Diversicare Healthcare Services, Inc.  
Brentwood, Tennessee

We have audited the accompanying consolidated balance sheets of Diversicare Healthcare Services, Inc. and subsidiaries as of December 31, 2014 and 2013 and the related consolidated statements of operations, comprehensive income (loss), shareholders' equity, and cash flows for each of the three years in the period ended December 31, 2014. In connection with our audits of the financial statements, we have also audited the financial statement schedule listed in the accompanying index. These financial statements and schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and schedule based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. The Company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audits included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the financial statements and schedule. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Diversicare Healthcare Services, Inc. and subsidiaries at December 31, 2014 and 2013, and the results of its operations and its cash flows for each of the three years in the period ended December 31, 2014, in conformity with accounting principles generally accepted in the United States of America.

Also, in our opinion, the financial statement schedule, when considered in relation to the basic consolidated financial statements taken as a whole, presents fairly, in all material respects, the information set forth therein.

/s/ BDO USA, LLP

Nashville, Tennessee  
March 5, 2015

**DIVERSICARE HEALTHCARE SERVICES, INC. AND SUBSIDIARIES**  
**CONSOLIDATED BALANCE SHEETS**  
**DECEMBER 31, 2014 AND 2013**

ASSETS	2014	2013	LIABILITIES AND SHAREHOLDERS' EQUITY	2014	2013
<b>CURRENT ASSETS:</b>			<b>CURRENT LIABILITIES:</b>		
Cash and cash equivalents	\$ 3,818,000	\$ 3,781,000	Current portion of long-term debt and capitalized lease obligations	\$ 5,705,000	\$ 4,549,000
Receivables, less allowance for doubtful accounts of \$6,044,000 and \$3,879,000, respectively	41,272,000	32,658,000	Trade accounts payable	8,121,000	7,177,000
Other receivables	862,000	1,118,000	Current liabilities of discontinued operations	482,000	1,359,000
Prepaid expenses and other current assets	2,339,000	2,442,000	Accrued expenses:		
Income tax refundable	559,000	763,000	Payroll and employee benefits	14,642,000	12,255,000
Current assets of discontinued operations	73,000	2,870,000	Self-insurance reserves, current portion	11,833,000	11,711,000
Deferred income taxes	7,016,000	6,579,000	Other current liabilities	6,359,000	5,116,000
Total current assets	<u>55,939,000</u>	<u>50,211,000</u>	Total current liabilities	<u>47,142,000</u>	<u>42,167,000</u>
			<b>NONCURRENT LIABILITIES:</b>		
			Long-term debt and capitalized lease obligations, less current portion	42,559,000	43,552,000
			Self-insurance reserves, noncurrent portion	14,268,000	16,375,000
			Long-term liabilities of discontinued operations	—	5,952,000
			Other noncurrent liabilities	13,366,000	15,214,000
			Total noncurrent liabilities	<u>70,193,000</u>	<u>81,093,000</u>
<b>PROPERTY AND EQUIPMENT, at cost</b>	98,869,000	93,572,000	<b>COMMITMENTS AND CONTINGENCIES</b>		
Less accumulated depreciation and amortization	(55,014,000)	(48,516,000)	<b>SERIES C REDEEMABLE PREFERRED STOCK</b>		
Discontinued operations, net	<u>—</u>	8,987,000	\$ .10 par value, 5,000 shares authorized, none issued and outstanding	—	4,918,000
Property and equipment, net	<u>43,855,000</u>	<u>54,043,000</u>	<b>SHAREHOLDERS' EQUITY:</b>		
			Series A preferred stock, authorized 200,000 shares, \$.10 par value, none issued and outstanding	—	—
			Common stock, authorized 20,000,000 shares, \$.01 par value, 6,388,000 and 6,307,000 shares issued, and 6,156,000 and 6,075,000 shares outstanding, respectively	64,000	63,000
<b>OTHER ASSETS:</b>			Treasury stock at cost, 232,000 shares of common stock	(2,500,000)	(2,500,000)
Deferred income taxes	12,885,000	15,912,000	Paid-in capital	19,970,000	19,570,000
Deferred financing and other costs, net	1,692,000	1,914,000	Retained earnings (accumulated deficit)	(5,285,000)	(8,435,000)
Investment in unconsolidated affiliate	463,000	487,000	Accumulated other comprehensive loss	(495,000)	(569,000)
Other noncurrent assets	6,411,000	5,698,000	Total shareholders' equity of Diversicare Healthcare Services, Inc.	11,754,000	8,129,000
Acquired leasehold interest, net	7,844,000	8,228,000	Noncontrolling interests	—	1,437,000
Noncurrent assets of discontinued operations	<u>29,295,000</u>	<u>33,490,000</u>	Total shareholders' equity	<u>11,754,000</u>	<u>9,566,000</u>
Total other assets	<u>\$ 129,089,000</u>	<u>\$ 137,744,000</u>		<u>\$ 129,089,000</u>	<u>\$ 137,744,000</u>

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

**DIVERSICARE HEALTHCARE SERVICES, INC. AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF OPERATIONS**

	Years Ended December 31,		
	2014	2013	2012
PATIENT REVENUES, net	\$ 344,192,000	\$ 260,221,000	\$ 231,047,000
EXPENSES:			
Operating	275,605,000	213,064,000	186,958,000
Lease and rent expense	26,151,000	20,396,000	18,018,000
Professional liability	7,216,000	5,666,000	4,304,000
General and administrative	22,133,000	20,940,000	19,515,000
Depreciation and amortization	7,078,000	6,363,000	5,758,000
Restructuring	—	1,446,000	—
Total expenses	338,183,000	267,875,000	234,553,000
OPERATING INCOME (LOSS)	6,009,000	(7,654,000)	(3,506,000)
OTHER INCOME (EXPENSE):			
Equity in net losses of unconsolidated affiliate	(5,000)	(183,000)	(280,000)
Interest expense, net	(3,697,000)	(3,032,000)	(2,232,000)
Debt retirement costs	—	(320,000)	—
	(3,702,000)	(3,535,000)	(2,512,000)
INCOME (LOSS) FROM CONTINUING OPERATIONS BEFORE INCOME TAXES	2,307,000	(11,189,000)	(6,018,000)
BENEFIT (PROVISION) FOR INCOME TAXES	(857,000)	4,196,000	2,147,000
INCOME (LOSS) FROM CONTINUING OPERATIONS	1,450,000	(6,993,000)	(3,871,000)
INCOME (LOSS) FROM DISCONTINUED OPERATIONS:			
Operating income (loss), net of tax provision (benefit) of \$(878,000), \$(863,000) and \$411,000, respectively	(1,486,000)	(1,469,000)	777,000
Gain on disposal, net of tax provision of \$2,802,000, \$0 and \$107,000, respectively	4,744,000	—	174,000
INCOME (LOSS) FROM DISCONTINUED OPERATIONS	3,258,000	(1,469,000)	951,000
NET INCOME (LOSS)	4,708,000	(8,462,000)	(2,920,000)
Less: net (income) loss attributable to noncontrolling interests	25,000	(72,000)	(126,000)
NET INCOME (LOSS) ATTRIBUTABLE TO DIVERSICARE HEALTHCARE SERVICES, INC.	4,733,000	(8,534,000)	(3,046,000)
PREFERRED STOCK DIVIDENDS	(220,000)	(344,000)	(344,000)
NET INCOME (LOSS) FOR DIVERSICARE HEALTHCARE SERVICES, INC. COMMON SHAREHOLDERS	\$ 4,513,000	\$ (8,878,000)	\$ (3,390,000)
NET INCOME (LOSS) PER COMMON SHARE FOR DIVERSICARE HEALTHCARE SERVICES, INC. SHAREHOLDERS:			
Per common share – basic			
Continuing operations	\$ 0.21	\$ (1.26)	\$ (0.74)
Discontinued operations	0.54	(0.25)	0.16
	\$ 0.75	\$ (1.51)	\$ (0.58)
Per common share – diluted			
Continuing operations	\$ 0.20	\$ (1.26)	\$ (0.74)
Discontinued operations	0.52	(0.25)	0.16
	\$ 0.72	\$ (1.51)	\$ (0.58)
DIVIDENDS DECLARED PER SHARE OF COMMON STOCK	\$ 0.22	\$ 0.22	\$ 0.22
WEIGHTED AVERAGE COMMON SHARES OUTSTANDING:			
Basic	6,011,000	5,899,000	5,821,000
Diluted	6,197,000	5,899,000	5,821,000

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

**DIVERSICARE HEALTHCARE SERVICES, INC. AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)**

	<b>Years Ended December 31,</b>		
	<b>2014</b>	<b>2013</b>	<b>2012</b>
NET INCOME (LOSS)	\$ 4,708,000	\$ (8,462,000)	\$ (2,920,000)
OTHER COMPREHENSIVE INCOME (LOSS):			
Change in fair value of cash flow hedge, net of tax	368,000	666,000	354,000
Less: reclassification adjustment for amounts recognized in net income	(294,000)	(315,000)	(329,000)
Total other comprehensive income	74,000	351,000	25,000
COMPREHENSIVE INCOME (LOSS)	4,782,000	(8,111,000)	(2,895,000)
Less: comprehensive income (loss) attributable to noncontrolling interest	25,000	(72,000)	(126,000)
COMPREHENSIVE INCOME (LOSS) ATTRIBUTABLE TO DIVERSICARE HEALTHCARE SERVICES, INC.	<u>\$ 4,807,000</u>	<u>\$ (8,183,000)</u>	<u>\$ (3,021,000)</u>

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

**DIVERSICARE HEALTHCARE SERVICES, INC. AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY**

	Common Stock		Treasury Stock		Total Shareholders' Equity				
	Shares Issued	Amount	Shares	Amount	Retained Earnings (Accumulated Deficit)	Accumulated Other Comprehensive Loss	Diversicare Healthcare	Non-Controlling Interests	Total Shareholders' Equity
<b>BALANCE, DECEMBER 31, 2011</b>	6,061,000	\$ 61,000	232,000	\$ (2,500,000)	\$ 6,480,000	\$ (945,000)	\$ 21,315,000	\$ 1,654,000	\$ 22,969,000
Net income (loss)	—	—	—	—	(3,046,000)	—	(3,046,000)	126,000	(2,920,000)
Preferred stock dividends	—	—	—	—	(344,000)	—	(344,000)	—	(344,000)
Common stock dividends declared	—	—	—	—	(1,311,000)	—	(1,282,000)	—	(1,282,000)
Issuance/redemption of equity grants, net	100,000	1,000	—	—	—	—	55,000	—	55,000
Interest rate cash flow hedge	—	—	—	—	—	25,000	25,000	—	25,000
Tax impact of equity grant exercises	—	—	—	—	—	—	(26,000)	—	(26,000)
Consolidation of non-controlling interests of variable interest entity	—	—	—	—	—	—	—	(207,000)	(207,000)
Stock based compensation	—	—	—	—	—	—	481,000	—	481,000
<b>BALANCE, DECEMBER 31, 2012</b>	6,161,000	62,000	232,000	(2,500,000)	1,779,000	(920,000)	17,178,000	1,573,000	18,751,000
Net income (loss)	—	—	—	—	(8,534,000)	—	(8,534,000)	72,000	(8,462,000)
Preferred stock dividends	—	—	—	—	(344,000)	—	(344,000)	—	(344,000)
Common stock dividends declared	—	—	—	—	(1,336,000)	—	(1,301,000)	—	(1,301,000)
Issuance/redemption of equity grants, net	146,000	1,000	—	—	—	—	22,000	—	22,000
Interest rate cash flow hedge	—	—	—	—	—	351,000	351,000	—	351,000
Tax impact of equity grant exercises	—	—	—	—	—	—	(20,000)	—	(20,000)
Consolidation of non-controlling interests of variable interest entity	—	—	—	—	—	—	—	(208,000)	(208,000)
Stock based compensation	—	—	—	—	—	—	777,000	—	777,000
<b>BALANCE, DECEMBER 31, 2013</b>	6,307,000	63,000	232,000	(2,500,000)	(8,435,000)	(569,000)	8,129,000	1,437,000	9,566,000
Net income (loss)	—	—	—	—	4,733,000	—	4,733,000	(25,000)	4,708,000
Preferred stock dividends	—	—	—	—	(220,000)	—	(220,000)	—	(220,000)
Common stock dividends declared	—	—	—	—	(1,363,000)	—	(1,322,000)	—	(1,322,000)
Issuance/redemption of equity grants, net	81,000	1,000	—	—	—	—	(48,000)	—	(48,000)
Interest rate cash flow hedge	—	—	—	—	—	74,000	74,000	—	74,000
Tax impact of equity grant exercises	—	—	—	—	—	—	(10,000)	—	(10,000)
Deconsolidation of noncontrolling interest	—	—	—	—	—	—	—	(1,412,000)	(1,412,000)
Stock based compensation	—	—	—	—	—	—	418,000	—	418,000
<b>BALANCE, DECEMBER 31, 2014</b>	6,388,000	\$ 64,000	232,000	\$ (2,500,000)	\$ (5,285,000)	\$ (495,000)	\$ 11,754,000	\$ —	\$ 11,754,000

