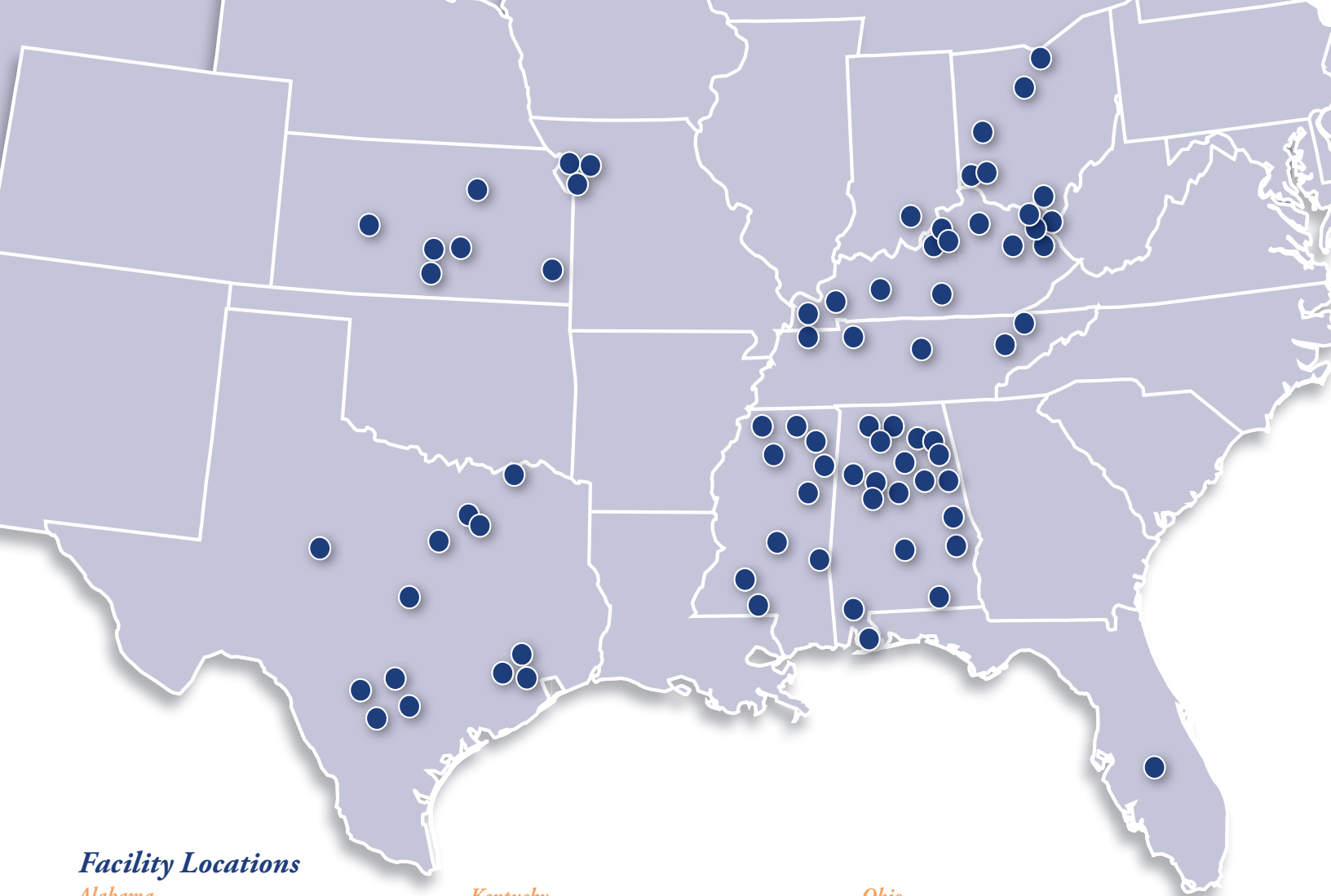




*A Trusted Name • Decades of Quality Care*

**2016**  
*Annual Report*



## Facility Locations

### Alabama

Baron House of Hueytown  
 Brookshire Healthcare Center  
 Canterbury Healthcare Facility  
 Diversicare of Arab  
 Diversicare of Bessemer  
 Diversicare of Big Springs  
 Diversicare of Boaz  
 Diversicare of Foley  
 Diversicare of Lanett  
 Diversicare of Montgomery  
 Diversicare of Oneonta  
 Diversicare of Oxford  
 Diversicare of Pell City  
 Diversicare of Riverchase  
 Diversicare of Winfield  
 Hartford Health Care  
 Lynwood Nursing Center  
 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

### Kentucky

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

### Mississippi

Diversicare of Amory  
 Diversicare of Batesville  
 Diversicare of Brookhaven  
 Diversicare of Carthage  
 Diversicare of Eupora  
 Diversicare of Meridian  
 Diversicare of Ripley  
 Diversicare of Southaven  
 Diversicare of Tupelo  
 Diversicare of Tylertown

### Missouri

Diversicare of St. Joseph  
 Riverside Place  
 St. Joseph Chateau

### 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  
 Diversicare of Lake Highlands  
 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

\*Sold 06/01/2016

## LETTER TO SHAREHOLDERS

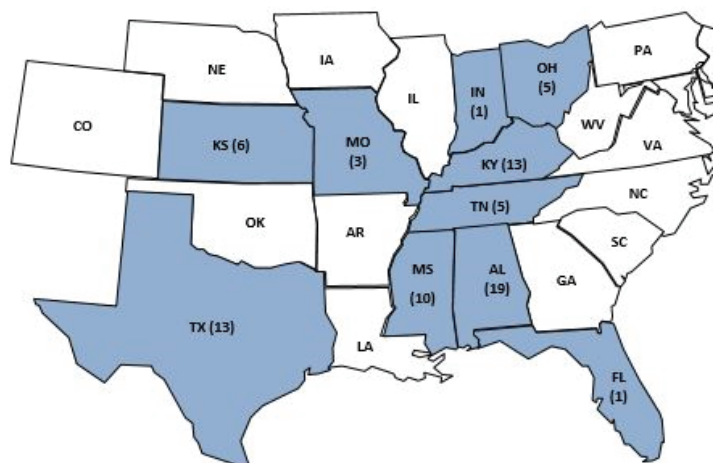
Dear Shareholder:

We are proud of our accomplishments in 2016. We had multiple notable achievements that contributed significantly to the growth and performance of the company. We hope to continue our momentum in 2017 by continuing to focus on executing our strategic plan and building upon our historical progress to deliver long term value to our shareholders.

Over the past few years, the performance of both our legacy and acquired centers has continued to improve. This year we were successful in utilizing this improved performance to complete a new credit package to recapitalize the Company's debt for future acquisitions. The net result was that we put in place a permanent credit facility of approximately \$115 million with a syndicate of six banks that is expandable to approximately \$125 million for certain needs. The features of this new credit line are a mortgage loan of \$60 million, an acquisition line of \$12.5 million, a permanent working capital revolver of \$42.25 million, and a \$10 million accordion revolver.

Without a doubt, the most important achievement for the year was the acquisition of 22 centers which were previously operated by Golden Living. Of this group, 20 are leased from Golden Living and two are leased from independent parties. As we shared at the time of this acquisition, we expect these centers to contribute annual revenue of approximately \$185 million now that they are fully implemented and on our operating platform. This expansion gives us improved scale to continue to leverage our clinical and operating platform across a broader base to contribute to our positive trends currently and moving forward. In total, this transaction represents nearly 50% incremental growth in our annual revenue run rate from our prior base and is notable in that it achieves the goal we set for ourselves in 2013 of doubling the Company's revenue within five years.

Now that we have successfully integrated the new centers from this transaction, our portfolio today consists of 76 centers comprising approximately 8,500 beds in 10 states. As shown below, our expanded geographic footprint and relative density of operating locations within each state provides for an improved marketing advantage with our referral sources and payers as they seek to source single provider relationship solutions. Our significant geographic density will support continued expansion in current and future markets.



### Key Financial Highlights for 2016

- Quarterly revenue increased in 2016 from \$98.0 million in the first quarter to \$135.0 million for the fourth quarter.
- Operating expenses decreased as a percentage of revenue from 80.3% for the first quarter to 78.9% for the fourth quarter.

## LETTER TO SHAREHOLDERS

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- General and administrative expenses increased as a percentage of revenue during the second and third quarters as we prepared for the acquisition of the 22 centers, but finished the year for the fourth quarter at 6.8% of revenue.
- Our average Medicare rate increased from \$455.24 in 2015 to \$456.30 for 2016 and our average Medicaid rate increased from \$166.16 to \$169.91 for the same year over year period.

### Scale of Growth from 2012 – 2016

- Revenue for 2016 of \$426.1 million is 84% greater than 2012 revenue of \$231.0 million, continuing a trend of significant year over year growth.
- Licensed skilled nursing beds have increased from 4,117 in 2012 to 8,500 at the end of 2016.
- Average Daily Census increased from 4,626 in 2015 to 5,061 for 2016 and was 6,402 for the fourth quarter of 2016.
- Considering the quantity and timing of our acquisitions, our expense control for operating and general and administrative expenses has been consistent and thoughtful.
- Adjusted EBITDA contributions have trended up considerably over the past five years:
  - 2012 - \$7,340,000
  - 2013 - \$4,834,000
  - 2014 - \$13,638,000
  - 2015 - \$15,662,000
  - 2016 - \$13,598,000

### Notable Year-Over-Year performance trend improvements

- Occupancy of available beds was at a five year high of 81.2%.
- Average Skilled Mix (Medicare Part A and Medicare Advantage) over 2015 and 2016 of 15.7% compares favorably to the 2012 through 2014 average of 15.4%.
- Revenue for 2016 of \$426.1 million is 10% greater than 2015 revenue of \$387.6 million, continuing a trend of significant year over year growth.
- Operating margins have remained consistent despite industry headwinds and significant growth.
- Overhead expenses have been well controlled as a percentage of revenue.

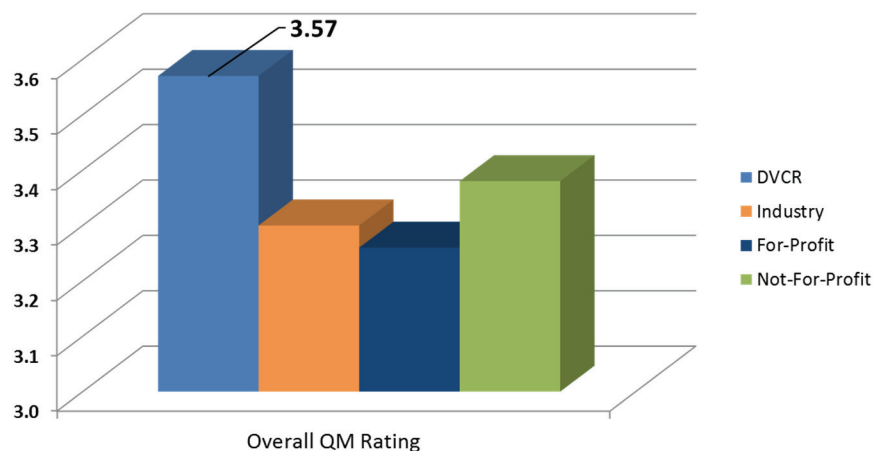
### Acquisition Performance

We have now completed 46 center acquisitions since the beginning of our growth phase, which was further defined when we set our goal of doubling our revenue in five years. A primary focus in our acquisition plan has been to own rather than lease whenever possible, and we are proud that 10 of these 46 transactions have included the purchase of the real estate. We now own the real estate for just over 22% of the centers we operate. In addition to fee simple acquisitions, we will also continue to supplement our growth opportunities by entering into long term operating leases as an additional means to continue to generate improved earnings and cash flow. Leasing of centers in this fashion is common throughout the industry and is an efficient means to leverage our growth capital. In evaluating acquisitions, we intend to focus on growth in our current markets, and to expand into new areas that complement our overall footprint.