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



**DIVERSICARE HEALTHCARE SERVICES, INC. AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**

	Years Ended December 31,		
	2014	2013	2012
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>			
Net income (loss)	\$ 4,708,000	\$ (8,462,000)	\$ (2,920,000)
Discontinued operations	3,258,000	(1,469,000)	951,000
Income (loss) from continuing operations	1,450,000	(6,993,000)	(3,871,000)
Adjustments to reconcile income (loss) from continuing operations to net cash provided by operating activities:			
Depreciation and amortization	7,078,000	6,363,000	5,758,000
Provision for doubtful accounts	5,710,000	4,068,000	2,844,000
Deferred income tax provision (benefit)	837,000	(4,148,000)	(1,791,000)
Provision for self-insured professional liability, net of cash payments	1,173,000	384,000	2,026,000
Stock based compensation	580,000	950,000	573,000
Debt retirement costs	—	320,000	—
Provision for leases net of cash payments	(1,180,000)	(631,000)	(148,000)
Equity in net losses of unconsolidated affiliate	—	(67,000)	(420,000)
Other	316,000	224,000	170,000
Changes in other assets and liabilities affecting operating activities:			
Receivables, net	(14,592,000)	(13,873,000)	(5,290,000)
Prepaid expenses and other assets	(184,000)	837,000	(425,000)
Trade accounts payable and accrued expenses	4,771,000	6,231,000	578,000
Net cash provided by (used in) continuing operations	5,959,000	(6,335,000)	4,000
Net cash provided by (used in) discontinued operations	(2,978,000)	5,108,000	3,213,000
Net cash provided by (used in) operating activities	2,981,000	(1,227,000)	3,217,000
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>			
Purchases of property and equipment	(5,494,000)	(5,351,000)	(3,801,000)
Acquisition of property and equipment through business combination	—	(14,742,000)	—
Proceeds from sale of discontinued operations	17,124,000	—	3,632,000
Change in restricted cash	31,000	(3,303,000)	752,000
Deposits and other deferred balances	(64,000)	—	(319,000)
Net cash provided by (used in) continuing operations	11,597,000	(23,396,000)	264,000
Net cash provided by (used in) discontinued operations	(61,000)	1,785,000	(1,049,000)
Net cash provided by (used in) investing activities	11,536,000	(21,611,000)	(785,000)
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>			
Repayment of debt obligations	(21,645,000)	(30,183,000)	(1,168,000)
Proceeds from issuance of debt and sale leaseback transaction	21,808,000	54,500,000	—
Financing costs	(195,000)	(1,341,000)	(34,000)
Issuance and redemption of employee equity awards	(47,000)	22,000	55,000
Redemption of preferred stock	(4,918,000)	—	—
Payment of common stock dividends	(1,322,000)	(972,000)	(1,282,000)
Payment of preferred stock dividends	(220,000)	(344,000)	(344,000)
Deconsolidation of noncontrolling interests, net of income	(1,385,000)	(208,000)	(206,000)
Payment for preferred stock restructuring	(600,000)	(581,000)	(563,000)
Net cash provided by (used in) continuing operations	(8,524,000)	20,893,000	(3,542,000)
Net cash provided by (used in) discontinued operations	(5,956,000)	(202,000)	354,000
Net cash provided by (used in) financing activities	(14,480,000)	20,691,000	(3,188,000)

(Continued)

**DIVERSICARE HEALTHCARE SERVICES, INC. AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**  
(continued)

	<b>Years Ended December 31,</b>		
	<b>2014</b>	<b>2013</b>	<b>2012</b>
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	\$ 37,000	\$ (2,147,000)	\$ (756,000)
CASH AND CASH EQUIVALENTS, beginning of period	3,781,000	5,928,000	6,684,000
CASH AND CASH EQUIVALENTS, end of period	<u>\$ 3,818,000</u>	<u>\$ 3,781,000</u>	<u>\$ 5,928,000</u>
SUPPLEMENTAL INFORMATION:			
Cash payments of interest, net of amounts capitalized	\$ 3,324,000	\$ 2,637,000	\$ 2,028,000
Cash payments of income taxes	<u>\$ 84,000</u>	<u>\$ 88,000</u>	<u>\$ 497,000</u>

As discussed in Note 6, the Company entered into capitalized lease agreements and recorded \$0, \$0 and \$293,000 in 2014, 2013 and 2012, respectively, in fixed assets and capital lease obligations. These non-cash investing and financing transactions have been excluded from the consolidated statements of cash flows.

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

**DIVERSICARE HEALTHCARE SERVICES, INC. AND SUBSIDIARIES.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**DECEMBER 31, 2014, 2013, and 2012**

**1. BUSINESS AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

***Description of Business***

Diversicare Healthcare Services, Inc. ("Diversicare" or the "Company") provides a broad range of post-acute care services to patients and residents including skilled nursing, ancillary health care services and assisted living. In addition to the nursing and social services usually provided in long-term care centers, we offer a variety of rehabilitative, nutritional, respiratory, and other specialized ancillary services.

As of December 31, 2014, our continuing operations consist of 52 nursing centers with 5,825 licensed nursing beds. Our nursing centers range in size from 48 to 320 licensed nursing beds. The licensed nursing bed count does not include 496 licensed assisted living beds. Our continuing operations include centers in Alabama, Florida, Indiana, Kansas, Kentucky, Missouri, Ohio, Tennessee, and Texas.

***Summary of Significant Accounting Policies***

***Principles of Consolidation***

The consolidated financial statements include the financial position, operations and accounts of Diversicare and its subsidiaries, all wholly-owned. All significant intercompany accounts and transactions have been eliminated in consolidation. Any variable interest entities ("VIEs") in which the Company has an interest are consolidated when the Company identifies that it is the primary beneficiary. The Company had one variable interest entity and it related to a nursing center in West Virginia described in Note 7.

The investment in unconsolidated affiliate reflected on the consolidated balance sheet relates to a pharmacy joint venture partnership in which the Company owns a 50% interest. The joint venture partnership is accounted for using the equity method. An equity method investment is the Company's investment in an entity over which the Company lacks control, but otherwise has the ability to exercise significant influence over operating and financial policies. The Company's share of the profits and losses from this investment are reported in equity in earnings of unconsolidated affiliates in the accompanying consolidated statement of operations. The Company monitors this investment for other-than-temporary impairment by considering factors such as current economic and market conditions and the operating performance of the company and will record reductions in carrying value when or if necessary. Under the equity method, the investment, originally recorded at cost, is adjusted to recognize the Company's share of the net earnings or losses of the affiliate as they occur. The investment in unconsolidated affiliate balance relates to this partnership and was \$463,000 at December 31, 2014 and \$487,000 at December 31, 2013.

***Use of Estimates***

The preparation of consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

***Revenue Recognition***

The fees charged by the Company to patients in its nursing centers are recorded on an accrual basis. These rates are contractually adjusted with respect to individuals receiving benefits under federal and state-funded programs and other third-party payors. Rates under federal and state-funded programs are determined prospectively for each facility and may be based on the acuity of the care and services provided. These rates may be based on facility's actual costs subject to program ceilings and other limitations or on established rates based on acuity and services provided as determined by the federal and state-funded programs. Amounts earned under federal and state programs with respect to nursing home patients are subject to review by the third-party payors which may result in retroactive adjustments. In the opinion of management, adequate provision has been made for any adjustments that may result from such reviews. Retroactive adjustments, if any, are recorded when objectively determinable, generally within three years of the close of a reimbursement year depending upon the timing of appeals and third-party settlement reviews or audits. During the years ended December 31, 2014, 2013 and 2012, the Company recorded \$(298,000), \$(141,000) and \$(118,000) of net favorable (unfavorable) estimated settlements from federal and state programs for periods prior to the beginning of fiscal 2014, 2013 and 2012, respectively.

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*Allowance for Doubtful Accounts*

The Company's allowance for doubtful accounts is estimated utilizing current agings of accounts receivable, historical collections data and other factors. Management monitors these factors and determines the estimated provision for doubtful accounts. Historical bad debts have generally resulted from uncollectible private balances, some uncollectible coinsurance and deductibles and other factors. Receivables that are deemed to be uncollectible are written off. The allowance for doubtful accounts balance is assessed on a quarterly basis, with changes in estimated losses being recorded in the Consolidated Statements of Operations in the period identified.

The Company includes the provision for doubtful accounts in operating expenses in its Consolidated Statements of Operations. The provisions for doubtful accounts of continuing operations were \$5,710,000, \$4,068,000, and \$2,844,000 for 2014, 2013 and 2012, respectively. The provision for doubtful accounts of continuing operations was 1.7%, 1.6%, and 1.2% of net revenue during 2014, 2013, and 2012, respectively.

*Lease Expense*

As of December 31, 2014, the Company operates 39 nursing centers under operating leases, including 23 owned by Omega, 13 owned by AVIV REIT, and three owned by other parties. The Company's operating leases generally require the Company to pay stated rent, subject to increases based on changes in the Consumer Price Index, a minimum percentage increase, or increases in the net revenues of the leased properties. The Company's Omega leases require the Company to pay certain scheduled rent increases. Such scheduled rent increases are recorded as additional lease expense on a straight-line basis recognized over the term of the related leases and the difference between the amounts recorded for rent expense as compared to rent payments as an accrued liability.

See Notes 2, 3, and 11 for a discussion regarding the Company's Master Lease with Omega, the termination of leases for certain facilities, and the addition of certain leased facilities.

*Classification of Expenses*

The Company classifies all expenses (except lease, interest, depreciation and amortization expenses) that are associated with its corporate and regional management support functions as general and administrative expenses. All other expenses (except lease, professional liability, interest, depreciation and amortization expenses) incurred by the Company at the facility level are classified as operating expenses.

*Property and Equipment*

Property and equipment are recorded at cost or at fair value determined on the respective dates of acquisition for assets obtained in a business combination, with depreciation and amortization being provided over the shorter of the remaining lease term (where applicable) or the assets' estimated useful lives on the straight-line basis as follows:

Buildings and improvements	- 5 to 40 years
Leasehold improvements	- 2 to 10 years
Furniture, fixtures and equipment	- 2 to 15 years

Interest incurred during construction periods for qualifying expenditures is capitalized as part of the building cost. Maintenance and repairs are expensed as incurred, and major betterments and improvements are capitalized.

In accordance with the Financial Accounting Standards Board ("FASB") guidance on "Property, Plant and Equipment," specifically the discussion around the accounting for the impairment or disposal of long-lived assets, the Company routinely evaluates the recoverability of the carrying value of its long-lived assets, including when significant adverse changes in the general economic conditions and significant deteriorations of the underlying undiscounted cash flows or fair values of the property indicate that the carrying amount of the property may not be recoverable. The need to recognize impairment is based on estimated undiscounted future cash flows from a property compared to the carrying value of that property.

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*Cash and Cash Equivalents*

Cash and cash equivalents include cash on deposit with banks and all highly liquid investments with original maturities of three months or less when purchased. Our cash on deposit with banks was subject to the Federal Deposit Insurance Corporation ("FDIC") minimum insurance levels. Effective January 1, 2013, the coverage provided by the FDIC that had been unlimited under the Dodd-Frank Deposit Insurance Provision is limited to the legal maximum, which is generally \$250,000 per ownership category.

*Deferred Financing and Other Costs*

The Company records deferred financing and lease costs for direct and incremental expenditures related to entering into or amending debt and lease agreements. These expenditures include lenders and attorneys fees. Financing costs are amortized using the effective interest method over the term of the related debt. The amortization is reflected as interest expense in the accompanying consolidated statements of operations. Deferred lease costs are amortized on a straight-line basis over the term of the related leases. See Note 6 for further discussion.

*Acquired Leasehold Interest*

The Company has recorded an acquired leasehold interest intangible asset related to an acquisition completed during 2007. The intangible asset is accounted for in accordance with the FASB's guidance on goodwill and other intangible assets, and is amortized on a straight-line basis over the remaining life of the acquired lease, including renewal periods, the original period of which is approximately 28 years from the date of acquisition. The lease terms for the seven centers this intangible relates to provide for an initial term and renewal periods at the Company's option through May 31, 2035. As the renewal periods of the acquired leased facilities are solely based on the Company's option, it is expected that costs (if any) to renew the lease through its current amortization period would be nominal and the decision to continue to lease the acquired facilities lies solely within the Company's intent to continue to operate the seven facilities. Any renewal costs would be included in deferred lease costs and amortized over the renewal period. Amortization expense of approximately \$384,000 related to this intangible asset was recorded during each of the years ended December 31, 2014, 2013 and 2012, respectively.

The carrying value of the acquired leasehold interest intangible and the accumulated amortization are as follows:

	<b>December 31,</b>	
	<b>2014</b>	<b>2013</b>
Intangible assets	\$ 10,652,000	\$ 10,652,000
Accumulated amortization	(2,808,000)	(2,424,000)
Net intangible assets	<u>\$ 7,844,000</u>	<u>\$ 8,228,000</u>

The Company evaluates the recoverability of the carrying value of the acquired leasehold intangible in accordance with the FASB's guidance on accounting for the impairment or disposal of long-lived assets. Included in this evaluation is whether significant adverse changes in general economic conditions, and significant deteriorations of the underlying cash flows or fair values of the intangible asset, indicate that the carrying amount of the intangible asset may not be recoverable. The need to recognize an impairment charge is based on estimated future undiscounted cash flows from the asset compared to the carrying value of that asset. If recognition of an impairment charge is necessary, it is measured as the amount by which the carrying amount of the intangible asset exceeds the fair value of the intangible asset.

The expected amortization expense for the acquired leasehold interest intangible asset is as follows:

2015	\$ 384,000
2016	384,000
2017	384,000
2018	384,000
2019	384,000
Thereafter	5,924,000
	<u>\$ 7,844,000</u>

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*Self-Insurance*

Self-insurance liabilities primarily represent the unfunded accrual for self insured risks associated with general and professional liability claims, employee health insurance and workers' compensation. The Company's health insurance liability is based on known claims incurred and an estimate of incurred but unreported claims determined by an analysis of historical claims paid. The Company's workers' compensation liability relates primarily to periods of self insurance prior to May 1997 and consists of an estimate of the future costs to be incurred for the known claims.

Final determination of the Company's actual liability for incurred general and professional liability claims is a process that takes years. The Company evaluates the adequacy of this liability on a quarterly basis. Semi-annually, the Company retains a third-party actuarial firm to assist in the evaluation of this unfunded accrual. Since May 2012, Merlinos & Associates, Inc. ("Merlinos") has assisted management in the preparation of the appropriate accrual for incurred but not reported general and professional liability claims based on data furnished by the Company. Merlinos primarily utilizes historical data regarding the frequency and cost of the Company's past claims over a multi-year period, industry data and information regarding the number of occupied beds to develop its estimates of the Company's ultimate professional liability cost for current periods. The Actuarial Division of Willis of Tennessee, Inc. assisted the Company with all estimates prior to May 2012.

On a quarterly basis, the Company obtains reports of asserted claims and lawsuits incurred. These reports, which are provided by the Company's insurers and a third party claims administrator, contain information relevant to the actual expense already incurred with each claim as well as the third-party administrator's estimate of the anticipated total cost of the claim. This information is reviewed by the Company quarterly and provided to the actuary semi-annually. Based on the Company's evaluation of the actual claim information obtained, the semi-annual estimates received from the third-party actuary, the amounts paid and committed for settlements of claims and on estimates regarding the number and cost of additional claims anticipated in the future, the reserve estimate for a particular period may be revised upward or downward on a quarterly basis. Any increase in the accrual has an unfavorable impact on results of operations in the period and any reduction in the accrual increases results of operations during the period.