### Quality of Care Outcomes for 2016

Of particular and notable importance throughout the year, we reported industry-leading Quality Measures scores under the CMS 5 Star program for the first three quarters of 2016 when compared to our for-profit peer group. We take great pride in being a national leader in patient quality of care outcomes and it will continue to be among our most important ongoing strategic priorities as an organization. While our same store group of centers continues this trend, our company-wide quality measures score declined as a result of our recent acquisition from Golden Living. Although our combined score is still higher than our for profit group segment, our goals are set much higher and our team is committed and working diligently to regain our position as the clear industry quality leader.

## LETTER TO SHAREHOLDERS



### Our Strategy Going Forward

We believe that the accomplishments of 2016 validate the plans that we have shared with our investors. More broadly, our accomplishments over the past 5 years point to a clear track record of success, which supports our belief that we are making significant progress towards achieving our goal of being a recognized national leader in the post-acute sector. We continue to be excited about our forward momentum and are optimistically facing the challenges on the road ahead. As always, none of this would be possible without our thousands of team members who work tirelessly to provide high quality care in our centers. Our team is committed to our mission to *Improve Every Life We Touch, Provide Exceptional Healthcare, and Exceed Expectations*.

Thank you for your continued trust and confidence in us. We greatly appreciate your support and 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 centers near the time we commence operations.

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 nursing centers.* 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. 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.

*Development of additional specialty services.* Our strategy includes the development of additional specialty units and programming in nursing centers 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 centers 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 centers, 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, 2016, our continuing operations consist of 76 nursing centers with 8,453 licensed skilled 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, Mississippi, 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, 2016:

	Number of Centers	Licensed Nursing Beds <sup>(1)</sup>	Available Nursing Beds <sup>(1)</sup>
<b>Operating Locations:</b>			
Alabama	19	2,282	2,203
Florida	1	79	79
Indiana	1	158	158
Kansas	6	464	464
Kentucky	13	1,127	1,123
Mississippi	10	1,138	1,103
Missouri	3	339	289
Ohio	5	404	393
Tennessee	5	617	537
Texas	13	1,845	1,571
	<u>76</u>	<u>8,453</u>	<u>7,920</u>
<b>Classification:</b>			
Owned	17	1,504	1,266
Leased	59	6,949	6,654
Total	<u>76</u>	<u>8,453</u>	<u>7,920</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 centers, 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, and the number of centers excludes one stand-alone Assisted Living Facility in Ohio. 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



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

and community involvement complement 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 complemented 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.

*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 centers 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. We originally invested approximately \$112,000 per nursing center to deploy EMR in all our centers at the time of implementation. We currently implement EMR at each of the centers we acquire or at which time we assume operations during the transition process.

***Organization.*** Our nursing centers are currently organized into ten 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, 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 2016 and 2015:

Period		High	Low	Dividends
2015	— 1 <sup>st</sup> Quarter	\$ 13.95	\$ 8.46	\$ 0.055
2015	— 2 <sup>nd</sup> Quarter	\$ 17.15	\$ 11.89	\$ 0.055
2015	— 3 <sup>rd</sup> Quarter	\$ 13.00	\$ 8.14	\$ 0.055
2015	— 4 <sup>th</sup> Quarter	\$ 10.59	\$ 6.45	\$ 0.055
2016	— 1 <sup>st</sup> Quarter	\$ 9.95	\$ 6.75	\$ 0.055
2016	— 2 <sup>nd</sup> Quarter	\$ 8.90	\$ 7.00	\$ 0.055
2016	— 3 <sup>rd</sup> Quarter	\$ 10.07	\$ 6.41	\$ 0.055
2016	— 4 <sup>th</sup> Quarter	\$ 12.82	\$ 9.98	\$ 0.055

Our common stock has been traded since May 10, 1994. On February 15, 2017, the closing price for our common stock was \$9.27, as reported by NASDAQ.com.

*Holders.* On February 15, 2017, there were approximately 264 holders of record. Most of our shareholders have their holdings in the street name of their broker/dealer.

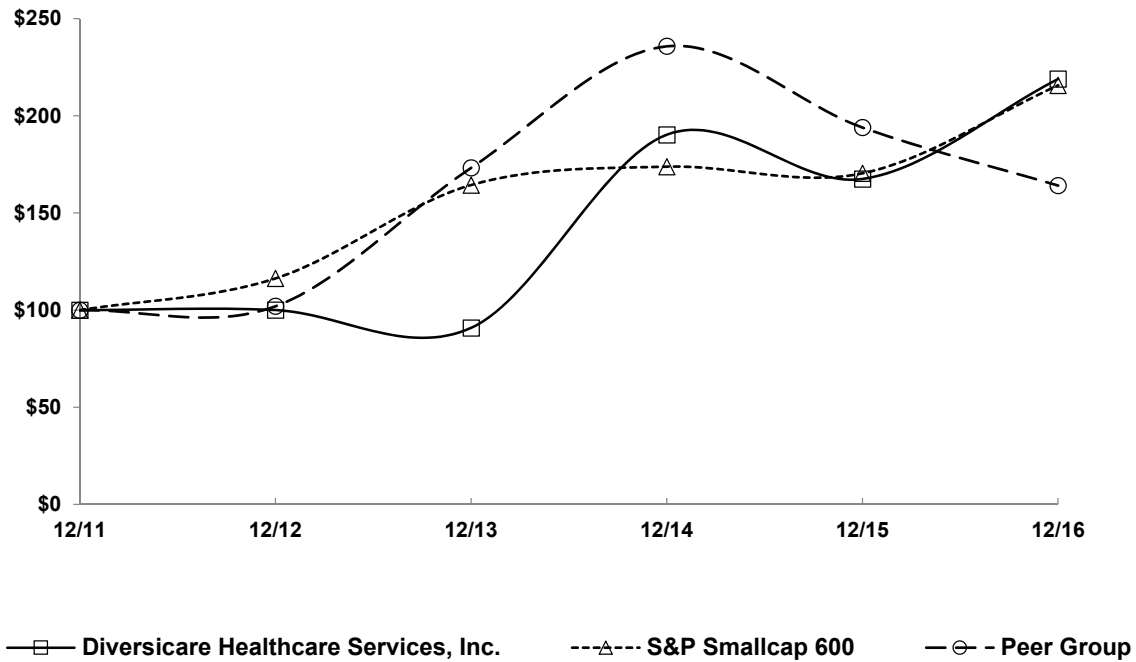
*Dividends.* For each of the two most recent fiscal years, we have paid a quarterly dividend of \$0.055 per common share. While the Board of Directors intends to continue to pay quarterly dividends, the Board will make the determination of the amount of future cash dividends, if any, to be declared and 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.

## 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 12/31/2011 to 12/31/2016.

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

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



\*\$100 invested on 12/31/11 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,				
	2016	2015	2014	2013	2012
<b>Statement of Operations Data</b>	<b>(in thousands, except per share)</b>				
<b>REVENUES:</b>					
Patient revenues, net	\$ 426,063	\$ 387,595	\$ 344,192	\$ 260,221	\$ 231,047
<b>EXPENSES:</b>					
Operating	342,932	311,035	275,605	213,064	186,958
Lease	33,364	28,690	26,151	20,396	18,018
Professional liability	8,456	8,122	7,216	5,666	4,304
General and administrative	30,271	24,793	22,133	20,940	19,515
Depreciation and amortization	8,292	7,524	7,078	6,363	5,758
Lease termination costs	2,008	—	—	—	—
Restructuring	—	—	—	1,446	—
	<u>425,323</u>	<u>380,164</u>	<u>338,183</u>	<u>267,875</u>	<u>234,553</u>
<b>OPERATING INCOME (LOSS)</b>	<u>740</u>	<u>7,431</u>	<u>6,009</u>	<u>(7,654)</u>	<u>(3,506)</u>
<b>OTHER INCOME (EXPENSE):</b>					
Equity in net income (losses) of investment in unconsolidated affiliate	273	339	(5)	(183)	(280)
Gain on sale of investment in unconsolidated affiliate	1,366	—	—	—	—
Interest expense, net	(4,802)	(4,102)	(3,697)	(3,032)	(2,232)
Debt retirement costs	(351)	—	—	(320)	—
	<u>(3,514)</u>	<u>(3,763)</u>	<u>(3,702)</u>	<u>(3,535)</u>	<u>(2,512)</u>
<b>INCOME (LOSS) FROM CONTINUING OPERATIONS BEFORE INCOME TAXES</b>	<u>(2,774)</u>	<u>3,668</u>	<u>2,307</u>	<u>(11,189)</u>	<u>(6,018)</u>
<b>BENEFIT (PROVISION) FOR INCOME TAXES</b>	<u>1,030</u>	<u>(916)</u>	<u>(857)</u>	<u>4,196</u>	<u>2,147</u>
<b>INCOME (LOSS) FROM CONTINUING OPERATIONS</b>	<u>(1,744)</u>	<u>2,752</u>	<u>1,450</u>	<u>(6,993)</u>	<u>(3,871)</u>
<b>DISCONTINUED OPERATIONS, net of taxes</b>	<u>(67)</u>	<u>(1,128)</u>	<u>3,258</u>	<u>(1,469)</u>	<u>951</u>
<b>NET INCOME (LOSS)</b>	<u>\$ (1,811)</u>	<u>\$ 1,624</u>	<u>\$ 4,708</u>	<u>\$ (8,462)</u>	<u>\$ (2,920)</u>
<b>INCOME (LOSS) PER COMMON SHARE:</b>					
<b>Basic</b>					
Continuing operations	\$ (0.28)	\$ 0.45	\$ 0.21	\$ (1.26)	\$ (0.74)
Discontinued operations	(0.01)	(0.18)	0.54	(0.25)	0.16
Net income (loss) per common share	<u>\$ (0.29)</u>	<u>\$ 0.27</u>	<u>\$ 0.75</u>	<u>\$ (1.51)</u>	<u>\$ (0.58)</u>
<b>Diluted</b>					
Continuing operations	\$ (0.28)	\$ 0.44	\$ 0.20	(1.26)	(0.74)
Discontinued operations	(0.01)	(0.18)	0.52	(0.25)	0.16
Net income (loss) per common share	<u>\$ (0.29)</u>	<u>\$ 0.26</u>	<u>\$ 0.72</u>	<u>\$ (1.51)</u>	<u>\$ (0.58)</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>6,199</u>	<u>6,100</u>	<u>6,011</u>	<u>5,899</u>	<u>5,821</u>
Diluted	<u>6,199</u>	<u>6,315</u>	<u>6,197</u>	<u>5,899</u>	<u>5,821</u>

# SELECTED CONSOLIDATED FINANCIAL DATA

	December 31,				
	2016	2015	2014	2013	2012
<b>Balance Sheet Data</b>	<b>(in thousands)</b>				
Working capital	\$ 21,165	\$ 13,052	\$ 8,797	\$ 8,044	\$ 15,663
Total assets	\$ 163,051	\$ 137,084	\$ 129,089	\$ 137,744	\$ 114,963
Long-term debt and capitalized lease obligations, including current portion	\$ 82,133	\$ 60,867	\$ 48,265	\$ 53,577	\$ 29,462
Preferred Stock - Series C	\$ —	\$ —	\$ —	\$ 4,918	\$ 4,918
Total Shareholders' Equity of Diversicare Healthcare Services, Inc.	\$ 11,420	\$ 13,267	\$ 11,754	\$ 8,129	\$ 17,178
Total Shareholders' Equity	\$ 11,420	\$ 13,267	\$ 11,754	\$ 9,566	\$ 18,751

## 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 ten states, primarily in the Southeast, Midwest 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, 2016, our continuing operations consist of 76 nursing centers with 8,453 licensed skilled nursing beds and 496 assisted-living and other residential beds. We own 17 and lease 59 of our nursing centers included in continuing operations. The Company's continuing operations include centers in Alabama, Florida, Indiana, Kansas, Kentucky, Mississippi, Missouri, Ohio, Tennessee, and Texas.