All losses are projected on an undiscounted basis. The self-insurance liabilities include estimates of liability for incurred but not reported claims, estimates of liability for reported but unresolved claims, actual liabilities related to settlements, including settlements to be paid over time, and estimates of related legal costs incurred and expected to be incurred.

One of the key assumptions in the actuarial analysis is that historical losses provide an accurate forecast of future losses. Changes in legislation such as tort reform, changes in our financial condition, changes in our risk management practices and other factors may affect the severity and frequency of claims incurred in future periods as compared to historical claims.

The facts and circumstances of each claim vary significantly, and the amount of ultimate liability for an individual claim may vary due to many factors, including whether the case can be settled by agreement, the quality of legal representation, the individual jurisdiction in which the claim is pending, and the views of the particular judge or jury deciding the case.

Although the Company adjusts its unfunded accrual for professional and general liability claims on a quarterly basis and retains a third-party actuarial firm semi-annually to assist management in estimating the appropriate accrual, professional and general liability claims are inherently uncertain, and the liability associated with anticipated claims is very difficult to estimate. Professional liability cases have a long cycle from the date of an incident to the date a case is resolved, and final determination of the Company's actual liability for claims incurred in any given period is a process that takes years. As a result, the Company's actual liabilities may vary significantly from the unfunded accrual, and the amount of the accrual has and may continue to fluctuate by a material amount in any given period. Each change in the amount of this accrual will directly affect the Company's results of operations and financial position for the period in which the change in accrual is made.

*Income Taxes*

The Company follows the FASB's guidance on *Accounting for Income Taxes*, which requires the asset and liability method of accounting for income taxes whereby deferred income taxes are recorded for the future tax consequences attributable to differences between the financial statement and tax bases of assets and liabilities. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. Valuation allowances are provided against any estimated non-realizable deferred tax assets where necessary.

Where the Company believes that a tax position is supportable for income tax purposes, the item is included in its income tax returns. Where treatment of a position is uncertain, liabilities are recorded based upon the Company's evaluation of the "more likely than not" outcome considering the technical merits of the position. While the judgments and estimates made by the

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Company are based on management's evaluation of the technical merits of a matter, historical experience and other assumptions that management believes are appropriate and reasonable under current circumstances, actual resolution of these matters may differ from recorded estimated amounts, resulting in charges or credits that could materially affect future financial statements. See Note 10 for additional information related to the provision for income taxes.

*Disclosure of Fair Value of Financial Instruments*

Fair value is defined as the price that would be received to sell an asset, or paid to transfer a liability, in an orderly transaction between market participants. In calculating fair value, a company must maximize the use of observable market inputs, minimize the use of unobservable market inputs and disclose in the form of an outlined hierarchy the details of such fair value measurements. The carrying amounts of cash and cash equivalents, receivables, trade accounts payable and accrued expenses approximate fair value because of the short-term nature of these accounts. The Company's self-insurance liabilities are reported on an undiscounted basis as the timing of estimated settlements cannot be determined.

The Company follows the FASB's guidance on *Fair Value Measurements and Disclosures* which provides rules for using fair value to measure assets and liabilities as well as a fair value hierarchy that prioritizes the information used to develop the measurements. It applies whenever other guidance requires (or permits) assets or liabilities to be measured at fair value and gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (Level 1 measurements) and the lowest priority to unobservable inputs (Level 3 measurements).

A summary of the fair value hierarchy that prioritizes observable and unobservable inputs used to measure fair value into three broad levels is described below:

Level 1: Quoted prices (unadjusted) in active markets that are accessible at the measurement date for identical assets or liabilities. The fair value hierarchy gives the highest priority to Level 1 inputs.

Level 2: Observable prices that are based on inputs not quoted on active markets, but corroborated by market data.

Level 3: Unobservable inputs are used when little or no market data is available. The fair value hierarchy gives the lowest priority to Level 3 inputs.

The Company has not elected to expand the use of fair value measurements for assets and liabilities. It is noted that the assessment of carrying value compared to fair value for impairment analysis follow these fair value principles and hierarchy.

As further discussed in Note 6, in conjunction with the debt agreements entered into in March 2011, the Company entered into an interest rate swap agreement with a member of the bank syndicate as the counterparty. The applicable guidance requires companies to recognize all derivative instruments as either assets or liabilities at fair value in a company's balance sheets.

As the Company's interest rate swap, a cash flow hedge, is not traded on a market exchange, the fair value is determined using a valuation model based on a discounted cash flow analysis. This analysis reflects the contractual terms of the interest rate swap agreement and uses observable market-based inputs, including estimated future LIBOR interest rates. The fair value of the Company's interest rate swap is the net difference in the discounted future fixed cash payments and the discounted expected variable cash receipts. The variable cash receipts are based on the expectation of future interest rates and are observable inputs available to a market participant. The interest rate swap valuation is classified in Level 2 of the fair value hierarchy. The debt balances as presented in the consolidated balance sheets approximate the fair value of the respective instruments, the estimates of which are considered Level 2 fair value calculations within the fair value hierarchy.

The following table presents by level, within the fair value hierarchy, assets and liabilities measured at fair value on a recurring basis as of December 31, 2014 and 2013:

<b>December 31, 2014</b>	<b>Fair Value Measurements - Assets (Liabilities)</b>			
	<b>Total</b>	<b>Level 1</b>	<b>Level 2</b>	<b>Level 3</b>
Interest rate swap	\$ (798,000)	\$ —	\$ (798,000)	\$ —
<b>December 31, 2013</b>	<b>Fair Value Measurements - Assets (Liabilities)</b>			
	<b>Total</b>	<b>Level 1</b>	<b>Level 2</b>	<b>Level 3</b>
Interest rate swap	\$ (918,000)	\$ —	\$ (918,000)	\$ —

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The change in fair value of the Company's cash flow hedge is detailed in the Company's Consolidated Statements of Comprehensive Income (Loss).

*Net Income (Loss) per Common Share*

The Company follows the FASB's guidance on *Earnings Per Share* for the financial reporting of net income (loss) per common share. Basic earnings per common share excludes dilution and restricted shares and is computed by dividing income available to common shareholders by the weighted-average number of common shares, excluding restricted shares, outstanding for the period. Diluted earnings per common share reflects the potential dilution that could occur if securities or other contracts to issue common stock were exercised or converted into common stock or otherwise resulted in the issuance of common stock that then shared in the earnings of the Company. See Note 9 for additional disclosures about the Company's Net Income (Loss) per Common Share.

*Stock Based Compensation*

The Company follows the FASB's guidance on *Stock Compensation* to account for share-based payments granted to employees and recorded non-cash stock based compensation expense of \$580,000, \$950,000 and \$573,000 during the years ended December 31, 2014, 2013 and 2012, respectively. Such amounts are included as components of general and administrative expense or operating expense based upon the classification of cash compensation paid to the related employees. See Note 8 for additional disclosures about the Company's stock based compensation plans.

*Accumulated Other Comprehensive Loss*

Accumulated other comprehensive income consists of other comprehensive income (loss). Comprehensive income (loss) is a more inclusive financial reporting method that includes disclosure of financial information that historically has not been recognized in the calculation of net income (loss). The Company has chosen to present the components of other comprehensive income in a separate statement of comprehensive income (loss). Currently, the Company's other comprehensive income (loss) consists of the change in fair value of the Company's interest rate swap transaction accounted for as a cash flow hedge.

*Recent Accounting Guidance*

In April 2014, the FASB issued ASU 2014-08, *Presentation of Financial Statements (Topic 205) and Property, Plant, and Equipment (Topic 360): Reporting Discontinued Operations and Disclosures of Disposals of Components of an Entity* changing the criteria for reporting discontinued operations. The ASU states that only those disposed components (or components held-for-sale) representing a strategic shift that have a significant effect on operations and financial results will be reported in discontinued operations. The ASU also required expanded disclosures about discontinued operations in the financial statement notes. The ASU is effective for disposals (or classifications as held-for-sale) that occur within annual periods beginning on or after December 15, 2014 and interim periods within those annual periods. Early application is permitted, but only for those disposals that have not been reported in financial statements previously issued or available for issuance. We have chosen to early adopt this ASU and have applied the new criteria in determining the accounting treatment for the nursing centers exited during 2014. The adoption of this guidance did not have a material impact on the Company's consolidated financial results.

In May 2014, the FASB issued ASU No. 2014-09, *Revenue from Contracts with Customers (Topic 606)*, which requires an entity to recognize the amount of revenue to which it expects to be entitled for the transfer of promised goods or services to customers. The ASU will replace most existing revenue recognition guidance in U.S. GAAP when it becomes effective. The new standard is effective for the Company on January 1, 2017. Early application is not permitted. The standard permits the use of either the retrospective or cumulative effect transition method. The Company is evaluating the effect that ASU 2014-09 will have on its consolidated financial statements and related disclosures. The Company has not yet selected a transition method nor has it determined the effect of the standard on its ongoing financial reporting.

*Reclassifications*

As discussed in Note 3, the consolidated financial statements of the Company have been retroactively reclassified for all periods presented to reflect as discontinued operations certain divestitures and lease terminations.



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**2. BUSINESS DEVELOPMENT**

*Kansas Acquisition*

On March 6, 2013, the Company entered into an asset purchase agreement ("the Agreement") with Cumberland & Ohio Co. of Texas, as receiver of the assets of SeniorTrust of Florida, Inc. to acquire certain land, improvements, furniture, fixtures and equipment, and personal property of five facilities, all located in Kansas, for an aggregate purchase price of \$15,500,000. The purchase of the Kansas facilities commenced on May 1, 2013. The five facilities acquired under the Agreement include the following:

- 77-bed skilled nursing facility known as Chanute HealthCare Center
- 80-bed skilled nursing facility known as Council Grove HealthCare Center
- 119-bed skilled nursing facility known as Haysville HealthCare Center
- 80-bed skilled nursing facility known as Larned HealthCare Center
- 62-bed skilled nursing facility known as Sedgwick HealthCare Center

As a result of the consummation of the Agreement, the Company allocated the purchase price of \$15,500,000 between the assets associated with the transaction based on the fair value of the acquired identifiable net assets. In addition to the assets acquired in the transaction, the Company also assumed liabilities of \$758,000 which resulted in total cash outlay of \$14,742,000. The Company also incurred \$338,000 in acquisition-related expenses that were expensed as incurred. The allocation of the purchase price was determined with the assistance of HealthTrust LLC, a third-party real estate valuation firm. The allocation for the net assets acquired is as follows:

	<b>As of May 1, 2013</b>
Purchase Price	\$ 15,500,000
Land	\$ 2,130,000
Buildings	12,127,000
Furniture, fixtures, and equipment	1,200,000
Inventory	43,000
	<hr/>
Less: Liabilities assumed	\$ 758,000
	<hr/>
Total cash paid	\$ 14,742,000
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Since finalizing the purchase, the aforementioned facilities contributed \$25,813,000 and \$15,440,000 in revenue to the consolidated statement of operations during 2014 and 2013, respectively.

*Lease Agreements*

During the years ended December 31, 2014 and 2013, the Company completed transactions to assume the operations of eight and five facilities, respectively, through the assumption of long-term operating leases. The transactions during these periods are as follows:

- On October 1, 2014, the Company assumed operations of a 62-bed skilled nursing facility in Greenville, Kentucky. This facility has an initial lease terms of 14 years. The center was already operating and treating patients on the transition date. There was no purchase price paid to enter into the lease agreement for this skilled nursing center.
- On August 1, 2014, the Company assumed operations of two centers in Ohio. The centers included in this transaction are a 142-bed skilled nursing facility and a 42-bed assisted living center. The lease provides for an initial lease term of 10 years. The centers were already operating and treating patients on the transition date. There was no purchase price paid to enter into the lease agreement for these skilled nursing centers.
- On July 1, 2014, the Company completed a transaction to enter the state of Missouri through the assumption of operations of three facilities totaling 339 skilled nursing beds. The lease provides for an initial 15-year lease term with

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a 5-year renewal option. The centers were already operating and treating patients on the transition date. There was no purchase price paid to enter into the lease agreement for these skilled nursing centers.

- On June 1, 2014, the Company assumed operations at Diversicare of Nicholasville, an existing 73-bed facility in Nicholasville, Kentucky. The lease provides for an initial 15-year lease term with a 5-year renewal option. The center was already operating and treating patients on the transition date. There was no purchase price paid to enter into the lease agreement for this skilled nursing center.
- On March 1, 2014, the Company assumed operations at Diversicare of Big Springs, an existing 135-bed facility in Huntsville, Alabama. The nursing center is owned by an unrelated third-party and the lease provides for an initial 10-year lease term with two additional 5-year renewal options. The additional skilled nursing center increases the Company's footprint in Alabama to seven centers, and the third center in the Huntsville market. The center was already operating and treating patients on the transition date. There was no purchase price paid to enter into the lease agreement for this skilled nursing center.
- On October 1, 2013, the Company assumed operations at four existing nursing centers, three in Ohio and one in Indiana. The lease of these centers provides for an initial 15-year lease term with a 5-year renewal option. This transaction represents an increase in the Company's footprint in the Midwest, expanding into one new state, Indiana. All four of the centers were operating and treating patients on the transition date. There was no purchase price paid to enter into the lease agreement for these skilled nursing centers.
- On August 1, 2013, the Company assumed operations at Seneca Place, an existing 107-bed facility in Louisville, Kentucky. The lease provides for an initial 15-year lease term with a 5-year renewal option. The center was already operating and treating patients on the transition date. There was no purchase price paid to enter into the lease agreement for this skilled nursing center.

### **3. DISCONTINUED OPERATIONS**

#### *West Virginia Disposition*

Effective April 3, 2014, the Company entered into an asset purchase agreement with Rose Terrace Acq., LLC ("Purchaser") to sell its skilled nursing facility in Culloden, West Virginia. The original asset purchase agreement was subject to a number of conditions including an amendment to the Consolidated Amended and Restated Master Lease ("Master Lease") with Omega to terminate the lease only with respect to two other skilled nursing facilities in West Virginia, state licensure and regulatory approval.