### Divestitures

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, in May 2016, we ceased operations at our Avon, Ohio, facility, thus terminating our lease with Avon Ohio, LLC. This transaction was not reported as a discontinued operation as described in Note 2 to the consolidated financial statements. Additionally, in 2014, we disposed of all operations within the state of West Virginia, including the sale of Rose Terrace. More information on this divestiture is included below.

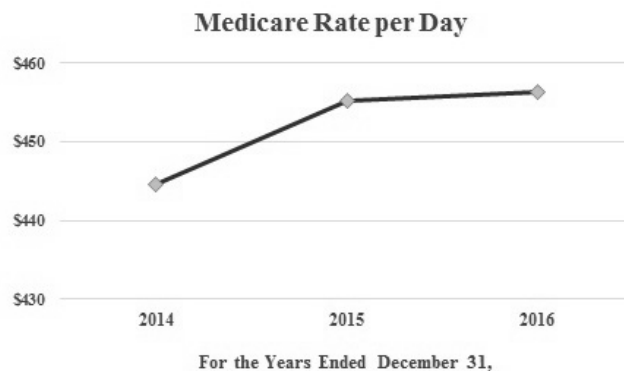
Effective July 1, 2014, the Company completed the transaction with Rose Terrace Acq., LLC to sell Rose Terrace, a 90-bed skilled nursing center in Culloden, West Virginia for a sales price of \$16,500,000. The Company also entered into the Fifteenth Amendment to Consolidated Amended and Restated Master Lease with Omega Health Investors, Inc. ("Omega") to terminate the lease only with respect to two other skilled nursing centers 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 centers 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 center. 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 July 1, 2014.

### Strategic Operating Initiatives

We identified several key strategic objectives to increase shareholder value through improved operations and business development. These strategic operating initiatives include: improving skilled mix in our nursing centers, improving our average Medicare rate, implementing and maintaining Electronic Medical Records ("EMR") to improve Medicaid capture, 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:*

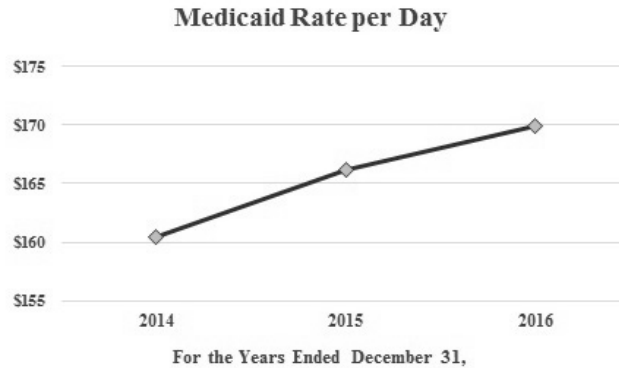
Our strategic operating initiatives of improving our skilled mix and our average Medicare rate required investing in nursing and clinical care to treat more acute patients along with nursing center-based marketing representatives to attract these patients. These initiatives developed referral and Managed Care relationships that have attracted and are expected to continue to attract payor sources for patients covered by Medicare and Managed Care. The Company's skilled mix for the periods ending December 31, 2016, 2015 and 2014 was 15.2%, 16.2% and 16.3%, respectively. The graph below illustrates our success with increasing our average Medicare rate per day:



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

### *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 EMR 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 accurate and timely capture of care delivery. The graph below illustrates our success with increasing our average Medicaid rate per day since implementation:



### *Completing strategic transactions:*

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.

On October 1, 2016 and November 1, 2016, we assumed the operations of ten centers in Mississippi and 12 centers in Alabama, respectively, which is further discussed in Note 2 to the consolidated financial statements. The completion of this transaction brings the Company's operations to 76 nursing centers with 8,453 skilled nursing beds. These centers are expected to contribute in excess of \$185 million in annual revenues.

# 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, 2016, 2015 and 2014, and sets forth this data as a percentage of revenues for the same year:

	Year Ended December 31,					
	(Dollars in thousands)					
	2016		2015		2014	
Revenues:						
Patient revenues, net	\$ 426,063	100.0 %	\$ 387,595	100.0 %	\$ 344,192	100.0 %
Expenses:						
Operating	342,932	80.5 %	311,035	80.2 %	275,605	80.1 %
Lease	33,364	7.8 %	28,690	7.4 %	26,151	7.6 %
Professional liability	8,456	2.0 %	8,122	2.1 %	7,216	2.1 %
General & administrative	30,271	7.1 %	24,793	6.4 %	22,133	6.4 %
Depreciation and amortization	8,292	1.9 %	7,524	1.9 %	7,078	2.1 %
Lease termination costs	2,008	0.5 %	—	— %	—	— %
	<u>425,323</u>	<u>99.8 %</u>	<u>380,164</u>	<u>98.0 %</u>	<u>338,183</u>	<u>98.3 %</u>
Operating income (loss)	<u>740</u>	<u>0.2 %</u>	<u>7,431</u>	<u>2.0 %</u>	<u>6,009</u>	<u>1.7 %</u>
Other income (expense):						
Equity in net losses of unconsolidated affiliate	273	0.1 %	339	0.1 %	(5)	— %
Gain on sale of unconsolidated affiliate	1,366	0.3 %	—	— %	—	— %
Interest expense, net	(4,802)	(1.1)%	(4,102)	(1.1)%	(3,697)	(1.1)%
Debt retirement costs	(351)	(0.1)%	—	— %	—	— %
	<u>(3,514)</u>	<u>(0.8)%</u>	<u>(3,763)</u>	<u>(1.0)%</u>	<u>(3,702)</u>	<u>(1.1)%</u>
Income (loss) from continuing operations before income taxes	(2,774)	(0.6)%	3,668	1.0 %	2,307	0.6 %
Benefit (provision) for income taxes	1,030	0.2 %	(916)	(0.2)%	(857)	(0.2)%
Income (loss) from continuing operations	<u>\$ (1,744)</u>	<u>(0.4)%</u>	<u>\$ 2,752</u>	<u>0.8 %</u>	<u>\$ 1,450</u>	<u>0.4 %</u>

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

	December 31,		
	2016	2015	2014
Licensed Nursing Center Beds:			
Owned	1,504	1,370	1,220
Leased	6,949	4,690	4,605
Total	<u>8,453</u>	<u>6,060</u>	<u>5,825</u>
Facilities:			
Owned	17	15	13
Leased	59	40	39
Total	<u>76</u>	<u>55</u>	<u>52</u>

## 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 78.1%, 77.6% and 78.0% for 2016, 2015, and 2014, 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%, 1.9%, and 1.7% for 2016, 2015, and 2014, 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 centers, 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 \$20.0 million as of December 31, 2016, including \$1.4 million for settlements that are expected to be paid in 2017, 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.

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, on 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.

The Company's cash expenditures for self-insured professional liability costs from continuing operations were \$4.5 million, \$3.3 million and \$4.8 million for the years ended December 31, 2016, 2015 and 2014, respectively.

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

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 due to the significance of judgments and estimates.

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 \$8.5 million, \$8.1 million and \$7.2 million for the years ended December 31, 2016, 2015 and 2014, respectively. These amounts are material in relation to our reported income (loss) from continuing operations for the related periods of \$(1.7) million, \$2.8 million and \$1.5 million, respectively. The total liability recorded at December 31, 2016 was \$20.0 million, compared to current assets of \$79.3 million and total assets of \$163.1 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, 2007 until June 30, 2008, the Company is completely self-insured for workers' compensation exposure. For the period from July 1, 2008 through December 31, 2016, 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 if impairment indicators exist. 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.

No impairment of long lived assets was recognized during 2016, 2015, or 2014. 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 on a straight-line basis over the vesting period. We calculated the recognized and unrecognized stock-based compensation for options and stock-only stock appreciation rights ("SOSARs") using the 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

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

and expected term. For restricted shares, we utilize the 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, 2016, 2015, and 2014, we recorded charges of approximately \$1.0 million, \$1.2 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 \$(0.7) 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, 2016, 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>	\$ 95,263	\$ 10,786	\$ 20,889	\$ 63,588	\$ —
Settlement obligations <sup>(2)</sup>	1,398	1,398	—	—	—
Elimination of Preferred Stock Conversion feature <sup>(3)</sup>	1,202	687	515	—	—
Operating leases <sup>(4)</sup>	1,131,816	57,051	117,240	121,423	836,102
Required capital expenditures under operating leases <sup>(5)</sup>	13,260	1,379	2,736	2,720	6,425
<b>Total</b>	<b>\$ 1,242,939</b>	<b>\$ 71,301</b>	<b>\$ 141,380</b>	<b>\$ 187,731</b>	<b>\$ 842,527</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. Our long-term debt obligations increased \$20.6 million between December 31, 2015 and December 31, 2016, which is related to assumption of operations for the Golden Living centers and our Amended and Restated Credit agreements. See Note 6, "Long-Term Debt and Interest Rate Swap," to the consolidated financial statements included in this report for additional information.
- (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 35 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 are enacted. Our operating lease obligations increased \$558.9 million between December 31, 2015 and December 31, 2016, which is related to our assumption of the Golden Living centers.
- (5) Includes annual expenditure requirements under operating leases. Our required capital expenditures increased \$10.1 million between December 31, 2015 and December 31, 2016, which is related to our assumption of the Golden Living centers.

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, 2016. 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.

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

Based on the closing price of our common stock on December 31, 2016, there is \$0.5 million in contingent liabilities for the repurchase of the equity grants. No amounts have been accrued for these contingent liabilities.

### Revenue Sources

We classify our revenues from patients and residents into four major categories: Medicare, Medicaid, managed care, and private pay and other. Medicaid revenues are those received under the traditional Medicaid program, which provides 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. Managed Care revenues are received from insurance entities, including third-party plans that administer Medicare benefits, known as Medicare Advantage plans. 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 category 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,					
	2016		2015		2014	
Medicaid	\$ 215,381	50.6%	\$ 188,323	48.6%	\$ 166,497	48.4%
Medicare	117,143	27.5%	112,305	29.0%	101,806	29.6%
Managed Care	29,066	6.8%	27,856	7.2%	23,178	6.7%
Private Pay and other	64,473	15.1%	59,111	15.2%	52,711	15.3%
Total	<u>\$ 426,063</u>	<u>100.0%</u>	<u>\$ 387,595</u>	<u>100.0%</u>	<u>\$ 344,192</u>	<u>100.0%</u>

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,					
	2016		2015		2014	
Medicaid	3,448	68.1%	3,104	67.1%	2,844	67.0%
Medicare	591	11.7%	577	12.5%	540	12.7%
Managed Care	178	3.5%	173	3.7%	151	3.6%
Private Pay and other	844	16.7%	772	16.7%	709	16.7%
Total	<u>5,061</u>	<u>100.0%</u>	<u>4,626</u>	<u>100.0%</u>	<u>4,244</u>	<u>100.0%</u>

Consistent with the nursing center industry in general, changes in the mix of a center's patient population among Medicaid, Medicare, Managed Care, and private pay and other can significantly affect the profitability of the center's operations. We will attempt to increase revenues from non-governmental sources to the extent capital is available to do so. 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.