Effective July 1, 2014, the Company completed the transaction with Rose Terrace Acq., LLC to sell Rose Terrace, a 90-bed skilled nursing facility in Culloden, West Virginia for a sales price of \$16,500,000. The Company also entered into the Fifteenth Amendment to the Master Lease with Omega to terminate the lease only with respect to two other skilled nursing facilities in West Virginia, and concurrently entered into an operations transfer agreement with American Health Care Management, LLC, an affiliate of the purchaser with respect to two other skilled nursing facilities located in Danville and Ivydale, West Virginia. The amendment effectively reduced the annual rent payments due under the Master Lease by \$1,900,000. Upon completion of the transaction, Diversicare no longer operates any skilled nursing centers in the state of West Virginia. In conjunction with the closing of the sale, the Company paid the balance of the \$8,000,000 mortgage loan outstanding on the Rose Terrace facility.

The transaction resulted in a gain on the disposition of Rose Terrace which, along with the results of operations for these nursing facilities, is presented within Discontinued Operations on the Consolidated Statements of Operations. The pretax gain on the transaction was \$7,522,000. The tax expense associated with the gain was \$2,793,000 for which the Company plans to apply net operating loss carryforwards from our deferred tax assets to substantially offset and minimize the cash outlay for this transaction.

These centers contributed revenues of \$10,961,000, \$21,698,000, and \$15,243,000 and net income (loss) of \$(26,000), \$1,516,000, and \$196,000 during the twelve months ended December 31, 2014, 2013, and 2012, respectively. The net income or loss for the nursing centers included in discontinued operations does not reflect any allocation of corporate general and administrative expense or any allocation of corporate interest expense. The Company considered these additional costs along with the centers' future prospects based upon operating history when determining the contribution of the skilled nursing centers to its operations.

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*Arkansas Lease Termination*

Effective September 1, 2013, the Company entered into an agreement with Omega to terminate its lease with respect to eleven nursing centers and 1,181 licensed beds located in the state of Arkansas, and concurrently entered into operation transfer agreements to transfer the operations of each of those eleven centers to an operator selected by Omega. Upon the completion of the transaction, the Company no longer operates any skilled nursing centers in the State of Arkansas. In connection with the closing of this transaction, the Company and Omega entered into the Thirteenth Amendment to the Master Lease. This amendment effectively modifies the terms of the Master Lease to terminate the terms surrounding the eleven nursing centers in Arkansas, and only as to those eleven centers, and effectively reduces the annual rent payable under the Master Lease by \$5,000,000.

As a result of this transaction, the Company has reclassified the operations of these centers as discontinued operations for all periods presented in the accompanying consolidated financial statements. These centers contributed revenues of \$0, \$40,151,000, and \$61,782,000 during the twelve months ended December 31, 2014, 2013, and 2012, respectively. Further, these centers contributed net losses of \$1,111,000 and \$2,865,000 during the years ended December 31, 2014 and 2013, respectively, and net income of \$457,000 during the year ended December 31, 2012. The net income or loss for the nursing centers included in discontinued operations does not reflect any allocation of corporate general and administrative expense or any allocation of corporate interest expense. The Company considered these additional costs along with the centers' future prospects based upon operating history when determining the contribution of the skilled nursing centers to its operations. In addition to the expenses associated with the discontinued operations, the Company also incurred \$1,446,000 in restructuring expenses in 2013 that represent corporate expenses and exit costs associated with the Arkansas lease termination, but not classified as discontinued operations.

Effective September 1, 2012, we sold an owned skilled nursing center in Arkansas to an unrelated party and have reclassified the operations of this facility as discontinued operations for all periods presented in the accompanying consolidated financial statements. The operating margins and the long-term business prospects of the nursing center did not meet our strategic goals. This skilled nursing center contributed revenues of \$0, \$0, and \$3,463,000, and net income (loss) of \$(19,000), \$(85,000), and \$68,000 during the years ended December 31, 2014, 2013, and 2012, respectively. The net income (loss) for the nursing center included in discontinued operations does not reflect any allocation of regional or corporate general and administrative expense or any allocation of corporate interest expense. The Company considered these additional costs along with the future prospects of this nursing center when determining the contribution of the skilled nursing center to its operations. The gain on disposal, net of taxes, of \$174,000 was primarily the amount of sales price in excess of the net carrying value of the fixed assets sold.

A summary of the discontinued operations for the periods presented is as follows:

	<b>December 31,</b>		
	<b>2014</b>	<b>2013</b>	<b>2012</b>
Net revenues	\$ 10,961,000	\$ 61,849,000	\$ 80,488,000
Operating expenses	(13,325,000)	(64,312,000)	(79,300,000)
Gain from disposal of assets	7,546,000	—	281,000
Income (loss) from discontinued operations	5,182,000	(2,463,000)	1,469,000
Benefit (provision) for income taxes	(1,924,000)	994,000	(518,000)
Income (loss) from discontinued operations, net of tax	\$ 3,258,000	\$ (1,469,000)	\$ 951,000

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**4. RECEIVABLES**

Receivables, before the allowance for doubtful accounts, consist of the following components:

	<b>December 31,</b>	
	<b>2014</b>	<b>2013</b>
Medicare	\$ 16,312,000	\$ 12,889,000
Medicaid and other non-federal government programs	14,710,000	13,131,000
Other patient and resident receivables	16,294,000	10,517,000
	<u>\$ 47,316,000</u>	<u>\$ 36,537,000</u>
Other receivables and advances	<u>\$ 862,000</u>	<u>\$ 1,118,000</u>

The other receivables and advances balance are composed of \$588,000 and \$843,000 related to renovation projects to be funded by Omega at December 31, 2014 and 2013, respectively. See Note 11 for additional discussion of these receivables and leased facility construction projects.

Our accounts receivable at December 31, 2014 included approximately \$5.5 million of accounts that had not yet been billed as a result of the change of ownership process. The unbilled receivables are primarily attributable for the newly leased facilities in Nicholasville, Kentucky, and Greenville, Kentucky, for which we assumed operations in August 2013 and October 2014, respectively. These two facilities have approximately \$2.7 million of unbilled receivables as of December 31, 2014. Additionally, the three facilities in Missouri, for which we assumed operations in July 2014, contributed \$2.3 million to the unbilled receivables balance. The balance of the unbilled receivables at December 31, 2014 also includes amounts attributable to the Avon and Ontario Pointe facilities for which we assumed operations in August 2014. During the change of ownership process, we are required to hold these accounts while waiting for final Medicare and Medicaid approvals. We expect these accounts to be collectible as soon as we are able to submit them for payment.

The Company provides credit for a substantial portion of its revenues and continually monitors the credit-worthiness and collectability from its patients, including proper documentation of third-party coverage. The Company is subject to accounting losses from uncollectible receivables in excess of its reserves.

Substantially all receivables are pledged as collateral on the Company's debt obligations.

**5. PROPERTY AND EQUIPMENT**

Property and equipment, at cost, consists of the following:

	<b>December 31,</b>	
	<b>2014</b>	<b>2013</b>
Land	\$ 3,857,000	\$ 3,857,000
Buildings and leasehold improvements	64,446,000	63,107,000
Furniture, fixtures and equipment	30,566,000	26,608,000
	<u>98,869,000</u>	<u>93,572,000</u>
Less: accumulated depreciation	(55,014,000)	(48,516,000)
Net property and equipment	<u>\$ 43,855,000</u>	<u>\$ 45,056,000</u>

As discussed further in Note 6, the property and equipment of certain skilled nursing centers are pledged as collateral for mortgage debt obligations. In addition, the Company has assets recorded as capital leased assets purchased through capitalized lease obligations. The Company capitalizes leasehold improvements which will revert back to the lessor of the property at the expiration or termination of the lease, and depreciates these improvements over the shorter of the remaining lease term or the assets' estimated useful lives.

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**6. LONG-TERM DEBT, INTEREST RATE SWAP AND CAPITALIZED LEASE OBLIGATIONS**

Long-term debt consists of the following:

	<b>December 31,</b>	
	<b>2014</b>	<b>2013</b>
Mortgage loan with a syndicate of banks; issued in March 2011, amended May 2013; payable monthly, interest at 4.5% above LIBOR, a portion of which is fixed at 6.87% based on the interest rate swap described below.	\$ 43,441,000	\$ 44,434,000
Revolving credit facility borrowings payable to a bank; entered into in March 2010; amended in March 2011 and further amended May 2013 and March 2014; secured by receivables of the Company; interest at 4.5% above LIBOR.	4,500,000	3,000,000
Commercial loan of consolidated VIE, payable by variable interest entity landlord to a bank; issued in January 2011; payable monthly, fixed interest rate of 5.3% (classified in discontinued operations)	—	5,476,000
	<u>47,941,000</u>	<u>52,910,000</u>
Less current portion	(5,539,000)	(4,211,000)
	<u>\$ 42,402,000</u>	<u>\$ 48,699,000</u>

As of December 31, 2014, the Company's weighted average interest rate on long-term debt, including the impact of the interest rate swap, was approximately 5.71%.

The Company has agreements with a syndicate of banks for a mortgage term loan ("Original Mortgage Loan") and the Company's revolving credit agreement ("Original Revolver"). On May 1, 2013, the Company executed an Amended and Restated Credit Agreement (the "Credit Agreement") which modified the terms of the Original Mortgage Loan and the Original Revolver Agreements dated February 28, 2011. The Credit Agreement increases the Company's borrowing capacity to \$65,000,000 allocated between a \$45,000,000 Mortgage Loan ("Amended Mortgage Loan") and a \$20,000,000 Revolver ("Amended Revolver"). Loan acquisition costs associated with the Amended Mortgage Loan and the Amended Revolver were capitalized in the amount of \$1,341,000 and are being amortized over the five-year term of the agreements.

Under the terms of the amended agreements, the syndicate of banks provided the Amended Mortgage Loan with an original balance of \$45,000,000 with a five-year maturity through April 30, 2018, and a \$20,000,000 Amended Revolver through April 30, 2018. The Amended Mortgage Loan has a term of five years, with principal and interest payable monthly based on a 25-year amortization. Interest is based on LIBOR plus 4.5%. A portion of the Amended Mortgage Loan is effectively fixed at 6.87% pursuant to an interest rate swap with a notional amount of \$21,678,000 as of December 31, 2014. As of December 31, 2014, the interest rate related to the Amended Mortgage Loan was 4.7%. The Amended Mortgage Loan is secured by 13 owned nursing centers, related equipment and a lien on the accounts receivable of these centers. The Amended Mortgage Loan and the Amended Revolver are cross-collateralized. The Company's Amended Revolver has an interest rate of LIBOR plus 4.5% and is secured by accounts receivable and is subject to limits on the maximum amount of loans that can be outstanding under the revolver based on borrowing base restrictions.

Effective March 31, 2014, the Company entered into the Second Amendment to the Amended and Restated Revolver ("Second Amendment"). The Second Amendment temporarily increased the Amended Revolver capacity from the \$20,000,000 in the original Amended Revolver to \$27,500,000 through September 30, 2014, as a result of the increase in receivables related to new facilities that continue to progress through the change in ownership process. Effective July 1, 2014, the Company entered into the Third Amendment to the Amended and Restated Revolver ("Third Amendment"). The Third Amendment makes the previously temporary increase to the Amended Revolver capacity from the \$20,000,000 in the original Amended Revolver to \$27,500,000, a permanent change to the borrowing capacity as a result of the increase in receivables related to new facilities that continue to progress through the change in ownership process.

As of December 31, 2014, the Company had \$4,500,000 in borrowings outstanding under the Amended Revolver compared to \$3,000,000 outstanding as of December 31, 2013. The outstanding borrowings on the Amended Revolver primarily reflect the Company's approach to accumulated Medicaid and Medicare receivables at recently acquired facilities as these facilities proceed through the change in ownership process with CMS. Annual fees for letters of credit issued under the Amended Revolver are 3.0% of the amount outstanding. The Company has 11 letters of credit with a total value of \$8,106,000 outstanding as of December 31, 2014. Considering the balance of eligible accounts receivable, the letter of credit, the amounts outstanding under the Amended Revolver and the maximum loan amount of \$27,500,000, the balance available for borrowing under the Amended Revolver is \$13,848,000 at December 31, 2014.

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Effective March 27, 2014, the Company executed its purchase option to acquire all assets associated with the Rose Terrace nursing center in Culloden, West Virginia from Milton Holdings, LLC which was considered a variable interest entity ("VIE") by the Company and consolidated prior to the date of this transaction. As a result of the purchase of Rose Terrace, the Company no longer consolidated the commercial loan held by the VIE which had a balance of \$5,476,000 as of December 31, 2013. See Note 7 for further information on the VIE considerations. In conjunction with the purchase of the assets, the Company entered into an interest-only \$8,000,000 term loan ("Rose Terrace Note") with a maturity date of March 27, 2015. The short-term nature and interest-only structure of the Rose Terrace Note reflected the Company's intent to sell the property and transfer operations to an unrelated third-party operator as further disclosed in Note 3. This transaction closed on July 1, 2014, at which time the Rose Terrace Note was paid in full.

The Company's debt agreements contain various financial covenants, the most restrictive of which relate to minimum cash deposits, cash flow and debt service coverage ratios. The Company is in compliance with all such covenants at December 31, 2014.

In connection with the Company's 2014 and 2013 financing agreements, the Company recognized the following debt retirement costs related to the write off of deferred financing on the existing financing agreements and recorded new deferred loan costs related the new financing agreements as follows:

	<u>2014</u>	<u>2013</u>
Write-off of deferred financing costs	\$ —	\$ 320,000
Deferred financing costs capitalized	\$ 195,000	\$ 1,341,000

Scheduled principal payments of long-term debt are as follows:

2015	\$ 5,539,000
2016	1,089,000
2017	1,145,000
2018	40,168,000
Total	<u>\$ 47,941,000</u>

*Interest Rate Swap Cash Flow Hedge*

As part of the debt agreements entered into in March 2011, the Company entered into an interest rate swap agreement with a member of the bank syndicate as the counterparty. The Company entered into the interest rate swap agreement to mitigate the variable interest rate risk on its outstanding mortgage borrowings. The Company designated its interest rate swap as a cash flow hedge and the effective portion of the hedge, net of taxes, is reflected as a component of other comprehensive income (loss). In conjunction with the aforementioned amendment to the Credit Agreement that occurred in May 2013, the Company retained the previously agreed upon interest rate swap modifying the terms of the swap to reflect the amended Credit Agreement. The Company redesignated the interest rate swap as a cash flow hedge. The interest rate swap agreement has the same effective date and maturity date as the Amended Mortgage Loan, and carries a notional amount of \$21,678,000 as of December 31, 2014. The interest rate swap agreement requires the Company to make fixed rate payments to the bank calculated on the applicable notional amount at an annual fixed rate of 6.87% while the bank is obligated to make payments to the Company based on LIBOR on the same notional amounts. The applicable guidance requires companies to recognize all derivative instruments as either assets or liabilities at fair value in a company's balance sheets.

The Company assesses the effectiveness of its interest rate swap on a quarterly basis and at December 31, 2014, the Company determined that the interest rate swap was effective. The interest rate swap valuation model indicated a net liability of \$798,000 at December 31, 2014. The fair value of the interest rate swap is included in "other noncurrent liabilities" on the Company's consolidated balance sheet. The balance of accumulated other comprehensive loss at December 31, 2014, is \$495,000 and reflects the liability related to the interest rate swap, net of the income tax benefit of \$303,000. As the Company's interest rate swap is not traded on a market exchange, the fair value is determined using a valuation model based on a discounted cash flow analysis. This analysis reflects the contractual terms of the interest rate swap agreement and uses observable market-based inputs, including estimated future LIBOR interest rates. The fair value of the Company's interest rate swap is the net difference in the discounted future fixed cash payments and the discounted expected variable cash receipts. The variable cash receipts are based on the expectation of future interest rates and are observable inputs available to a market participant. The interest rate swap valuation is

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classified in Level 2 of the fair value hierarchy, in accordance with the FASB's guidance on *Fair Value Measurements and Disclosures*.

*Capitalized Lease Obligations*

During 2011, the Company entered into a series of lease agreements to finance the purchase of certain equipment primarily for the implementation of Electronic Medical Records ("EMR") in its nursing centers. Additionally, upon acquisition of certain facilities we assumed certain leases, primarily related to equipment, that constitute capital leases. As a result, we have recorded the underlying lease assets and capitalized lease obligations of \$324,000 and \$667,000 as of December 31, 2014 and 2013, respectively. These lease agreements provide three to five year terms.

Scheduled payments of the capitalized lease obligations are as follows:

2015	\$	176,000
2016		135,000
2017		27,000
Total		<u>338,000</u>
Amounts related to interest		<u>(14,000)</u>
Principal payments on capitalized lease obligation	\$	<u><u>324,000</u></u>

**7. VARIABLE INTEREST ENTITY**

On December 28, 2011, the Company completed construction of Rose Terrace Health and Rehabilitation Center ("Rose Terrace"), its third health care center in West Virginia. The 90-bed skilled nursing center is located in Culloden, West Virginia, along the Huntington-Charleston corridor, and offers 24-hour skilled nursing care designed to meet the care needs of both short and long-term nursing patients. The Rose Terrace nursing center utilizes a Certificate of Need the Company obtained in June 2009, when the Company completed the acquisition of certain assets of a skilled nursing center in West Virginia.

The Company initially entered into a lease agreement with the real estate developer that constructed, furnished, and equipped Rose Terrace. The agreement included the right to purchase the center and all associated assets beginning at the end of the first year of the initial term of the lease and continuing through the fifth year for a purchase price ranging from 110% to 120% of the total project cost. On March 27, 2014, the Company exercised this purchase option and acquired the land, building, and all other assets of the Rose Terrace nursing center from the real estate developer for the contractually agreed upon price of \$7,693,000.

Prior to the exercise of the purchase option, the Company had determined it was the primary beneficiary of the variable interest entity ("VIE") that developed the Rose Terrace nursing center based on the ownership of the Certificate of Need, the fixed price purchase option described above, the Company's ability to direct the activities that most significantly impact the economic performance of the VIE, and the right to receive potentially significant benefits from the VIE. Accordingly, as the primary beneficiary, the Company consolidated the balance sheet and results of operations of the VIE for periods prior to the exercise of the purchase option. However, after the exercise of the purchase option, the previous owners paid the outstanding debt related to the entity in full. Subsequently, as further disclosed in Note 3, the Company sold the Rose Terrace facility and all assets associated with the facility. As a result of these events, the real estate development entity is no longer considered a VIE.

The following table summarizes the accounts and amounts included in the Company's Consolidated Balance Sheet that are associated with the real estate developer's interests in the VIE. As a result of the aforementioned transaction, no balances exist as of December 31, 2014.

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	December 31, 2014	December 31, 2013
Land	\$ —	\$ 787,000
Building and improvements, net	—	5,613,000
Furniture, fixtures and equipment, net	—	431,000
Other assets	—	80,000
	<u>\$ —</u>	<u>\$ 6,911,000</u>
Current accruals	\$ —	\$ —
Notes payable, including current portion	—	5,476,000
Non-controlling interests	—	1,435,000
	<u>\$ —</u>	<u>\$ 6,911,000</u>

	Year Ended December 31, 2014	Year Ended December 31, 2013
Beginning non-controlling interests	\$ 1,437,000	\$ 1,573,000
Comprehensive income attributable to non-controlling interests	(25,000)	72,000
Deconsolidation of/distributions to non-controlling interest owners	(1,412,000)	(208,000)
Ending non-controlling interests	<u>\$ —</u>	<u>\$ 1,437,000</u>

## **8. SHAREHOLDERS' EQUITY, STOCK PLANS AND PREFERRED STOCK**

### **Shareholders' Rights Plan**

On May 7, 2014, the Company entered into a fourth amendment (the “Fourth Amendment”) to the Amended and Restated Rights Agreement, dated as of December 7, 1998, as amended March 19, 2005, August 15, 2008, and August 14, 2009 between the Company (formerly Advocat Inc.) and ComputerShare Trust Company, N.A., as successor to SunTrust Bank, as Rights Agent. In the Fourth Amendment, the Company changed the Expiration Date of the preferred share purchase rights (the “Rights”) under the Rights Agreement from August 2, 2018 to May 15, 2014. As a result of the Fourth Amendment, the Rights Agreement terminated by its terms and is of no further force and effect and the Rights expired at the close of business on May 15, 2014.

### **Stock Based Compensation Plans**

The Company follows the FASB's guidance on *Stock Compensation* to account for stock-based payments granted to employees and non-employee directors.

#### *Overview of Plans*

In December 2005, the Compensation Committee of the Board of Directors adopted the 2005 Long-Term Incentive Plan (“2005 Plan”). The 2005 Plan allows the Company to issue stock options and other share and cash based awards. Under the 2005 Plan, 700,000 shares of the Company's common stock have been reserved for issuance upon exercise of equity awards granted thereunder. All grants under this plan expire 10 years from the date the grants were authorized by the Board of Directors.

In June 2008, the Company adopted the Advocat Inc. 2008 Stock Purchase Plan for Key Personnel (“Stock Purchase Plan”). The Stock Purchase Plan provides for the granting of rights to purchase shares of the Company's common stock to directors and officers and 150,000 shares of the Company's common stock has been reserved for issuance under the Stock Purchase Plan. The Stock Purchase Plan allows participants to elect to utilize a specified portion of base salary, annual cash bonus, or director compensation to purchase restricted shares or restricted share units (“RSU's”) at 85% of the quoted market price of a share of the Company's common stock on the date of purchase. The restriction period under the Stock Purchase Plan is generally two years from the date of purchase and during which the shares will have the rights to receive dividends, however, the restricted share certificates will not be delivered to the shareholder and the shares cannot be sold, assigned or disposed of during the restriction period and are subject to forfeiture. No grants can be made under the Stock Purchase Plan after April 25, 2018.



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In April 2010, the Compensation Committee of the Board of Directors adopted the 2010 Long-Term Incentive Plan ("2010 Plan"), followed by approval by the Company's shareholders in June 2010. The 2010 Plan allows the Company to issue stock appreciation rights, stock options and other share and cash based awards. Under the 2010 Plan, 380,000 shares of the Company's common stock have been reserved for issuance upon exercise of equity awards granted.

*Equity Grants and Valuations*

During 2014 and 2013, the Compensation Committee of the Board of Directors approved grants totaling approximately 68,000 shares of restricted common stock to certain employees and members of the Board of Directors. These restricted shares vest one-third on the first, second and third anniversaries of the grant date. A portion of these restricted shares vest 33% on the first, second and third anniversaries of the grant date, while another portion vested 33% upon grant and on the first and second anniversaries of the grant date. Unvested shares may not be sold or transferred. During the vesting period, dividends accrue on the restricted shares, but are paid in additional shares of common stock upon vesting, subject to the vesting provisions of the underlying restricted shares. The restricted shares are entitled to the same voting rights as other common shares. Upon vesting, all restrictions are removed.

During 2012, the Compensation Committee of the Board of Directors approved the grant of Stock Only Stock Appreciation Rights ("SOSARs") at the market price of the Company's common stock on the grant date. The SOSARs vest one-third on the first, second and third anniversaries of the grant date. The SOSARs are valued and recorded in the same manner as stock options, and will be settled with issuance of new stock for the difference between the market price on the date of exercise and the strike price.

The Company recorded non-cash stock-based compensation expense from continuing operations for equity grants and RSU's issued under the Plans of \$580,000, \$950,000, and \$573,000 during the years ended December 31, 2014, 2013, and 2012, respectively. Such amounts are included as components of general and administrative expense or operating expense based upon the classification of cash compensation paid to the related employees. As of December 31, 2014, there was \$251,000 in unrecognized compensation costs related to stock-based compensation to be recognized over the applicable remaining vesting periods. The Company estimated the total recognized and unrecognized compensation for all options and SOSARs using the Black-Scholes-Merton equity grant valuation model. Restricted stock awards are valued using an intrinsic valuation method based on the market price on the grant date.

The table below shows the weighted average assumptions the Company used to develop the fair value estimates under its option valuation model:

	<b>Year Ended December 31,</b>		
	<b>2014</b>	<b>2013</b>	<b>2012</b>
Expected volatility (range)	N/A <sup>(1)</sup>	N/A <sup>(1)</sup>	58% - 59%
Risk free interest rate (range)	N/A <sup>(1)</sup>	N/A <sup>(1)</sup>	0.80% - 1.03%
Expected dividends	N/A <sup>(1)</sup>	N/A <sup>(1)</sup>	3.75%
Weighted average expected term (years)	N/A <sup>(1)</sup>	N/A <sup>(1)</sup>	6

- (1) The Company did not issue any options or other equity grants that would require application of the Black-Scholes-Merton equity grant valuation model during the years ended December 31, 2014 and 2013. All equity grants during these periods were restricted common shares which are valued using an intrinsic valuation method based on market price.

In computing the fair value estimates using the Black-Scholes-Merton valuation model, the Company took into consideration the exercise price of the equity grants and the market price of the Company's stock on the date of grant. The Company used an expected volatility that equals the historical volatility over the most recent period equal to the expected life of the equity grants. The risk free interest rate is based on the U.S. treasury yield curve in effect at the time of grant. The Company used the expected dividend yield at the date of grant, reflecting the level of annual cash dividends currently being paid on its common stock.

In computing the fair value of these equity grants, the Company estimated the equity grants' expected term based on the average of the vesting term and the original contractual terms of the grants, consistent with the Securities and Exchange Commission's interpretive guidance often referred to as the "Simplified Method." The Company continues to use the Simplified Method since the Company's exercise history is not representative of the expected term of the equity granted in 2011. The Company's recent exercise history is primarily from options granted in 2005 that were vested at grant date and were significantly in-the-money due

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to an increase in stock price during the period between grant date and formal approval by shareholders, and from older options granted several years ago that had fully vested.

The table below describes the resulting weighted average grant date fair values calculated as well as the intrinsic value of options exercised under the Company's equity awards during each of the following years:

	<b>Year Ended December 31,</b>		
	<b>2014<sup>(1)</sup></b>	<b>2013<sup>(1)</sup></b>	<b>2012</b>
Weighted average grant date fair value	—	\$ —	\$ 2.29
Total intrinsic value of exercises	\$ 126,000	\$ 53,000	\$ 12,000

- (1) The Company did not issue any options or other equity grants that would require application of the Black-Scholes-Merton equity grant valuation model during the years ended December 31, 2014 and 2013. All equity grants during these periods were restricted common shares which are valued using an intrinsic valuation method based on market price.

The following table summarizes information regarding stock options and SOSAR grants outstanding as of December 31, 2014:

<b>Range of Exercise Prices</b>	<b>Weighted Average Exercise Prices</b>	<b>Grants Outstanding</b>	<b>Intrinsic Value-Grants Outstanding</b>	<b>Grants Exercisable</b>	<b>Intrinsic Value-Grants Exercisable</b>
\$10.40 to \$11.59	\$ 11.14	57,000	\$ —	57,000	\$ —
\$2.37 to \$6.21	\$ 5.50	214,000	849,000	201,000	801,000
		<u>271,000</u>		<u>258,000</u>	

As of December 31, 2014, the outstanding equity grants have a weighted average remaining life of 4.78 years and those outstanding equity grants that are exercisable have a weighted average remaining life of 4.63 years. During the year ended December 31, 2014, approximately 25,000 stock option and SOSAR grants were exercised under these plans. All of the equity grants exercised were net settled, therefore no proceeds were contributed.

Summarized activity of the equity compensation plans is presented below:

	<b>SOSARs/ Options</b>	<b>Weighted Average Exercise Price</b>
Outstanding, December 31, 2013	333,000	\$ 6.64
Granted	—	—
Exercised	(25,000)	4.58
Expired or cancelled	(37,000)	7.87
Outstanding, December 31, 2014	<u>271,000</u>	<u>\$ 6.67</u>
Exercisable, December 31, 2014	<u>258,000</u>	<u>\$ 6.71</u>

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	<b>Restricted Shares</b>	<b>Weighted Average Grant Date Fair Value</b>
Outstanding, December 31, 2013	118,000	\$ 5.41
Granted	68,000	5.51
Dividend Equivalents	4,000	8.06
Vested	(57,000)	5.61
Cancelled	(3,000)	5.50
Outstanding December 31, 2014	130,000	\$ 5.45

Summarized activity of the Restricted Share Units for the Stock Purchase Plan is as follows:

	<b>Restricted Share Units</b>	<b>Weighted Average Grant Date Fair Value</b>
Outstanding, December 31, 2013	41,000	\$ 5.35
Granted	25,000	5.51
Dividend Equivalents	1,000	8.15
Vested	(21,000)	5.69
Cancelled	—	—
Outstanding December 31, 2014	46,000	\$ 5.35

### **Series A Preferred Stock**

The Company is authorized to issue up to 200,000 shares of Series A Preferred Stock. The Company's Board of Directors is authorized to establish the terms and rights of each series, including the voting powers, designations, preferences, and other special rights, qualifications, limitations, or restrictions thereof.