### 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,			
	2016	2015	Change	%
PATIENT REVENUES, net	\$ 426,063	\$ 387,595	\$ 38,468	9.9 %
EXPENSES:				
Operating	342,932	311,035	31,897	10.3 %
Lease	33,364	28,690	4,674	16.3 %
Professional liability	8,456	8,122	334	4.1 %
General and administrative	30,271	24,793	5,478	22.1 %
Depreciation and amortization	8,292	7,524	768	10.2 %
Lease termination costs	2,008	—	2,008	100.0 %
Total expenses	425,323	380,164	45,159	11.9 %
OPERATING INCOME	740	7,431	(6,691)	(90.0)%
OTHER INCOME (EXPENSE):				
Equity in net income (losses) of investment in unconsolidated affiliate	273	339	(66)	(19.5)%
Gain on sale of investment in unconsolidated affiliate	1,366	—	1,366	100.0 %
Interest expense, net	(4,802)	(4,102)	(700)	(17.1)%
Debt retirement costs	(351)	—	(351)	(100.0)%
	(3,514)	(3,763)	249	6.6 %
INCOME (LOSS) FROM CONTINUING OPERATIONS BEFORE INCOME TAXES	(2,774)	3,668	(6,442)	(175.6)%
BENEFIT (PROVISION) FOR INCOME TAXES	1,030	(916)	1,946	212.4 %
INCOME (LOSS) FROM CONTINUING OPERATIONS	\$ (1,744)	\$ 2,752	\$ (4,496)	(163.4)%

(in thousands)	Year Ended December 31,			
	2015	2014	Change	%
PATIENT REVENUES, net	\$ 387,595	\$ 344,192	\$ 43,403	12.6 %
EXPENSES:				
Operating	311,035	275,605	35,430	12.9 %
Lease	28,690	26,151	2,539	9.7 %
Professional liability	8,122	7,216	906	12.6 %
General and administrative	24,793	22,133	2,660	12.0 %
Depreciation and amortization	7,524	7,078	446	6.3 %
Total expenses	380,164	338,183	41,981	12.4 %
OPERATING INCOME (LOSS)	7,431	6,009	1,422	23.7 %
OTHER EXPENSE:				
Equity in net losses of investee	339	(5)	344	6,880.0 %
Interest expense, net	(4,102)	(3,697)	(405)	(11.0)%
	(3,763)	(3,702)	(61)	(1.6)%
INCOME (LOSS) FROM CONTINUING OPERATIONS BEFORE INCOME TAXES	3,668	2,307	1,361	59.0 %
PROVISION FOR INCOME TAXES	(916)	(857)	(59)	(6.9)%
INCOME FROM CONTINUING OPERATIONS	\$ 2,752	\$ 1,450	\$ 1,302	89.8 %

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

**Year Ended December 31, 2016 Compared With Year Ended December 31, 2015**

*Patient Revenues*

Patient revenues were \$426.1 million in 2016 and \$387.6 million in 2015, an increase of \$38.5 million or 9.9%. This increase is primarily attributable to the acquisition of Golden Living operations in Alabama and Mississippi during the fourth quarter of 2016. The following table summarizes the revenue increases attributable to our portfolio growth (in thousands):

	<b>Year Ended December 31,</b>		
	<b>2016</b>	<b>2015</b>	<b>Change</b>
Same-store revenue	\$ 372,452	\$ 376,497	\$ (4,045)
2015 acquisition revenue	16,438	11,098	5,340
2016 acquisition revenue	37,173	—	37,173
Total revenue	<u>\$ 426,063</u>	<u>\$ 387,595</u>	<u>38,468</u>

The overall increase in revenue of \$38.5 million is primarily attributable to revenue contributions from the acquisition of Golden Living operations in Alabama and Mississippi during the fourth quarter of 2016 of \$37.2 million. Additionally, the 2015 acquisitions experienced an incremental increase in revenues of \$5.3 million as a result of having a full year in operations during 2016. The increase from the acquisition activity was partially offset by a decrease in same-store revenue of \$4.0 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>2016</b>	<b>2015</b>
Skilled nursing occupancy	78.1%	77.1%
As a percent of total census:		
Medicaid census	68.1%	67.1%
Medicare census	11.7%	12.5%
Managed Care census	3.5%	3.7%
As a percent of total revenues:		
Medicaid revenues	50.6%	48.6%
Medicare revenues	27.5%	29.0%
Managed Care revenues	6.8%	7.2%
Average rate per day:		
Medicare	\$ 456.30	\$ 455.24
Medicaid	\$ 169.91	\$ 166.16
Managed Care	\$ 385.71	\$ 389.73

The average Medicaid rate per patient day for same-store nursing centers in 2016 increased 1.2% compared to 2015, 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 2016 increased 1.0% compared to 2015, resulting in an increase in revenue of \$0.9 million also related to our ability to attract and provide care for patients with increased acuity levels. Same-store Private payors rate per patient day for 2016 also experienced favorable results compared to 2015 resulting in a \$1.0 million increase in revenue.

Our total average daily census increased by approximately 9.4% for the full portfolio compared to 2015 on a consolidated basis, but was primarily attributable to the aforementioned acquisition activity. On a same-store basis, our Medicare and Medicaid average daily census for 2016 decreased compared to 2015, resulting in decreases in revenue of \$7.5 million and \$0.8 million, respectively.

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

### *Operating Expense*

Operating expense increased to \$342.9 million in 2016 from \$311.0 million in 2015, driven primarily by the \$28.0 million in operating costs at the Golden Living nursing centers added in 2016, and \$3.6 million incremental increase from the centers acquired in 2015 due to a full year of operations. Operating expense increased to 80.5% of revenue in 2016, compared to 80.2% of revenue in 2015.

	<b>Year Ended December 31,</b>		
	<b>2016</b>	<b>2015</b>	<b>Change</b>
Same-store operating expenses	\$ 301,991	\$ 301,720	\$ 271
2015 acquisition operating expenses	12,953	9,315	3,638
2016 acquisition operating expenses	27,988	—	27,988
Total operating expenses	<u>\$ 342,932</u>	<u>\$ 311,035</u>	<u>31,897</u>

The largest component of operating expenses is wages, which increased to \$199.6 million in 2016 from \$180.8 million in 2015, an increase of \$18.8 million, or 10.4%. On a same-store basis, wages were controlled and increased by \$0.4 million to \$175.8 million in 2016 from \$175.4 million in 2015, which is a direct result from our decrease in same-store revenues during 2016.

Other factors driving the fluctuation in operating expenses at the same-store nursing centers include an increase in health insurance premiums by \$1.2 million, which was offset by a \$1.2 million decrease in nursing and ancillary related expenses. Bad debt expenses decreased by \$0.3 million. This fluctuation was driven significantly by the growth in Medicare and Medicaid patients undergoing the initial qualification process.

### *Lease Expense*

Lease expense increased to \$33.4 million in 2016 from \$28.7 million in 2015, an increase of \$4.7 million, or 16.3%. The increase in lease expense was driven by \$5.7 million from the assumption of the Golden Living centers in the fourth quarter of 2016. This was slightly offset from the purchase of Clinton and Hutchinson in February 2016, and the termination of the Avon, Ohio lease in May 2016.

### *Professional Liability*

Professional liability expense was \$8.5 million in 2016 compared to \$8.1 million in 2015, an increase of \$0.4 million, or 4.1%. As centers have been acquired in 2015 and 2016, 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 67 professional liability lawsuits as of December 31, 2016, compared to 55 as of December 31, 2015. Our cash expenditures for professional liability costs of continuing operations were \$4.5 million and \$3.3 million for 2016 and 2015, 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 \$30.3 million in 2016 compared to \$24.8 million in 2015, an increase of \$5.5 million, or 22.1%. The overall increase in general and administrative expenses were attributable to a \$1.6 million increase in salaries and related expenses associated with continued growth at the regional level, as well as additional corporate infrastructure to support the on-going growth of the portfolio. Legal and consulting fees experienced an increase of \$1.2 million and \$1.3 million, respectively, related to regulatory and acquisition expenses.

### *Depreciation and Amortization*

Depreciation and amortization expense was approximately \$8.3 million in 2016 and \$7.5 million in 2015. The increase in 2016 is primarily due to \$0.4 million of depreciation associated with the purchases of Hutchinson and Clinton in February 2016. Additionally, the Company incurred an increase of \$0.3 million in depreciation and amortization expenses related to the assumed Golden Living operations in the fourth quarter of 2016.

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

### *Lease Termination Costs*

Lease termination costs were \$2.0 million in 2016 due to the termination of the Avon, Ohio operating lease in May 2016.

### *Gain on Sale of Investment in Unconsolidated Affiliate*

Gain on the sale of the pharmacy joint venture was \$1.4 million, which occurred in the fourth quarter of 2016. This transaction also resulted in an immaterial gain contingency, which has not been recorded and income has not been recognized.

### *Interest Expense, Net*

Interest expense has increased to \$4.8 million in 2016 compared to \$4.1 million in 2015, an increase of \$0.7 million. The increase was primarily attributable to higher debt balances in 2016 as a result of higher outstanding borrowings on the revolving credit facility from the purchase of Hutchinson and Clinton during the first quarter of 2016, as well as a result of the change in ownership processes for the newly acquired Golden Living centers.

### *Debt Retirement Costs*

Debt retirement costs were \$0.4 million in 2016, which relates to the write off of our term loan deferred financing costs, as a result of our debt refinance that took place in February 2016.

### *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 a loss before taxes of \$2.8 million in 2016, as compared to income of \$3.7 million in 2015. The benefit for income taxes was \$1.0 million in 2016, an effective rate of 37.1% and the provision for income taxes was \$0.9 million in 2015, an effective rate of 25.0%. The increase in our effective tax rate is due to an increase in our Work Opportunity Tax Credit ("WOTC") and the valuation allowance. The basic and diluted loss per common share from continuing operations were \$0.28 and \$0.28 in 2016, respectively, compared to a basic and diluted income per common share from continuing operations of \$0.45 and \$0.44 in 2015, respectively.

## **Year Ended December 31, 2015 Compared With Year Ended December 31, 2014**

### *Patient Revenues*

Patient revenues were \$387.6 million in 2015 and \$344.2 million in 2014, an increase of \$43.4 million or 12.6%. 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):

	<b>Year Ended December 31,</b>		
	<b>2015</b>	<b>2014</b>	<b>Change</b>
Same-store revenue	\$ 329,463	\$ 318,096	\$ 11,367
2014 acquisition revenue	47,034	26,096	20,938
2015 acquisition revenue	11,098	—	11,098
Total revenue	<u>\$ 387,595</u>	<u>\$ 344,192</u>	<u>\$ 43,403</u>

The overall increase in revenue of \$43.4 million is primarily attributable to revenue contributions from acquisition activity in 2015 of \$11.1 million, as well as an incremental increase in revenues from 2014 acquisitions of \$20.9 million as a result of having a full year in operations during 2015. The balance of the increase in revenues year-over-year is attributable to increases in same-store revenue of \$11.4 million which is explained in more detail below.