### **Series B and Series C Redeemable Preferred Stock**

As part of the consideration paid to Omega for restructuring the terms of the Omega Master Lease in November 2000, the Company issued to Omega 393,658 shares of the Company's Series B Redeemable Convertible Preferred Stock ("Series B Preferred Stock") with a stated value of \$3,300,000 and an annual dividend rate of 7% of the stated value. In October 2006, the Company and Omega entered into a Restructuring Stock Issuance and Subscription Agreement ("Restructuring Agreement") to restructure the Series B Preferred Stock, eliminating the option of Omega to convert the Series B Preferred Stock into shares of Diversicare (formerly Advocat) common stock.

At the time of the Restructuring Agreement, the Series B Preferred Stock had a recorded value (including accrued dividends) of approximately \$4,918,000 and was convertible into approximately 792,000 shares of common stock. The Company issued 5,000 shares of a new Series C Redeemable Preferred Stock ("Series C Preferred Stock") to Omega in exchange for the 393,658 shares of Series B Preferred Stock held by Omega. The Series C Preferred Stock had a stated value of approximately \$4,918,000 and an annual dividend rate of 7% of its stated value payable quarterly in cash. The Series C Preferred Stock was not convertible, but has been redeemable at its stated value at Omega's option since September 30, 2010, and since September 30, 2007, was redeemable at its stated value at the Company's option.

In connection with the termination of the conversion feature, the Company agreed to pay Omega an additional \$687,000 per year under the Lease Amendment. The additional annual payments of \$687,000 were discounted over the twelve year term of the renewal to arrive at a net present value of \$6,701,000, the preferred stock premium. The Company recorded the fair value of the elimination of the conversion feature as a reduction in Paid In Capital with an offsetting increase to record a premium on the Series C Preferred Stock. As a result, the Series C Preferred Stock was initially recorded at a total value of \$11,619,000, equal to the stated value of the Series B Preferred Stock, \$4,918,000, plus the value of the conversion feature, \$6,701,000 which was fully amortized in 2010. The stated value of the preferred stock was classified as temporary equity and the additional obligation

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is classified as a noncurrent in the accompanying consolidated balance sheet. As the related cash payments were made, the preferred stock premium was reduced and interest expense was recorded.

Effective August 14, 2014, the Company redeemed all of its outstanding shares of Series C Preferred Stock for approximately \$4,918,000 from the holder. The redemption was affected as a result of Omega's exercise of its pre-existing option to require the Company to redeem the Preferred Stock as provided in the Company's Certificate of Designation. As a result of the redemption, the Company no longer has any Series C Preferred Stock outstanding. The following table reflects activity in the Series C Preferred Stock:

<b>Series C Preferred Stock</b>			
	<b>2014</b>	<b>2013</b>	<b>2012</b>
Balance at the beginning of the period	\$ 4,918,000	\$ 4,918,000	\$ 4,918,000
Redemption of preferred stock	(4,918,000)	—	—
Balance at the end of the period	\$ —	\$ 4,918,000	\$ 4,918,000

## 9. NET INCOME (LOSS) PER COMMON SHARE

Information with respect to the calculation of basic and diluted net income (loss) per common share is presented below:

	<b>Years Ended December 31,</b>		
	<b>2014</b>	<b>2013</b>	<b>2012</b>
Numerator: Income (loss) amounts attributable to Diversicare Healthcare Services, Inc. common shareholders:			
Income (loss) from continuing operations	\$ 1,450,000	\$ (6,993,000)	\$ (3,871,000)
Less: net income attributable to noncontrolling interests	25,000	(72,000)	(126,000)
Income (loss) from continuing operations attributable to Diversicare Healthcare Services, Inc.	1,475,000	(7,065,000)	(3,997,000)
Preferred stock dividends	(220,000)	(344,000)	(344,000)
Income (loss) from continuing operations attributable to Diversicare Healthcare Services, Inc. shareholders	1,255,000	(7,409,000)	(4,341,000)
Income (loss) from discontinued operations, net of income taxes	3,258,000	(1,469,000)	951,000
Net income (loss) attributable to Diversicare Healthcare Services, Inc. Shareholders	\$ 4,513,000	\$ (8,878,000)	\$ (3,390,000)
Denominator: Basic Weighted Average Common Shares Outstanding:	6,011,000	5,899,000	5,821,000
Basic net income per common share			
Income (loss) from continuing operations	\$ 0.21	\$ (1.26)	\$ (0.74)
Income (loss) from discontinued operations			
Operating income (loss), net of taxes	(0.25)	(0.25)	0.13
Gain on disposal, net of taxes	0.79	—	0.03
Discontinued operations, net of taxes	0.54	(0.25)	0.16
Basic net income (loss) per common share	\$ 0.75	\$ (1.51)	\$ (0.58)

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	<u>2014</u>	<u>2013</u>	<u>2012</u>
Numerator: Income (loss) from continuing operations attributable to Diversicare Healthcare Services, Inc. shareholders	1,255,000	(7,409,000)	(4,341,000)
Income (loss) from discontinued operations, net of income taxes	3,258,000	(1,469,000)	951,000
Net income (loss) attributable to Diversicare Healthcare Services, Inc. Shareholders	<u>\$ 4,513,000</u>	<u>\$ (8,878,000)</u>	<u>\$ (3,390,000)</u>
Basic weighted average common shares outstanding	6,011,000	5,899,000	5,821,000
Incremental shares from assumed exercise of options, SOSARS and Restricted Stock Units	186,000	—	—
Denominator: Diluted Weighted Average Common Shares Outstanding:	<u>6,197,000</u>	<u>5,899,000</u>	<u>5,821,000</u>
Diluted net income per common share			
Income (loss) from continuing operations	\$ 0.20	\$ (1.26)	\$ (0.74)
Income (loss) from discontinued operations			
Operating income (loss), net of taxes	(0.25)	(0.25)	0.13
Gain on disposal, net of taxes	0.77	—	0.03
Discontinued operations, net of taxes	0.52	(0.25)	0.16
Diluted net income (loss) per common share	<u>\$ 0.72</u>	<u>\$ (1.51)</u>	<u>\$ (0.58)</u>

The dilutive effects of the Company's stock options, SOSARs, Restricted Shares and Restricted Share Units are included in the computation of diluted income per common share during the periods they are considered dilutive.

The following table reflects the weighted average outstanding SOSARs and Options that were excluded from the computation of diluted earnings per share, as they would have been anti-dilutive:

	<u>2014</u>	<u>2013</u>	<u>2012</u>
SOSARs/Options Excluded	57,000	310,000	348,000

The weighted average common shares for basic and diluted earnings for common shares were the same due to the losses in 2013 and 2012.

## 10. INCOME TAXES

### Overview

For the year ended December 31, 2014, the Company recorded a provision for income taxes from continuing operations of \$857,000 compared to a benefit of \$4,196,000 and \$2,147,000 in 2013 and 2012, respectively. The provision (benefit) for income taxes of continuing operations is composed of the following components:

	<u>Year Ended December 31,</u>		
	<u>2014</u>	<u>2013</u>	<u>2012</u>
Current provision (benefit) :			
Federal	\$ 10,000	\$ (77,000)	\$ (370,000)
State	10,000	29,000	14,000
	<u>20,000</u>	<u>(48,000)</u>	<u>(356,000)</u>
Deferred provision (benefit):			
Federal	798,000	(4,402,000)	(1,536,000)
State	39,000	254,000	(255,000)
	<u>837,000</u>	<u>(4,148,000)</u>	<u>(1,791,000)</u>
Provision (benefit) for income taxes of continuing operations	<u>\$ 857,000</u>	<u>\$ (4,196,000)</u>	<u>\$ (2,147,000)</u>

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A reconciliation of taxes computed at statutory income tax rates on income (loss) from continuing operations is as follows:

	<b>Year Ended December 31,</b>		
	<b>2014</b>	<b>2013</b>	<b>2012</b>
Provision (benefit) for federal income taxes at statutory rates	\$ 784,000	\$ (3,804,000)	\$ (2,046,000)
Provision (benefit) for state income taxes, net of federal benefit	76,000	(187,000)	(212,000)
Valuation allowance changes affecting the provision for income taxes	(66,000)	371,000	9,000
Employment tax credits	(169,000)	(930,000)	(172,000)
Nondeductible expenses	123,000	276,000	336,000
Stock based compensation expense	3,000	8,000	17,000
Other	106,000	70,000	(79,000)
Provision (benefit) for income taxes of continuing operations	<u>\$ 857,000</u>	<u>\$ (4,196,000)</u>	<u>\$ (2,147,000)</u>

*Deferred Taxes*

Deferred income taxes reflect the net tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes. Deferred tax assets are reduced by a valuation allowance if, based upon the weight of available evidence, it is more likely than not that we will realize only some portion of the deferred tax assets. The net deferred tax assets and liabilities, at the respective income tax rates, are as follows:

	<b>December 31,</b>	
	<b>2014</b>	<b>2013</b>
Current deferred tax assets:		
Credit carryforwards	\$ 365,000	\$ —
Net operating loss and other carryforwards	—	643,000
Allowance for doubtful accounts	2,277,000	1,788,000
Accrued liabilities	5,386,000	5,126,000
	<u>8,028,000</u>	<u>7,557,000</u>
Less valuation allowance	<u>(408,000)</u>	<u>(377,000)</u>
	<u>7,620,000</u>	<u>7,180,000</u>
Current deferred tax liabilities:		
Prepaid expenses	(604,000)	(601,000)
	<u>\$ 7,016,000</u>	<u>\$ 6,579,000</u>

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	<b>December 31,</b>	
	<b>2014</b>	<b>2013</b>
Noncurrent deferred tax assets:		
Net operating loss and other carryforwards	\$ 1,174,000	\$ 3,389,000
Credit carryforwards	2,030,000	2,210,000
Deferred lease costs	230,000	289,000
Depreciation	355,000	(634,000)
Tax goodwill and intangibles	(978,000)	(879,000)
Stock-based compensation	643,000	882,000
Accrued rent	3,786,000	4,219,000
Kansas acquisition costs	118,000	125,000
Impairment of long-lived assets	271,000	472,000
Interest rate swap	303,000	349,000
Noncurrent self-insurance liabilities	5,639,000	6,422,000
	<u>13,571,000</u>	<u>16,844,000</u>
Less valuation allowance	(686,000)	(932,000)
	<u>\$ 12,885,000</u>	<u>\$ 15,912,000</u>

*Deferred Tax Valuation Allowance*

The assessment of the amount of value assigned to our deferred tax assets under the applicable accounting standards is highly judgmental. We are required to consider all available positive and negative evidence in evaluating the likelihood that we will be able to realize the benefit of our deferred tax assets in the future. Such evidence includes scheduled reversals of deferred tax assets and liabilities, projected future taxable income, tax-planning strategies, and the results of recent operations. Since this evaluation requires consideration of historical and future events, there is significant judgment involved, and our conclusion could be materially different should certain of our expectations not transpire.

When assessing all available evidence, we consider the weight of the evidence, both positive and negative, based on the objectivity of the underlying evidence and the extent to which it can be verified. For the three-year period ended December 31, 2014, the Company has a cumulative pre-tax loss from continuing operations of \$14,900,000, which was partially offset by \$2,307,000 of income attributable to the year ended December 31, 2014. Additionally, the Company recognized governmental and regulatory changes have put downward revenue pressure on the long-term care industry as a piece of negative evidence in our analysis. As a result of this negative evidence, the Company performed a thorough assessment of the available positive and negative evidence in order to ascertain whether it is more-likely-than-not that in future periods the Company will generate sufficient pre-tax income to utilize all of our federal deferred tax assets and our net operating loss and other carryforwards and credits. State deferred tax assets are considered for valuation separately and on a state-by-state basis.

The Company also identified several pieces of objective positive evidence which were considered and weighed in the analysis performed regarding the valuation of deferred tax assets, including, but not limited to the improvement in financial performance for the year ended December 31, 2014, the degree to which nonrecurring expenses caused the last three year cumulative pre-tax loss, the expected accretive strategic acquisitions completed by us during the three-year period, corporate and regional restructuring expected to reduce costs while maintaining revenue levels, the long-term expiration dates of a majority of the net operating losses and credits, our history of not having carryforwards or credits expire unutilized, and the completed divestiture of the facilities in Arkansas in 2013 and West Virginia in 2014. The operations in the states of Arkansas and West Virginia demonstrated a trend of growing losses in recent years primarily as a result of disproportionate amount of professional liability expense relative to the revenue contributed. Additionally, the net operating loss created in 2013 was fully utilized during 2014 as a result of the income produced from operations and the taxable gain on the sale of Rose Terrace.

In performing the analysis, the Company contemplated utilization of the deferred tax assets under multiple scenarios. After consideration of these factors, the Company determined that it was more likely than not that future taxable income would be sufficient to realize substantially all of the recorded value of the Company's deferred tax assets for federal income tax purposes.

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Realization of the deferred tax assets is not assured and future events could result in a change in judgment. If future events result in a conclusion that realization is no longer more likely than not to occur, the Company would be required to establish a valuation allowance on the deferred tax assets at that time, which would result in a charge to income tax expense and a potentially material decrease in net income in the period in which the factors change our judgment.

At December 31, 2014, the Company had \$7,837,000 of net operating losses, which expire at various dates beginning in 2019 and continue through 2033. The use of a portion of these loss carryforwards is limited by change in ownership provisions of the Federal tax code to a maximum of approximately \$2,971,000. The Company has reduced the deferred tax asset and the corresponding valuation allowances for net operating loss deductions permanently lost as a result of the change in ownership provisions.

With respect to state deferred tax assets, the Company reduced the valuation allowance by approximately \$215,000 in 2014, primarily related to the expectation that deferred tax assets for which valuation allowances had previously been applied would more-likely-than-not be utilized as a result of the increase in taxable income during the year ended December 31, 2014. In 2013 and 2012, the Company recorded a deferred tax (provision) benefit to adjust approximately \$(448,000) and \$7,000, respectively, of the valuation allowance on state deferred tax assets. The changes in valuation allowance were based on the Company's assessment of the realization of certain individual tax assets. The Company has recorded a total valuation allowance of approximately \$1,094,000 at December 31, 2014 to reduce the deferred tax assets by the amount management believes is more likely than not to be realized through the turnaround of existing temporary differences, future earnings, or a combination thereof.