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

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

	<b>Year Ended December 31,</b>	
	<b>2015</b>	<b>2014</b>
Skilled nursing occupancy	77.1%	77.5%
As a percent of total census:		
Medicaid census	67.1%	67.0%
Medicare census	12.5%	12.7%
Managed Care census	3.7%	3.6%
As a percent of total revenues:		
Medicaid revenues	48.6%	48.4%
Medicare revenues	29.0%	29.6%
Managed Care revenues	7.2%	6.7%
Average rate per day:		
Medicare	\$ 455.24	\$ 444.63
Medicaid	\$ 166.16	\$ 160.43
Managed Care	\$ 389.73	\$ 383.44

The average Medicaid rate per patient day for same-store nursing centers in 2015 increased 3.6% compared to 2014, resulting in an increase in revenue of \$6.2 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 2015 increased 2.4% compared to 2014, resulting in an increase in revenue of \$1.6 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 2015 also experienced favorable results compared to 2014 resulting in a \$0.4 million increase in revenue as we continue to see growth in this portion of our patient population.

Our total average daily census increased by approximately 9.0% for the full portfolio compared to 2014 on a consolidated basis, but was primarily attributable to the aforementioned acquisition activity. On a same-store basis, our Medicare and Medicaid average daily census for 2015 decreased compared to 2014, resulting in decreases in revenue of \$1.4 million and \$0.2 million, respectively. Offsetting these decreases, Managed Care census increased at our same-store nursing centers resulting in a revenue increase of \$2.3 million compared to 2014.

In addition to the revenue changes driven by rate and census, the same-store group experienced additional revenue variances from ancillary services and participation in an inter-governmental transfer (IGT) program. Ancillary services at same-store centers increased \$1.9 million in 2015 as compared to 2014, while revenue related to the IGT program in Indiana resulted in \$1.1 million in additional revenue in 2015.

### *Operating Expense*

Operating expense increased to \$311.0 million in 2015 from \$275.6 million in 2014, driven primarily by the \$9.3 million in operating costs at the nursing centers added in 2015, and \$18.5 million incremental increase from the centers acquired in 2014 due to a full year of operations. Operating expense increased to 80.2% of revenue in 2015, compared to 80.1% of revenue in 2014.

	<b>Year Ended December 31,</b>		
	<b>2015</b>	<b>2014</b>	<b>Change</b>
Same-store operating expenses	\$ 262,378	\$ 254,769	\$ 7,609
2014 acquisition operating expenses	39,342	20,836	18,506
2015 acquisition operating expenses	9,315	—	9,315
Total revenue	<u>\$ 311,035</u>	<u>\$ 275,605</u>	<u>\$ 35,430</u>

The largest component of operating expenses is wages, which increased to \$180.8 million in 2015 from \$160.4 million in 2014, an increase of \$20.4 million, or 12.7%. On a same-store basis, wages increased by \$5.6 million to \$154.1 million in 2015 from \$148.5 million in 2014, which is a direct result from our increase in same-store revenues during 2015.

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

Other factors driving the increase in operating expenses at the same-store nursing centers include bad debt and Medicare crossover claims expense. The expense increased approximately \$1.8 million in 2015 compared to 2014 driven significantly by the growth in Medicare and Medicaid patients undergoing the initial qualification process. Provider taxes increased \$0.5 million in 2015 compared to 2014 primarily driven by rate increases in Tennessee.

### *Lease Expense*

Lease expense increased to \$28.7 million in 2015 from \$26.2 million in 2014, an increase of \$2.5 million, or 9.7%. The increase in lease expense was primarily driven by \$2.3 million in combined lease expense for the newly leased nursing centers acquired in 2014 as a result of a full year of operations. The remaining increase was the result of regular rent adjustments at existing centers.

### *Professional Liability*

Professional liability expense was \$8.1 million in 2015 compared to \$7.2 million in 2014, an increase of \$0.9 million. As centers have been acquired in 2014 and 2015, 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 55 professional liability lawsuits as of December 31, 2015, compared to 51 as of December 31, 2014. Our cash expenditures for professional liability costs of continuing operations were \$3.3 million and \$4.8 million for 2015 and 2014, 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 \$24.8 million in 2015 compared to \$22.1 million in 2014, an increase of \$2.7 million. The overall increase in general and administrative expenses were attributable to a \$1.2 million increase in salaries and related expenses associated with continued growth at the regional level, as well as additional corporate infrastructure to support the on-going growth of the portfolio. Stock-based incentive expenses experienced a corresponding increase of \$0.6 million. As previously noted, the Company began participating in an inter-governmental transfer program in Indiana during 2015. Certain costs associated with our participation in this program are recorded within general and administrative expense and resulted in \$0.3 million of additional costs during 2015.

### *Depreciation and Amortization*

Depreciation and amortization expense was approximately \$7.5 million in 2015 and \$7.1 million in 2014. The increase in 2015 is primarily due to \$0.3 million of depreciation associated with the Glasgow center purchased in February 2015.

### *Interest Expense, Net*

Interest expense has increased to \$4.1 million in 2015 compared to \$3.7 million in 2014, an increase of \$0.4 million. The increase was primarily attributable to higher debt balances in 2015 on the Revolver as a result of on-going change in ownership processes for newly acquired nursing centers, as well as interest on the debt associated with the two buildings purchased in 2015.

### *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 \$3.7 million in 2015, as compared to \$2.3 million in 2014. The provision for income taxes was \$0.9 million in 2015, an effective rate of 25.0% and \$0.9 million in 2014, an effective rate of 37.1%. The decrease in our effective tax rate is due to a decrease in our WOTC and the valuation allowance. The basic and diluted income per common share from continuing operations were \$0.45 and \$0.44 in 2015, respectively, compared to a basic and diluted income per common share from continuing operations of \$0.21 and \$0.20 in 2014, respectively.

## **Liquidity and Capital Resources**

### *Liquidity*

Our primary source of liquidity is the net cash flow provided by the operating activities of our centers. 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

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

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 used in operating activities of continuing operations totaled \$2.1 million in 2016, compared to net cash provided by operating activities of continuing operations of \$10.3 million and \$6.0 million in 2015 and 2014, respectively. One primary driver of the decline in cash provided by operating activities from continuing operations is the acquisition activity throughout the year. The Company is required to complete a Change in Ownership ("CHOW") process for each of the nursing centers for which we assumed operations during the year which results in limited cash inflows from the operations at these centers during this initial process. As of December 31, 2016, the twenty-two centers for which we assumed operation from Golden Living during 2016 continue to progress through the CHOW process, and we expect this process to be completed in mid-2017. Operating activities of discontinued operations used cash of \$3.5 million, \$7.0 million and \$3.0 million in 2016, 2015 and 2014, respectively.

Our cash expenditures related to professional liability claims of continuing operations were \$4.5 million, \$3.3 million and \$4.8 million for 2016, 2015 and 2014, respectively. We also continue to experience cash expenditures related to professional liability claims of discontinued operations. Our cash expenditures related to professional liability claims of discontinued operations were \$3.6 million, \$8.2 million, and \$5.5 million for 2016, 2015 and 2014, respectively. The Company will continue to defend, and make cash payments when required related to, professional liability claims asserted against discontinued operations. Although we work diligently to limit the cash required to settle and 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 used cash of \$9.8 million and \$13.1 million in 2016 and 2015, respectively, as compared to cash provided of \$11.6 million 2014. The cash used in 2016 was the result of the purchase of Hutchinson and Clinton for \$4.3 million and \$3.3 million, respectively, and cash used to assume the operations of the twenty-two Golden living centers in the fourth quarter of 2016. The cash used in 2015 is primarily attributable to the \$7.0 million and \$3.9 million of assets purchased in the Glasgow and Fulton transactions, respectively. The cash provided in 2014 was the result of 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. We have used \$6.0 million, \$4.6 million, and \$5.5 million in 2016, 2015 and 2014, respectively, for capital expenditures of continuing operations.

Financing activities of continuing operations provided cash of \$15.1 million and \$10.6 million in 2016 and 2015, respectively, compared to cash used of \$8.5 million in 2014. Cash provided by in 2016 is primarily attributable to the proceeds received from refinancing our credit facility resulting in proceeds of \$92.8 million, offset by the repayment of the existing mortgage loan and other debt payments during the year of \$73.4 million. Financing activities in 2015 reflect the proceeds received from refinancing our credit facility resulting in proceeds of \$27.9 million, offset by the repayment of the existing mortgage loan and other debt payments during the year of \$15.3 million. Cash used in 2014 primarily resulted from the \$4.9 million in the redemption of preferred stock. Financing activities reflect common stock and preferred stock dividends of \$1.4 million 2016, \$1.3 million in 2015, and \$1.5 million in 2014.

### *Dividends*

On February 24, 2017, 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, 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

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

West Virginia centers, 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, 2016, we have recorded total liabilities for reported professional liability claims and estimates for incurred, but unreported claims of \$20.0 million. Our calculation of this estimated liability is based on the Company's best estimates of the likelihood of severely adverse judgments 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.

### *Capital Resources*

As of December 31, 2016, we had \$82.1 million of outstanding long-term debt and capital lease obligations. The \$82.1 million total includes \$2.1 million in capital lease obligations. The balance of the long-term debt is comprised of \$58.8 million owed on our collateralized mortgage debt, \$15.0 million currently outstanding on the revolving credit facility, and \$6.3 million on the acquisition loan facility.

Under the terms of the agreements, the syndicate of banks provided the Amended Mortgage Loan with an original balance of \$72.5 million with a five year maturity through February 26, 2021, consisting of \$60.0 million term and \$12.5 million acquisition loan facilities, and a \$52.3 million Amended Revolver through February 26, 2021. The Amended Mortgage Loan has a term of five years, with principal and interest payable monthly based on a 25 year amortization. Interest on the term and acquisition loan facilities are based on LIBOR plus 4.0% and 4.75%, respectively. A portion of the Amended Mortgage Loan is effectively fixed at 5.79% pursuant to an interest rate swap with an initial notional amount of \$30.0 million. As of December 31, 2016, the interest rate related to the Amended Mortgage Loan is 4.75%. The Amended Mortgage Loan is secured by 17 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 and cross-defaulted. The Company's Amended Revolver has an interest rate of LIBOR plus 4.0% 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. 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 120 days.

As of December 31, 2016, the Company had \$15.0 million borrowings outstanding under the Amended Revolver compared to \$12.9 million outstanding as of December 31, 2015. The outstanding borrowings on the revolver primarily reflect the Company's approach to accumulated Medicaid and Medicare receivables at recently acquired centers as these centers 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 letters of credit of \$4.8 million and \$2.1 million to serve as a security deposit for our Omega and Golden Living leases, respectively. 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 other letters of credit, totaling \$2.4 million, to serve as security deposits at certain centers. Considering the balance of eligible accounts receivable at December 31, 2016, the letters of credit, the amounts outstanding under the revolving credit facility and the maximum loan amount of \$42.7 million, the balance available for borrowing under the Amended Revolver is \$14.4 million at December 31, 2016.

Our lending agreements contain various financial covenants, the most restrictive of which relate to debt service coverage ratios. We are in compliance with all such covenants at December 31, 2016.

Our calculated compliance with financial covenants is presented below:

	Requirement	Level at December 31, 2016
Minimum fixed charge coverage ratio	1.00:1.00	1.16:1.00
Minimum adjusted EBITDA	\$9.5 million	\$13.3 million
EBITDAR (mortgaged centers)	\$10.0 million	\$14.4 million
Current ratio (as defined in agreement)	1.00:1.00	1.49:1.00

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

As part of the debt agreements entered into in February 2016, the Company entered into an interest rate swap agreement with a member of the bank syndicate as the counterparty. The interest rate swap agreement has the same effective date and maturity date as the Amended Mortgage Loan, and carries an initial notional amount of \$30.0 million. 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 5.79% 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**

Upon acquisition of certain centers, we assume certain leases, primarily related to equipment, that constitute capital leases. Additionally, the Company leases certain technology equipment that supports the clinical systems, including electronic medical records, at our nursing centers that constitute capital leases.

As a result of the lease agreements above, we have recorded the underlying lease assets and capitalized lease obligations of \$2.1 million, \$0.6 million, and \$0.3 million as of December 31, 2016, 2015, and 2014, respectively. These lease agreements provide terms of three to five years.

### **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 \$72.5 million at December 31, 2016 compared to \$52.0 million at December 31, 2015, representing approximately 47 days and 45 days revenue in accounts receivable, respectively. The increase in accounts receivable is due primarily to accounts associated with centers 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, 2016, reflects the change in ownership of the twenty-two newly leased Golden Living centers in Alabama and Mississippi. The Company has entered into an agreement with Golden Living to utilize their billing credentials in order to perform the billing of the Medicare and Medicaid receivables until the change in ownership process has been completed. This agreement allows the Medicare and Medicaid receivables to be billed and collected in the interim. Payer sources could be delayed due to setting up new agreements and credentialing with those payers.

The allowance for bad debt was \$10.3 million and \$8.2 million at December 31, 2016 and 2015, respectively, which is commensurate with our overall revenue and receivables growth. 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 2017 to be relatively the same or slightly lower than the increases in 2016. 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 twelve letters of credit outstanding totaling approximately \$10.2 million as of December 31, 2016. Eleven of these letters of credit serve as a security deposits for certain center 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. Forward-looking statements are predictive in nature and are frequently identified by the use of terms such as “may,” “will,” “should,” “expect,” “believe,” “estimate,” “intend,” and similar words indicating possible future expectations, events or actions. 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 integrate the operations of our new nursing centers in Alabama, Mississippi, Kansas and Kentucky, as well as successfully operate all of our centers, our ability to increase census at our centers, changes in governmental reimbursement, including the impact of the CMS final rule that has resulted in a reduction in Medicare reimbursement 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 extend or replace our current credit facility, 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 HIPAA and 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, 2016, we had outstanding borrowings of approximately \$80.1 million, \$50.6 million of which were subject to variable interest rates. In connection with February 2016 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 \$0.5 million 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, 2016. 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). Our review excluded the centers assumed from Golden Living during 2016, whose consolidated assets of approximately \$6.6 million and whose revenues of approximately \$37.2 million, were included in the Company's consolidated balance sheet and statement of operations as of and for the year ended December 31, 2016. Based on this evaluation, management concluded that our internal control over financial reporting was effective as of December 31, 2016. 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, 2016 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, 2016 and 2015 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, 2016. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with 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 financial statement presentation. 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, 2016 and 2015, and the results of its operations and its cash flows for each of the three years in the period ended December 31, 2016, in conformity with accounting principles generally accepted in the United States of America.

/s/ BDO USA, LLP

Nashville, Tennessee  
March 2, 2017



**DIVERSICARE HEALTHCARE SERVICES, INC. AND SUBSIDIARIES**  
**CONSOLIDATED BALANCE SHEETS**  
**DECEMBER 31, 2016 AND 2015**

ASSETS	2016	2015	LIABILITIES AND SHAREHOLDERS' EQUITY	2016	2015
<b>CURRENT ASSETS:</b>			<b>CURRENT LIABILITIES:</b>		
Cash and cash equivalents	\$ 4,263,000	\$ 4,585,000	Current portion of long-term debt and capitalized lease obligations, net	\$ 7,715,000	\$ 6,603,000
Receivables, less allowance for doubtful accounts of \$10,326,000 and \$8,180,000.	62,152,000	43,819,000	Trade accounts payable	12,972,000	10,136,000
Other receivables	1,193,000	1,407,000	Current liabilities of discontinued operations	427,000	345,000
Prepaid expenses and other current assets	3,623,000	2,223,000	Accrued expenses:		
Income tax refundable	431,000	347,000	Payroll and employee benefits	20,108,000	14,404,000
Current assets of discontinued operations	28,000	36,000	Self-insurance reserves, current portion	9,401,000	10,224,000
Deferred income taxes	7,644,000	7,999,000	Provider taxes	3,114,000	1,603,000
Total current assets	<u>79,334,000</u>	<u>60,416,000</u>	Other current liabilities	<u>4,432,000</u>	<u>4,049,000</u>
			Total current liabilities	<u>58,169,000</u>	<u>47,364,000</u>
<b>PROPERTY AND EQUIPMENT, at cost</b>	128,822,000	114,383,000	<b>NONCURRENT LIABILITIES:</b>		
Less accumulated depreciation and	<u>(69,022,000)</u>	<u>(62,110,000)</u>	Long-term debt and capitalized lease obligations, less current portion, net	72,145,000	53,297,000
	<u>59,800,000</u>	<u>52,273,000</u>	Self-insurance reserves, noncurrent portion	11,766,000	12,344,000
			Other noncurrent liabilities	<u>9,551,000</u>	<u>10,812,000</u>
			Total noncurrent liabilities	<u>93,462,000</u>	<u>76,453,000</u>
<b>OTHER ASSETS:</b>			<b>COMMITMENTS AND CONTINGENCIES</b>		
Deferred income taxes	13,541,000	11,762,000	<b>SHAREHOLDERS' EQUITY:</b>		
Deferred financing and other costs, net	193,000	382,000	Common stock, authorized 20,000,000 shares, \$.01 par value, 6,592,000 and 6,513,000 shares issued, and 6,361,000 and 6,281,000 shares	66,000	65,000
Investment in unconsolidated affiliate	—	798,000	Treasury stock at cost, 232,000 shares of common	(2,500,000)	(2,500,000)
Other noncurrent assets	3,108,000	3,994,000	Paid-in capital	21,935,000	21,142,000
Acquired leasehold interest, net	<u>7,075,000</u>	<u>7,459,000</u>	Accumulated deficit	(8,276,000)	(5,053,000)
Total other assets	<u>23,917,000</u>	<u>24,395,000</u>	Accumulated other comprehensive income (loss)	<u>195,000</u>	<u>(387,000)</u>
	<u>\$ 163,051,000</u>	<u>\$ 137,084,00</u>	Total shareholders' equity	<u>11,420,000</u>	<u>13,267,000</u>
				<u>\$ 163,051,000</u>	<u>\$ 137,084,00</u>

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

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

	<b>Years Ended December 31,</b>		
	<b>2016</b>	<b>2015</b>	<b>2014</b>
PATIENT REVENUES, net	\$ 426,063,000	\$ 387,595,000	\$ 344,192,000
EXPENSES:			
Operating	342,932,000	311,035,000	275,605,000
Lease and rent expense	33,364,000	28,690,000	26,151,000
Professional liability	8,456,000	8,122,000	7,216,000
General and administrative	30,271,000	24,793,000	22,133,000
Depreciation and amortization	8,292,000	7,524,000	7,078,000
Lease termination costs	2,008,000	—	—
Total expenses	425,323,000	380,164,000	338,183,000
OPERATING INCOME	740,000	7,431,000	6,009,000
OTHER INCOME (EXPENSE):			
Equity in net income (losses) of investment in unconsolidated affiliate	273,000	339,000	(5,000)
Gain on sale of investment in unconsolidated affiliate	1,366,000	—	—
Interest expense, net	(4,802,000)	(4,102,000)	(3,697,000)
Debt retirement costs	(351,000)	—	—
	(3,514,000)	(3,763,000)	(3,702,000)
INCOME (LOSS) FROM CONTINUING OPERATIONS BEFORE INCOME TAXES	(2,774,000)	3,668,000	2,307,000
BENEFIT (PROVISION) FOR INCOME TAXES	1,030,000	(916,000)	(857,000)
INCOME (LOSS) FROM CONTINUING OPERATIONS	(1,744,000)	2,752,000	1,450,000
INCOME (LOSS) FROM DISCONTINUED OPERATIONS:			
Operating loss, net of income tax benefit of \$41,000, \$375,000 and \$878,000, respectively	(67,000)	(1,128,000)	(1,486,000)
Gain on disposal, net of income tax provision of \$0, \$0 and \$2,802,000, respectively	—	—	4,744,000
INCOME (LOSS) FROM DISCONTINUED OPERATIONS	(67,000)	(1,128,000)	3,258,000
NET INCOME (LOSS)	(1,811,000)	1,624,000	4,708,000
Less: net (income) loss attributable to noncontrolling interests	—	—	25,000
NET INCOME (LOSS) ATTRIBUTABLE TO DIVERSICARE HEALTHCARE SERVICES, INC.	(1,811,000)	1,624,000	4,733,000
PREFERRED STOCK DIVIDENDS	—	—	(220,000)
NET INCOME (LOSS) FOR DIVERSICARE HEALTHCARE SERVICES, INC. COMMON SHAREHOLDERS	\$ (1,811,000)	\$ 1,624,000	\$ 4,513,000
NET INCOME (LOSS) PER COMMON SHARE FOR DIVERSICARE HEALTHCARE SERVICES, INC. COMMON SHAREHOLDERS:			
Per common share – basic			
Continuing operations	\$ (0.28)	\$ 0.45	\$ 0.21
Discontinued operations	(0.01)	(0.18)	0.54
	<u>\$ (0.29)</u>	<u>\$ 0.27</u>	<u>\$ 0.75</u>
Per common share – diluted			
Continuing operations	\$ (0.28)	\$ 0.44	\$ 0.20
Discontinued operations	(0.01)	(0.18)	0.52
	<u>\$ (0.29)</u>	<u>\$ 0.26</u>	<u>\$ 0.72</u>
DIVIDENDS DECLARED PER SHARE OF COMMON STOCK	<u>\$ 0.22</u>	<u>\$ 0.22</u>	<u>\$ 0.22</u>
WEIGHTED AVERAGE COMMON SHARES OUTSTANDING:			
Basic	6,199,000	6,100,000	6,011,000
Diluted	6,199,000	6,315,000	6,197,000

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>2016</b>	<b>2015</b>	<b>2014</b>
NET INCOME (LOSS)	\$ (1,811,000)	\$ 1,624,000	\$ 4,708,000
OTHER COMPREHENSIVE INCOME (LOSS):			
Change in fair value of cash flow hedge, net of tax	1,082,000	556,000	368,000
Less: reclassification adjustment for amounts recognized in net income	(500,000)	(448,000)	(294,000)
Total other comprehensive income	582,000	108,000	74,000
COMPREHENSIVE INCOME (LOSS)	(1,229,000)	1,732,000	4,782,000
Less: comprehensive loss attributable to noncontrolling interest	—	—	25,000
COMPREHENSIVE INCOME (LOSS) ATTRIBUTABLE TO DIVERSICARE HEALTHCARE SERVICES, INC.	\$ (1,229,000)	\$ 1,732,000	\$ 4,807,000