Under the Work Opportunity Tax Credit ("WOTC") program, the Company recorded \$550,000, \$1,124,000 and \$130,000 in Work Opportunity Tax Credits during 2014, 2013 and 2012, respectively. On December 19, 2014, the Tax Increase Prevention Act of 2012 (the "Act") was signed into law. The Act retroactively reinstated the federal Work Opportunity Tax Credit for qualifying costs paid during 2014. Pursuant to ASC 740-10-25-47, the effect of changes in the tax laws including retroactive changes are recognized in the period the law was enacted, and as a result of the retroactive treatment, the credit was recognized in the financial statements during the fourth quarter of 2014. The remaining WOTC credit carryforwards expire at various dates beginning in 2030 and continue through 2034.

#### *Unrecognized Tax Benefits and Liabilities*

The Company follows the FASB's guidance on financial statement recognition and measurement of tax positions taken, or expected to be taken, in tax returns evaluating the need to recognize or unrecognized uncertain tax positions. A reconciliation of the beginning and ending amount of unrecognized tax benefits is as follows:

	<b>2014</b>	<b>2013</b>	<b>2012</b>
Balance at the beginning of the period	\$ —	\$ 86,000	\$ 84,000
Changes in tax positions for prior years	—	(86,000)	2,000
Balance at the end of the period	<u>\$ —</u>	<u>\$ —</u>	<u>\$ 86,000</u>

The Company records the liabilities associated with our unrecognized tax benefits in "other current liabilities" on the consolidated balance sheet. The net change in the amount of unrecognized tax benefits during the years ended December 31, 2013 and 2012 was related primarily to the adjustment of the estimated liability and resolution of outstanding uncertain tax positions. Further, the Company recognizes interest and penalties related to unrecognized tax benefits within the income tax expense line in the consolidated statements of operations.

The Company has received notice of a pending audit by the Internal Revenue Service related to the 2012 tax year. As of December 31, 2014, the Company's tax years for 2011 forward are subject to examination by tax authorities.

## **11. COMMITMENTS AND CONTINGENCIES**

### **Lease Commitments**

The Company is committed under long-term operating leases with various expiration dates and varying renewal options. Minimum annual rentals, including renewal option periods (exclusive of taxes, insurance, and maintenance costs) under these leases beginning January 1, 2015, are as follows:



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2015	\$ 31,140,000
2016	31,407,000
2017	31,808,000
2018	32,338,000
2019	33,300,000
Thereafter	432,138,000
	<u>\$ 592,131,000</u>

Under these lease agreements, the Company's lease payments are subject to periodic annual escalations as described below and in Note 1. Total lease expense for continuing operations was \$26,151,000, \$20,396,000 and \$18,018,000 for 2014, 2013 and 2012, respectively. The accrued liability related to straight line rent was \$9,579,000 and \$10,759,000 at December 31, 2014 and 2013, respectively, and is included in "Other noncurrent liabilities" on the accompanying consolidated balance sheets.

### **Omega Master Lease**

The Company leases 23 nursing centers from Omega under a Master Lease. On October 20, 2006, the Company and Omega entered into a Third Amendment to Consolidated Amended and Restated Master Lease ("Lease Amendment") to extend the term of its facilities leased from Omega. The Lease amendment extended the term to September 30, 2018 and provided a renewal option of an additional twelve years. Consistent with prior terms, the lease provides for annual increases in lease payments equal to the lesser of two times the increase in the consumer price index or 3 percent. Under generally accepted accounting principles, the Company is required to report these scheduled rent increases on a straight line basis over the term of the lease including the 12 year term of the renewal period. These scheduled increases had no effect on cash rent payments at the start of the lease term and only result in additional cash outlay as the annual increases take effect each year.

The Company entered into an agreement with Omega to terminate its lease with respect to eleven nursing centers located in Arkansas and concurrently entered into operation transfer agreements to transfer the operations of each of those eleven centers to an operator selected by Omega. In connection with the closing of this transaction, the Company and Omega entered into the Thirteenth Amendment to the Master Lease. This amendment effectively modifies the terms of the Master Lease to terminate the terms surrounding the eleven nursing centers in Arkansas, and only as to those eleven centers, and effectively reduced the annual rent payable under the Master Lease by \$5,000,000.

In addition to the amendment to terminate the portion of the lease with respect to the Arkansas centers, the Company further amended the Master Lease by entering into the Fifteenth Amendment to Consolidated Amended and Restated Master Lease as a result of the disposition and transfer of operations of the Company's West Virginia nursing centers. This amendment effectively modified the terms of the Master Lease to terminate the lease with regard to the two West Virginia nursing centers, and effectively reduced the annual rent payable under the Master Lease by \$1,900,000.

The Master Lease requires the Company to fund annual capital expenditures related to the leased facilities at an amount currently equal to \$434 per licensed bed. These amounts are subject to adjustment for increases in the Consumer Price Index. The Company is in compliance with the capital expenditure requirements. Total required capital expenditures during the remaining lease term and renewal options are \$4,563,000. These capital expenditures are being depreciated on a straight-line basis over the shorter of the asset life or the appropriate lease term.

Upon expiration of the Master Lease or in the event of a default under the Master Lease, the Company is required to transfer all of the leasehold improvements, equipment, furniture and fixtures of the leased facilities to Omega. The assets to be transferred to Omega are being amortized on a straight-line basis over the shorter of the remaining lease term or estimated useful life, and will be fully depreciated upon the expiration of the lease. All of the equipment, inventory and other related assets of the facilities leased pursuant to the Master Lease have been pledged as security under the Master Lease. In addition, the Company has a letter of credit of \$4,551,000 as a security deposit for the Company's leases with Omega, as described in Note 6.

### **Renovation Funding**

In January 2013, we entered into an amendment to the Master lease with Omega under which Omega agreed to provide an additional \$5,000,000 to fund renovations to two nursing centers located in Texas that are leased from Omega. The annual base rent related to these facilities will be increased to reflect the amount of capital improvements to the respective facilities as the related expenditures are made. The increase is based on a rate of 10.25% per year of the amount financed under this amendment.

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This arrangement is similar to amendments entered into in previous years that provided financing totaling \$20,000,000 that was used to fund renovations at fourteen nursing centers leased from Omega.

The Company completed an expansion to one of its facilities by making use of fifteen licensed beds it acquired in 2005. This expansion project was funded by Omega with the renovation funding previously described. This project increased capacity and footprint compared to the Company's previous lessor-funded facility projects which included renovations of existing facilities, but did not increase capacity. Accordingly, the costs incurred to expand the facility are recorded as a leasehold improvement asset with the amounts reimbursed by Omega for this project included as a long-term liability and amortized to rent expense over the remaining term of the lease. The capitalized leasehold improvements and lessor reimbursed costs are being amortized over the initial lease term ending in September 2018. The leasehold improvement asset and accumulated amortization are as follows:

	<b>December 31</b>	
	<b>2014</b>	<b>2013</b>
Leasehold improvement	\$ 921,000	\$ 921,000
Accumulated Amortization	(526,000)	(421,000)
Net Intangible	<u>\$ 395,000</u>	<u>\$ 500,000</u>

*Other Operating Leases*

In addition to the Master Lease, the Company currently leases sixteen other nursing centers which primarily operate under individual leases. The lease terms for these centers range from nine years to twenty years including renewal options. While the individual lease terms vary from center to center, the majority of the lease include annual lease increases which are capped and, in most cases, are subject to adjustment for increases in the Consumer Price Index. All operating leases are accounted for using a straight-line rent methodology.

**Insurance Matters**

*Professional Liability and Other Liability Insurance*

The Company has professional liability insurance coverage for its nursing centers that, based on historical claims experience, is likely to be substantially less than the claims that are expected to be incurred. Effective July 1, 2013, the Company established a wholly-owned, offshore limited purpose insurance subsidiary, SHC Risk Carriers, Inc. ("SHC"), to replace some of the expiring commercial policies. SHC covers losses up to specified limits per occurrence. All of the Company's nursing centers in Florida, Tennessee, and West Virginia are now covered under the captive insurance policies along with most of the nursing centers in Alabama, Kentucky, and Texas. The insurance coverage provided for these centers under the SHC policy includes coverage limits of at least \$500,000 per medical incident with a sublimit per center of \$1,000,000 and total annual aggregate policy limits of \$5,000,000. All other centers within the Company's portfolio are covered through various commercial insurance policies which provide similar coverage limits per medical incident, per location, and on an aggregate basis for covered centers.

*Reserve for Estimated Self-Insured Professional Liability Claims*

Because the Company's actual liability for existing and anticipated professional liability and general liability claims will exceed the Company's limited insurance coverage, the Company has recorded total liabilities for reported and incurred, but not reported claims of \$25,163,000 as of December 31, 2014. This accrual includes estimates of liability for incurred but not reported claims, estimates of liability for reported but unresolved claims, actual liabilities related to settlements, including settlements to be paid over time, and estimates of legal costs related to these claims. All losses are projected on an undiscounted basis and are presented without regard to any potential insurance recoveries. Amounts are added to the accrual for estimates of anticipated liability for claims incurred during each period, and amounts are deducted from the accrual for settlements paid on existing claims during each period.

The Company evaluates the adequacy of this liability on a quarterly basis. Semi-annually, the Company retains a third-party actuarial firm to assist in the evaluation of this reserve. Since May 2012, Merlinos & Associates, Inc. ("Merlinos") has assisted management in the preparation of the appropriate accrual for incurred but not reported general and professional liability claims based on data furnished as of May 31 and November 30 of each year. Merlinos primarily utilizes historical data regarding the frequency and cost of the Company's past claims over a multi-year period, industry data and information regarding the number of occupied beds to develop its estimates of the Company's ultimate professional liability cost for current periods. The Actuarial Division of Willis of Tennessee, Inc. assisted the Company with all estimates prior to May 2012.

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On a quarterly basis, the Company obtains reports of asserted claims and lawsuits incurred. These reports, which are provided by the Company's insurers and a third party claims administrator, contain information relevant to the actual expense already incurred with each claim as well as the third-party administrator's estimate of the anticipated total cost of the claim. This information is reviewed by the Company quarterly and provided to the actuary semi-annually. Based on the Company's evaluation of the actual claim information obtained, the semi-annual estimates received from the third-party actuary, the amounts paid and committed for settlements of claims and on estimates regarding the number and cost of additional claims anticipated in the future, the reserve estimate for a particular period may be revised upward or downward on a quarterly basis. Any increase in the accrual decreases results of operations in the period and any reduction in the accrual increases results of operations during the period.

The Company's cash expenditures for self-insured professional liability costs from continuing operations were \$4,757,000, \$4,485,000, and \$1,805,000 for the years ended December 31, 2014, 2013 and 2012, respectively.

The Company follows the FASB Accounting Standards Update, "Presentation of Insurance Claims and Related Insurance Recoveries," that clarifies that a health care entity should not net insurance recoveries against a related professional liability claim and that the amount of the claim liability should be determined without consideration of insurance recoveries. Accordingly, the Company has recorded estimated insurance recovery receivables included within "Other Current Assets" on the Consolidated Balance Sheet of \$246,000 at December 31, 2014 and \$440,000 at December 31, 2013, respectively.

Although the Company adjusts its accrual for professional and general liability claims on a quarterly basis and retains a third-party actuarial firm semi-annually to assist management in estimating the appropriate accrual, professional and general liability claims are inherently uncertain, and the liability associated with anticipated claims is very difficult to estimate. Professional liability cases have a long cycle from the date of an incident to the date a case is resolved, and final determination of the Company's actual liability for claims incurred in any given period is a process that takes years. As a result, the Company's actual liabilities may vary significantly from the accrual, and the amount of the accrual has and may continue to fluctuate by a material amount in any given period. Each change in the amount of this accrual will directly affect the Company's reported earnings and financial position for the period in which the change in accrual is made.

#### *Other Insurance*

With respect to workers' compensation insurance, substantially all of the Company's employees became covered under either an indemnity insurance plan or state-sponsored programs in May 1997. The Company is completely self-insured for workers' compensation exposures prior to May 1997. The Company has been and remains a non-subscriber to the Texas workers' compensation system and is, therefore, completely self-insured for employee injuries with respect to its Texas operations. From June 30, 2003 until June 30, 2007, the Company's workers' compensation insurance programs provided coverage for claims incurred with premium adjustments depending on incurred losses. For the period from July 1, 2008 through December 31, 2013, the Company is covered by a prefunded deductible policy. Under this policy, the Company is self-insured for the first \$500,000 per claim, subject to an aggregate maximum of \$3,000,000. The Company funds a loss fund account with the insurer to pay for claims below the deductible. The Company accounts for premium expense under this policy based on its estimate of the level of claims subject to the policy deductibles expected to be incurred. The liability for workers' compensation claims is \$250,000 at December 31, 2014. The Company has a non-current receivable for workers' compensation policies covering previous years of \$1,357,000 as of December 31, 2014. The non-current receivable is a function of payments paid to the Company's insurance carrier in excess of the estimated level of claims expected to be incurred.

As of December 31, 2014, the Company is self-insured for health insurance benefits for certain employees and dependents for amounts up to \$175,000 per individual annually. The Company provides reserves for the settlement of outstanding self-insured health claims at amounts believed to be adequate. The liability for reported claims and estimates for incurred but unreported claims is \$687,000 at December 31, 2014. The differences between actual settlements and reserves are included in expense in the period finalized.

#### **Employment Agreements**

The Company has employment agreements with certain members of management that provide for the payment to these members of amounts up to 2.0 times their annual salary in the event of a termination without cause, a constructive discharge (as defined in each employee agreement), or upon a change in control of the Company (as defined in each employee agreement). The maximum contingent liability under these agreements is \$1,767,000 as of December 31, 2014. The terms of such agreements are from 1 to 3 years and automatically renew for 1 year if not terminated by the employee or the Company. In addition, upon the occurrence of any triggering event, these certain members of management may elect to require the Company to purchase equity awards granted to them for a purchase price equal to the difference in the fair market value of the Company's common stock at the date

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of termination versus the stated equity award exercise price. Based on the closing price of our common stock on December 31, 2014, there is \$366,000 of contingent liabilities for the repurchase of the equity grants.

No amounts have been accrued for these contingent liabilities for members of management the Company currently employs.