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		Accumulated Other		Total Shareholders' Equity of		Non-Controlling Interests	Total Shareholders' Equity
	Shares Issued	Amount	Shares	Amount	Paid-in Capital	Accumulated Deficit	Comprehensive Income (Loss)	Diversicare Healthcare		
<b>BALANCE, DECEMBER 31, 2013</b>	6,307,000	\$ 63,000	232,000	\$ (2,500,000)	\$ 19,570,000	\$ (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	—	—	—	—	41,000	(1,363,000)	—	(1,322,000)	—	(1,322,000)
Issuance/redemption of equity grants, net	81,000	1,000	—	—	(49,000)	—	—	(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)	—	(10,000)
Deconsolidation of noncontrolling	—	—	—	—	—	—	—	—	(1,412,000)	(1,412,000)
Stock based compensation	—	—	—	—	418,000	—	—	418,000	—	418,000
<b>BALANCE, DECEMBER 31, 2014</b>	6,388,000	64,000	232,000	(2,500,000)	19,970,000	(5,285,000)	(495,000)	11,754,000	—	11,754,000
Net income	—	—	—	—	—	1,624,000	—	1,624,000	—	1,624,000
Common stock dividends declared	—	—	—	—	45,000	(1,392,000)	—	(1,347,000)	—	(1,347,000)
Issuance/redemption of equity grants, net	125,000	1,000	—	—	78,000	—	—	79,000	—	79,000
Interest rate cash flow hedge	—	—	—	—	—	—	108,000	108,000	—	108,000
Tax impact of equity grant exercises	—	—	—	—	62,000	—	—	62,000	—	62,000
Stock based compensation	—	—	—	—	987,000	—	—	987,000	—	987,000
<b>BALANCE, DECEMBER 31, 2015</b>	6,513,000	65,000	232,000	(2,500,000)	21,142,000	(5,053,000)	(387,000)	13,267,000	—	13,267,000
Net loss	—	—	—	—	—	(1,811,000)	—	(1,811,000)	—	(1,811,000)
Common stock dividends declared	—	—	—	—	46,000	(1,412,000)	—	(1,366,000)	—	(1,366,000)
Issuance/redemption of equity grants, net	79,000	1,000	—	—	(106,000)	—	—	(105,000)	—	(105,000)
Interest rate cash flow hedge	—	—	—	—	—	—	582,000	582,000	—	582,000
Tax impact of equity grant exercises	—	—	—	—	65,000	—	—	65,000	—	65,000
Stock based compensation	—	—	—	—	788,000	—	—	788,000	—	788,000
<b>BALANCE, DECEMBER 31, 2016</b>	6,592,000	\$ 66,000	232,000	\$ (2,500,000)	\$ 21,935,000	\$ (8,276,000)	\$ 195,000	\$ 11,420,000	\$ —	\$ 11,420,000

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

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

	<b>Years Ended December 31,</b>		
	<b>2016</b>	<b>2015</b>	<b>2014</b>
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>			
Net income (loss)	\$ (1,811,000)	\$ 1,624,000	\$ 4,708,000
Discontinued operations	(67,000)	(1,128,000)	3,258,000
Income (loss) from continuing operations	(1,744,000)	2,752,000	1,450,000
Adjustments to reconcile income (loss) from continuing operations to net cash provided by operating activities:			
Depreciation and amortization	8,292,000	7,524,000	7,078,000
Provision for doubtful accounts	7,163,000	7,507,000	5,710,000
Deferred income tax provision (benefit)	(1,569,000)	(1,222,000)	837,000
Provision for self-insured professional liability, net of cash payments	1,968,000	3,200,000	1,173,000
Stock based compensation	1,012,000	1,152,000	580,000
Debt retirement costs	351,000	—	—
Provision for leases net of cash payments	(1,773,000)	(1,749,000)	(1,180,000)
Lease termination costs, net of cash payments	1,863,000	—	—
Equity in net income of investment in unconsolidated affiliate	(271,000)	(335,000)	—
Gain on sale of investment in unconsolidated affiliate	(1,366,000)	—	—
Deferred bonus	350,000	—	—
Other	576,000	396,000	316,000
Changes in other assets and liabilities affecting operating activities:			
Receivables, net	(25,551,000)	(9,883,000)	(14,592,000)
Prepaid expenses and other assets	(1,620,000)	(60,000)	(184,000)
Trade accounts payable and accrued expenses	10,224,000	1,009,000	4,771,000
Net cash provided by (used in) continuing operations	(2,095,000)	10,291,000	5,959,000
Net cash used in discontinued operations	(3,523,000)	(7,014,000)	(2,978,000)
Net cash provided by (used in) operating activities	(5,618,000)	3,277,000	2,981,000
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>			
Purchases of property and equipment	(6,022,000)	(4,646,000)	(5,494,000)
Property acquisitions	(7,550,000)	—	—
Acquisition of property and equipment through business combination	—	(10,900,000)	—
Proceeds from sale of discontinued operations	—	—	17,124,000
Proceeds from sale of unconsolidated affiliate	2,068,000	—	—
Change in restricted cash	1,658,000	2,489,000	31,000
Deposits and other deferred balances	—	(9,000)	(64,000)
Net cash provided by (used in) continuing operations	(9,846,000)	(13,066,000)	11,597,000
Net cash used in discontinued operations	—	—	(61,000)
Net cash provided by (used in) investing activities	(9,846,000)	(13,066,000)	11,536,000
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>			
Repayment of debt obligations	(73,374,000)	(15,342,000)	(21,645,000)
Proceeds from issuance of debt	92,789,000	27,945,000	21,808,000
Financing costs	(2,162,000)	(160,000)	(195,000)
Issuance and redemption of employee equity awards	(105,000)	79,000	(47,000)
Redemption of preferred stock	—	—	(4,918,000)
Payment of common stock dividends	(1,366,000)	(1,347,000)	(1,322,000)
Payment of preferred stock dividends	—	—	(220,000)
Deconsolidation of noncontrolling interests, net of income taxes	—	—	(1,385,000)
Payment for preferred stock restructuring	(640,000)	(619,000)	(600,000)
Net cash provided by (used in) continuing operations	15,142,000	10,556,000	(8,524,000)
Net cash used in discontinued operations	—	—	(5,956,000)
Net cash provided by (used in) financing activities	15,142,000	10,556,000	(14,480,000)

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

(Continued)

	<b>Years Ended December 31,</b>		
	<b>2016</b>	<b>2015</b>	<b>2014</b>
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	\$ (322,000)	\$ 767,000	\$ 37,000
CASH AND CASH EQUIVALENTS, beginning of period	4,585,000	3,818,000	3,781,000
CASH AND CASH EQUIVALENTS, end of period	<u>\$ 4,263,000</u>	<u>\$ 4,585,000</u>	<u>\$ 3,818,000</u>
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:			
Cash payments of interest, net of amounts capitalized	<u>\$ 3,965,000</u>	<u>\$ 3,629,000</u>	<u>\$ 3,324,000</u>
Cash payments of income taxes	<u>\$ 549,000</u>	<u>\$ 205,000</u>	<u>\$ 84,000</u>
SUPPLEMENTAL INFORMATION ON NON-CASH INVESTING AND FINANCING TRANSACTIONS:			
Acquisition of equipment through capital lease	<u>\$ 1,851,000</u>	<u>\$ —</u>	<u>\$ —</u>

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, 2016, 2015, and 2014**

**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, 2016, our continuing operations consist of 76 nursing centers with 8,453 licensed skilled 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, Mississippi, 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 through 2014 and it related to a nursing center in West Virginia described in Note 7, "Variable Interest Entity".

Any joint ventures are accounted for using the equity method, which is an 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 had one equity method investee through the fourth quarter of 2016. The investment in unconsolidated affiliate reflected on the 2015 consolidated balance sheet related to a pharmacy joint venture partnership in which the Company owned a 50% interest. The Company's share of the profits and losses from this investment are reported in equity in earnings of investment in unconsolidated affiliate and the proceeds received from the sale are reported in gain on sale of investment in unconsolidated affiliate in the accompanying consolidated statement of operations.

***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 center and may be based on the acuity of the care and services provided. These rates may be based on a center'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, 2016, 2015 and 2014, the Company recorded \$38,000, \$141,000 and \$298,000 of net unfavorable estimated settlements from federal and state programs for periods prior to the beginning of fiscal 2016, 2015 and 2014, 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 \$7,163,000, \$7,507,000, and \$5,710,000 for 2016, 2015 and 2014, respectively. The provision for doubtful accounts of continuing operations was 1.7%, 1.9%, and 1.7% of net revenue during 2016, 2015, and 2014, respectively.

*Lease Expense*

As of December 31, 2016, the Company operates 59 nursing centers under operating leases, including 35 owned by Omega, 20 owned by Golden Living and four 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 and Golden Living 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 Note 2, "Business Development and Other Significant Transactions", Note 3, "Discontinued Operations", and Note 11, "Commitments and Contingencies" for a discussion regarding the Company's Master Leases with Omega and Golden Living, the termination of leases for certain centers, and the addition of certain leased centers.

*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 center 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.

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. If circumstances suggest that the recorded amounts are not recoverable based upon estimated future undiscounted cash flows, the carrying values of such assets are reduced to fair value.



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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, "Long-term Debt, Interest Rate Swap and Capitalized Lease Obligations" for further discussion. As a result of our adoption of ASU No. 2015-03, which is further discussed below, the Company nets long-term debt and deferred financing costs in the consolidated balance sheets.

*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 centers 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 centers lies solely within the Company's intent to continue to operate the seven centers. 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, 2016, 2015 and 2014, respectively.

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

	<b>December 31,</b>	
	<b>2016</b>	<b>2015</b>
Intangible assets	\$ 10,652,000	\$ 10,652,000
Accumulated amortization	(3,577,000)	(3,193,000)
Net intangible assets	<u>\$ 7,075,000</u>	<u>\$ 7,459,000</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:

2017	\$ 384,000
2018	384,000
2019	384,000
2020	384,000
2021	384,000
Thereafter	<u>5,155,000</u>
	<u>\$ 7,075,000</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.

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.

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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 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, "Income Taxes" 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.

As further discussed in Note 6, "Long-term Debt, Interest Rate Swap and Capitalized Lease Obligations", in conjunction with the debt agreements entered into in February 2016, 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 as the debt is at a variable rate, 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, 2016 and 2015:

December 31, 2016	Fair Value Measurements - Assets (Liabilities)			
	Total	Level 1	Level 2	Level 3
Interest rate swap	\$ (129,000)	\$ —	\$ (129,000)	\$ —
December 31, 2015	Fair Value Measurements - Assets (Liabilities)			
	Total	Level 1	Level 2	Level 3
Interest rate swap	\$ (625,000)	\$ —	\$ (625,000)	\$ —

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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, "Net Income (Loss) per Common Share" 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 team members and recorded non-cash stock based compensation expense of \$1,012,000, \$1,152,000 and \$580,000 during the years ended December 31, 2016, 2015 and 2014, 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, "Shareholders' Equity, Stock Plans and Preferred Stock" for additional disclosures about the Company's stock based compensation plans.