### **Health Care Industry and Legal Proceedings**

The provision of health care services entails an inherent risk of liability. Participants in the health care industry are subject to lawsuits alleging malpractice, violations of false claims acts, product liability, or related legal theories, many of which involve large claims and significant defense costs. Like many other companies engaged in the long-term care profession in the United States, we have numerous pending liability claims, disputes and legal actions for professional liability and other related issues. It is expected that we will continue to be subject to such suits as a result of the nature of our business. Further, as with all health care providers, we are periodically subject to regulatory actions seeking fines and penalties for alleged violations of health care laws and are potentially subject to the increased scrutiny of regulators for issues related to compliance with health care fraud and abuse laws and with respect to the quality of care provided to residents of our facility. Like other health care providers, in the ordinary course of our business, we are also subject to claims made by employees and other disputes and litigation arising from the conduct of our business.

As of December 31, 2014, we are engaged in 51 professional liability lawsuits. Ten lawsuits are currently scheduled for trial or arbitration during the next twelve months, and it is expected that additional cases will be set for trial or hearing. The ultimate results of any of our professional liability claims and disputes cannot be predicted. We have limited, and sometimes no, professional liability insurance with regard to most of these claims. A significant judgment entered against us in one or more of these legal actions could have a material adverse impact on our financial position and cash flows.

In July 2013, the Company learned that the United States Attorney for the Middle District of Tennessee (DOJ) had commenced a civil investigation of potential violations of the False Claims Act (FCA) at two of the Company's facilities. Notice to the Company came in the form of a civil investigative demand (CID), a form of subpoena, to produce certain documents relating to our practices and policies for rehabilitation and other services since 2010 at those two facilities. The Company responded to this limited CID and has cooperated with the DOJ in connection with its investigation. In October 2014, the Company received a second CID indicating that the DOJ's investigation now covers all of the Company's facilities, but only directing the Company to produce material related to a total of six of the Company's facilities. The Company has also received from the OIG requests for the medical records of certain patients. The Company intends to respond to the most recent requests and to continue cooperating with the DOJ and the OIG in the investigation. The Company cannot predict the outcome of this investigation or any possible related proceedings, and the outcome could have a materially adverse effect on the Company, including the imposition of damages, fines, penalties and/or a corporate integrity agreement, but the Company is committed to provide caring and professional services to its patients and residents in compliance with applicable laws and regulations.

In November 2012, a purported stockholder class action complaint was filed in the Chancery Court for Williamson County, Tennessee (21st Judicial District) against the Company's Board of Directors. This action alleges that the Board of Directors breached its fiduciary duties to stockholders related to its response to certain expressions of interest in a potential strategic transaction from Covington Investments, LLC ("Covington"). The complaint asserts that the Board failed to negotiate or otherwise appropriately consider Covington's proposals. Plaintiff has filed a motion seeking to certify the action as a class action, which is not currently set for hearing. On May 23, 2014, the plaintiff and defendants entered into a memorandum of understanding outlining the terms of a settlement subject to the execution of definitive documentation and court approval. The agreement provides that the Company will adopt and maintain certain corporate governance procedures for a period of at least three years. This settlement has not yet been approved by the court. The settlement hearing is scheduled for April 7, 2015.

In June 2012, a collective action complaint was filed in the U.S. District Court for the Western District of Arkansas against us and certain of our subsidiaries. The complaint alleges that the defendants violated the Fair Labor Standards Act (FLSA) and seeks unpaid overtime wages as well as liquidated damages. The Court conditionally certified a nationwide class of all of the Company's hourly employees, but recently decertified the class. After the class was decertified, the law firm initiating the action filed two new separate actions in federal court in Tennessee and Texas, naming as plaintiffs many of the individuals who had filed claims in the original Arkansas action. The new actions assert the same claim as was asserted in the original Arkansas action. The Company intends to defend these lawsuits vigorously.

In January 2009, a purported class action complaint was filed in the Circuit Court of Garland County, Arkansas against the Company and certain of its subsidiaries and Garland Nursing & Rehabilitation Center (the "Facility"). The complaint alleges that the defendants breached their statutory and contractual obligations to the patients of the Facility over the five-year period

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prior to the filing of the complaints. The lawsuit remains in its early stages and has not yet been certified by the court as a class action. The Company intends to defend the lawsuit vigorously.

We cannot currently predict with certainty the ultimate impact of any of the above cases on our financial condition, cash flows or results of operations. Our reserve for professional liability expenses does not include any amounts for the collective actions, the pending DOJ investigation, the purported class action against the Arkansas facilities or the lawsuit filed against our directors. An unfavorable outcome in any of these lawsuits or any of our professional liability actions, any regulatory action, any investigation or lawsuit alleging violations of fraud and abuse laws or of elderly abuse laws or any state or Federal False Claims Act case could subject us to fines, penalties and damages, including exclusion from the Medicare or Medicaid programs, and could have a material adverse impact on our financial condition, cash flows or results of operations.

### **Reimbursement**

The Company is unable to predict what, if any, reform proposals or reimbursement limitations will be implemented in the future, or the effect such changes would have on its operations. For the year ended December 31, 2014, the Company derived 29.6% and 48.4% of its total patient and resident revenues related to continuing operations from the Medicare and Medicaid programs, respectively.

The Company will attempt to increase revenues from non-governmental sources to the extent capital is available to do so, if at all. However, private payors, including Managed Care payors, are increasingly demanding that providers accept discounted fees or assume all or a portion of the financial risk for the delivery of health care services. Such measures may include capitated payments, which can result in significant losses to health care providers if patients require expensive treatment not adequately covered by the capitated rate.

## **12. SUBSEQUENT EVENT**

Effective February 1, 2015, the Company has acquired a 94-bed skilled nursing center in Glasgow, Kentucky, for a purchase price of \$7 million. Additionally, in a separate and unrelated transaction, the Company assumed operations through a lease agreement of an 85-bed skilled nursing center in Hutchinson, Kansas. The center in Kansas has an initial lease term of 10 years and includes an option to purchase that becomes exercisable after the first year of the lease. Upon completion of these transactions, the Company now operates 54 nursing centers. These centers are expected to contribute in excess of \$9 million in annual revenues.

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**13. QUARTERLY FINANCIAL INFORMATION (UNAUDITED)**

Selected quarterly financial information for each of the quarters in the years ended December 31, 2014 and 2013 is as follows:

2014	Quarter			
	First	Second	Third	Fourth
Net revenues	\$ 77,799,000	\$ 82,313,000	\$ 90,331,000	\$ 93,749,000
Professional liability expense <sup>(1)</sup>	2,061,000	1,556,000	1,743,000	1,856,000
Income (loss) from continuing operations	(433,000)	973,000	219,000	691,000
Income (loss) from discontinued operations	(612,000)	128,000	3,928,000	(186,000)
Net income (loss) attributable to Diversicare Healthcare Services, Inc. Common Shareholders	\$ (1,106,000)	\$ 1,015,000	\$ 4,099,000	\$ 505,000

Basic net income (loss) per common share for Diversicare Healthcare Services, Inc. shareholders:

Income (loss) from continuing operations	\$ (0.08)	\$ 0.15	\$ 0.03	\$ 0.11
Income (loss) from discontinued operations	(0.10)	0.02	0.65	(0.03)
Net income (loss) per common share for Diversicare Healthcare Services, Inc. shareholders	\$ (0.18)	\$ 0.17	\$ 0.68	\$ 0.08

Diluted net income (loss) per common share for Diversicare Healthcare Services, Inc. shareholders:

Income (loss) from continuing operations	\$ (0.08)	\$ 0.14	\$ 0.03	\$ 0.11
Income (loss) from discontinued operations	(0.10)	0.02	0.63	(0.03)
Net income (loss) per common share for Diversicare Healthcare Services, Inc. shareholders	\$ (0.18)	\$ 0.16	\$ 0.66	\$ 0.08

- (1) The Company's quarterly results are significantly affected by the amounts recorded for professional liability expense, as discussed further in Note 11. The amount of expense recorded for professional liability in each quarter of 2014 is set forth in the table above.

**DIVERSICARE HEALTHCARE SERVICES, INC. AND SUBSIDIARIES.**  
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2013	Quarter			
	First	Second	Third	Fourth
Net revenues	\$ 58,439,000	\$ 61,488,000	\$ 64,631,000	\$ 75,663,000
Professional liability expense <sup>(1)</sup>	1,507,000	1,758,000	947,000	1,454,000
Loss from continuing operations	(1,274,000)	(2,421,000)	(2,321,000)	(977,000)
Income (loss) from discontinued operations	327,000	242,000	(2,444,000)	406,000
Net loss attributable to Diversicare Healthcare Services, Inc. Common Shareholders	\$ (1,051,000)	\$ (2,281,000)	\$ (4,868,000)	\$ (678,000)

Basic net income (loss) per common share for Diversicare Healthcare Services, Inc. shareholders:

Loss from continuing operations	\$ (0.24)	\$ (0.43)	\$ (0.41)	\$ (0.18)
Income (loss) from discontinued operations	0.06	0.04	(0.42)	0.07
Net loss per common share for Diversicare Healthcare Services, Inc. shareholders	\$ (0.18)	\$ (0.39)	\$ (0.83)	\$ (0.11)

Diluted net income (loss) per common share for Diversicare Healthcare Services, Inc. shareholders:

Loss from continuing operations	\$ (0.24)	\$ (0.43)	\$ (0.41)	\$ (0.18)
Income (loss) from discontinued operations	0.06	0.04	(0.42)	0.07
Net loss per common share for Diversicare Healthcare Services, Inc. shareholders	\$ (0.18)	\$ (0.39)	\$ (0.83)	\$ (0.11)

- (1) The Company's quarterly results are significantly affected by the amounts recorded for professional liability expense, as discussed further in Note 11. The amount of expense recorded for professional liability in each quarter of 2013 is set forth in the table above.





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## ***Corporate Data***

### ***Corporate Offices***

Diversicare Healthcare Services, Inc.  
1621 Galleria Boulevard  
Brentwood, Tennessee 37027  
615.771.7575  
615.771.7409 (fax)

### ***Registrar and Transfer Agent***

Computershare Trust Company, N.A.  
250 Royall Street  
Canton, MA 02021  
800.962.4284

Inquiries regarding stock transfers, lost certificates, or address changes should be directed to the Stock Transfer Department at the above address.

### ***Independent Registered Public Accounting Firm***

BDO USA, LLP  
Nashville, Tennessee

### ***Stockholder Inquiries and Availability of 10-K Report***

The Company has filed its Annual Report on Form 10-K with the Securities and Exchange Commission ("SEC") for the year ended December 31, 2014. A copy of the report is available to stockholders free of charge from the following:

### ***Corporate Secretary***

Diversicare Healthcare Services, Inc.  
1621 Galleria Boulevard  
Brentwood, Tennessee 37027

Additionally, a copy is retrievable free of charge through the EDGAR system maintained by the SEC. The Company's SEC filings can be accessed through the Company's website.  
Website: <http://www.dvcr.com>

## ***Executive Officers and Directors***

### ***Executive Officers***

**Kelly J. Gill**  
Chief Executive Officer, President and Director

**Leslie D. Campbell**  
Chief Operating Officer and  
Executive Vice President

**James R. McKnight, Jr.**  
Chief Financial Officer and  
Executive Vice President

### ***Directors***

**Chad A. McCurdy**  
Chairman of the Board  
Chairman, Compensation Committee  
Managing Partner of Marlin Capital Partners, LLC

**Wallace E. Olson**  
Vice Chairman of the Board  
Diversicare Healthcare Services, Inc.

**Kelly J. Gill**  
Chief Executive Officer, President and Director  
Diversicare Healthcare Services, Inc.

**Richard M. Brame**  
Chairman, Risk Management Committee  
Private Investor

**Robert Z. Hensley**  
Chairman, Audit Committee  
Private Investor

**William C. O'Neil, Jr.**  
Chairman, Governance & Nominating Committee  
Private Investor



1621 Galleria Blvd.  
Brentwood, TN 37027  
615.771.7575

#### FORWARD-LOOKING STATEMENTS

The foregoing discussion and analysis provides information deemed by management to be relevant to an assessment and understanding of our consolidated results of operations and financial condition. This discussion and analysis should be read in conjunction with our consolidated financial statements included herein. Certain statements made by or on behalf of us, including those contained in this "Management's Discussion and Analysis of Financial Condition and Results of Operations" and elsewhere, are forward-looking statements as defined in the Private Securities Litigation Reform Act of 1995. Actual results could differ materially from those contemplated by the forward-looking statements made herein. In addition to any assumptions and other factors referred to specifically in connection with such statements, other factors, many of which are beyond our ability to control or predict, could cause our actual results to differ materially from the results expressed or implied in any forward-looking statements including, but not limited to, our ability to successfully operate the new nursing centers in Alabama, Kansas, Kentucky, Missouri, Ohio, and Indiana, our ability to increase census at our renovated centers, changes in governmental reimbursement, including the impact of the CMS final rule that has resulted in a reduction in Medicare reimbursement as of October 2012 and our ability to mitigate the impact of the revenue reduction, government regulation, the impact of the recently adopted federal health care reform or any future health care reform, any increases in the cost of borrowing under our credit agreements, our ability to comply with covenants contained in those credit agreements, the outcome of professional liability lawsuits and claims, our ability to control ultimate professional liability costs, the accuracy of our estimate of our anticipated professional liability expense, the impact of future licensing surveys, the outcome of proceedings alleging violations of state or Federal False Claims Acts, laws and regulations governing quality of care or other laws and regulations applicable to our business including laws governing reimbursement from government payors, impacts associated with the implementation of our electronic medical records plan, the costs of investing in our business initiatives and development, our ability to control costs, changes to our valuation of deferred tax assets, changes in occupancy rates in our centers, changing economic and competitive conditions, changes in anticipated revenue and cost growth, changes in the anticipated results of operations, the effect of changes in accounting policies as well as others. Investors also should refer to the risks identified in this "Management's Discussion and Analysis of Financial Condition and Results of Operations" as well as risks identified in "Part I. Item 1A. Risk Factors" for a discussion of various risk factors of the Company and that are inherent in the health care industry. Given these risks and uncertainties, we can give no assurances that these forward-looking statements will, in fact, transpire and, therefore, caution investors not to place undue reliance on them. These assumptions may not materialize to the extent assumed, and risks and uncertainties may cause actual results to be different from anticipated results. These risks and uncertainties also may result in changes to the Company's business plans and prospects. Such cautionary statements identify important factors that could cause our actual results to materially differ from those projected in forward-looking statements. In addition, we disclaim any intent or obligation to update these forward-looking statements.