*Accumulated Other Comprehensive Income (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 May 2014, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("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. In March 2016, the FASB issued an update to ASU No. 2014-09 in the form of ASU No. 2016-08, which amended the principal-versus-agent implementation guidance and illustrations in the new revenue guidance. The update clarifies that an entity should evaluate whether it is the principal or the agent for each specified good or service promised in a contract with a customer. In April 2016, the FASB issued another update to the new revenue standard in the form of ASU No. 2016-10, which amends the guidance on identifying performance obligations and the implementation guidance on licensing. In May 2016, ASU No. 2016-12 was issued, which amends the new revenue recognition guidance on transition, collectibility, noncash consideration and the presentation of taxes. The new revenue standard (including updates) will be effective for annual and interim reporting periods beginning after December 15, 2017, with early adoption permitted only as of annual reporting periods beginning after December 15, 2016. The Company will adopt the requirements of this standard effective January 1, 2018. We are in the early stages of evaluating the expected adoption method of ASU No. 2014-09, and we are analyzing whether enhancements are needed to our business and accounting systems.

In April 2015, the FASB issued ASU No. 2015-03, Simplifying the Presentation of Debt Issuance Costs (Topic 835), which amends and simplifies the presentation of debt issuance costs. The main provisions of the standard require that debt issuance costs related to a recognized liability be presented in the balance sheet as a direct deduction from the carrying amount of that debt liability, and amortization of the debt issuance costs continues to be reported as interest expense. The Company adopted ASU No. 2015-03 as of January 1, 2016. The new standard was applied on a retroactive basis. The adoption of this guidance resulted in a \$967,000 reclass between deferred financing costs and long-term debt.

In November 2015, the FASB issued ASU No. 2015-17, Balance Sheet Classification of Deferred Taxes, which changes how deferred taxes are classified on the Company's balance sheets and is effective for financial statements issued for annual periods beginning after December 15, 2016, with early adoption permitted. ASU 2015-17 requires all deferred tax assets and liabilities to be classified as non-current. Upon adoption on January 1, 2017, the Company anticipates reclassifying deferred income taxes of approximately \$7,644,000 from current to non-current assets.

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In February 2016, the FASB issued ASU No. 2016-02, Leases. The new standard establishes a right-of-use (ROU) model that requires a lessee to record a ROU asset and a lease liability on the balance sheet for all leases with terms longer than 12 months. Leases will be classified as either finance or operating, with classification affecting the pattern of expense recognition in the income statement. The new standard is effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. A modified retrospective transition approach is required for lessees for capital and operating leases existing at, or entered into after, the beginning of the earliest comparative period presented in the financial statements, with certain practical expedients available. Disclosures will be required to meet the objective of enabling users of financial statements to assess the amount, timing, and uncertainty of cash flows arising from leases. We anticipate this standard will have a material impact on our consolidated financial statements. While we are continuing to assess all potential impacts of the standard, we currently believe the most significant impact relates to our accounting for building and equipment operating leases and will result in a significant increase in the assets and liabilities on the consolidated balance sheet.

In March 2016, the FASB issued ASU No. 2016-09, Compensation - Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting. The ASU was issued as part of the FASB Simplification Initiative and involves several aspects of accounting for share-based payment transactions, including the income tax consequences and classification on the statement of cash flows. The guidance is effective for annual periods beginning after December 15, 2016, which will be the Company's fiscal year 2017, and interim periods within those annual periods. Early adoption is permitted. The Company is in the early stages of evaluating the impact this standard will have on our consolidated financial statements.

In June 2016, the FASB issued ASU No. 2016-13, Measurement of Credit Losses on Financial Instruments. This update is intended to improve financial reporting by requiring timelier recognition of credit losses on loans and other financial instruments that are not accounted for at fair value through net income, including loans held for investment, held-to-maturity debt securities, trade and other receivables, net investment in leases and other such commitments. This update requires that financial statement assets measured at an amortized cost be presented at the net amount expected to be collected, through an allowance for credit losses that is deducted from the amortized cost basis. This standard is effective for the fiscal year beginning after December 15, 2019 with early adoption permitted. The Company is in the initial stages of evaluating the impact from the adoption of this new standard on the Consolidated Financial Statements and related notes.

In August 2016, the FASB issued ASU No. 2016-15, Statement of Cash Flows (Topic 230). The ASU provides clarification regarding how certain cash receipts and cash payments are presented and classified in the statement of cash flows. The guidance addresses eight specific cash flow issues with the objective of reducing the existing diversity in practice. The ASU is effective for annual and interim periods beginning after December 15, 2017, which will require the Company to adopt these provisions in the first quarter of fiscal 2018 using a retrospective approach. Early adoption is permitted. The Company is currently evaluating the impact this standard will have on our consolidated financial statements.

In November 2016, the FASB issued ASU No. 2016-18, Statement of Cash Flows (Topic 230): Restricted Cash, which requires that the Statement of Cash Flows explain the changes during the period of cash and cash equivalents inclusive of amounts categorized as Restricted Cash. As a result, amounts generally described as restricted cash and restricted cash equivalents should be included with cash and cash equivalents when reconciling the beginning-of-period and end-of-period total amounts shown on the statement of cash flows. The standard is effective for periods beginning after December 15, 2017.

### *Reclassifications*

As discussed above, the Company adopted ASU No. 2015-03 as of January 1, 2016, and was applied on a retroactive basis. We reclassified \$967,000 of debt issuance costs to long-term debt as of December 31, 2015.

As discussed in Note 3, "Discontinued Operations" 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.

## **2. BUSINESS DEVELOPMENT AND OTHER SIGNIFICANT TRANSACTIONS**

### *Golden Living Transaction*

On August 15, 2016, the Company entered into an Operation Transfer Agreement with Golden Living (the "Lessor") to assume the operations of 22 centers in Alabama and Mississippi.

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On October 1, 2016, the Company entered into a Master Lease Agreement (the "Lease") with Golden Living to directly lease eight centers located in Mississippi from the Lessor, which include: (i) a 152-bed skilled nursing center known as Golden Living Center - Amory; (ii) a 130-bed skilled nursing center known as Golden Living Center - Batesville; (iii) a 58-bed skilled nursing center known as Golden Living Center - Brook Manor; (iv) a 119-bed skilled nursing center known as Golden Living Center - Eupora; (v) a 140-bed skilled nursing center known as Golden Living Center - Ripley; (vi) a 140-bed skilled nursing center known as Golden Living Center - Southaven; (vii) a 120-bed skilled nursing center known as Golden Living Center - Eason Blvd; (viii) a 60-bed skilled nursing center known as Golden Living Center - Tylertown. The Lease is triple net and has an initial term of ten years with two separate five year options to extend the term. The Company also assumed the individual leases of a 120-bed center known as Broadmoor Nursing Home, with an initial lease term of ten years with first year rent of \$540,000, escalating to \$780,000 in the second year, and 2% annually thereafter, and a 99-bed skilled nursing center known as Leake County Nursing Home, with a lease term of two years with annual rent of \$300,000.

On November, 1 2016, the Company amended and restated the Lease ("Amended Lease") with the Lessor to directly lease an additional twelve centers located in Alabama from the Lessor, which include: (i) a 87-bed skilled nursing center known as Golden Living Center - Arab; (ii) a 180-bed skilled nursing center known as Golden Living Center - Meadowood; (iii) a 132-bed skilled nursing center known as Golden Living Center - Riverchase; (iv) a 100-bed skilled nursing center known as Golden Living Center - Boaz; (v) a 154-bed skilled nursing center known as Golden Living Center - Foley; (vi) a 50-bed skilled nursing center known as Golden Living Center - Hueytown; (vii) a 85-bed skilled nursing center known as Golden Living Center - Lanett; (viii) a 138-bed skilled nursing center known as Golden Living Center - Montgomery; (ix) a 120-bed skilled nursing center known as Golden Living Center - Oneonta; (x) a 173-bed skilled nursing center known as Golden Living Center - Oxford; (xi) a 94-bed skilled nursing center known as Golden Living Center - Pell City; (xii) a 123-bed skilled nursing center known as Golden Living Center - Winfield. The Amended Lease is triple net and has an initial term of ten years with two separate five year options to extend the term. Base rent for the amended lease is \$24,675,000 for the first year and escalates 2% annually thereafter.

### *2016 Acquisitions*

On February 26, 2016, the Company exercised its purchase options to acquire the real estate assets for Diversicare of Hutchinson in Hutchinson, Kansas and Clinton Place in Clinton, Kentucky for \$4,250,000 and \$3,300,000, respectively. The Company has operated these centers since February 2015 and April 2012, respectively. Hutchinson is an 85-bed skilled nursing center and Clinton is an 88-bed skilled nursing center. As a result of the consummation of the Agreements, the Company allocated the purchase price and acquisition costs between the assets acquired. The relative fair value allocation of the purchase price was determined with the assistance of HealthTrust LLC, a third-party real estate valuation firm. The allocation for the assets acquired is as follows:

	<u>Hutchinson</u>	<u>Clinton Place</u>
Purchase Price	4,250,000	3,300,000
Acquisition Costs	43,000	34,000
	<u>4,293,000</u>	<u>3,334,000</u>
Allocation:		
Buildings	3,443,000	2,898,000
Land	365,000	267,000
Furniture, Fixtures and Equipment	485,000	169,000
	<u>4,293,000</u>	<u>3,334,000</u>

### *2015 Acquisitions*

On February 1, 2015, the Company entered into an Asset Purchase Agreement (the "Purchase Agreement") with Barren County Health Care Center, Inc. to acquire a 94-bed skilled nursing center in Glasgow, Kentucky, for an aggregate purchase price of \$7,000,000, partially financed through a \$5,000,000 mortgage loan with The PrivateBank with the balance paid in cash consideration.

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As a result of this business combination transaction, the Company allocated the purchase price of \$7,000,000 based on the fair value of the acquired net assets. 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>February 1, 2015</b>
Purchase Price	\$ 7,000,000
Land	672,000
Buildings	5,778,000
Furniture, Fixtures, and Equipment	550,000
	<u>\$ 7,000,000</u>

On November 1, 2015, the Company entered into an Asset Purchase Agreement with Haws Fulton Investors, LLC to acquire a 60-bed skilled nursing center in Fulton, Kentucky, for an aggregate purchase price of \$3,900,000. As a result of this business combination transaction, the Company allocated the purchase price of \$3,900,000 based on the fair value of the acquired net assets. The allocation for the net assets acquired is as follows:

	<b>November 1, 2015</b>
Purchase Price	\$ 3,900,000
Land	300,000
Buildings	3,338,000
Furniture, Fixtures, and Equipment	262,000
	<u>\$ 3,900,000</u>

*2015 Lease Agreement*

On February 1, 2015, the Company assumed operations of a 85-bed skilled nursing center in Hutchinson, Kansas. This center has an initial lease term of 10 years, and included an option to purchase exercisable after the first year of operations. The center was already operating and treating patients on the transition date. There was no purchase price paid to enter into the lease agreement. As disclosed above, the Company purchased this center on February 26, 2016.

*2016 Lease Termination*

On May 31, 2016, the Company entered into an Agreement with Avon Ohio, LLC to amend the original lease agreement, thus terminating the Company's right of possession of the center. As a result, the Company incurred lease termination costs of \$2,008,000 in the second quarter of 2016. Under the amended agreement, the Company is required to pay \$300,000 per year through the term of the original lease agreement, July 31, 2024. For accounting purposes, this transaction was not reported as a discontinued operation, which is in accordance with the modified authoritative guidance for reporting discontinued operations, effective January 1, 2015. A disposal is now required to be reported in discontinued operations only if the disposal represents a strategic shift that has (or will have) a major effect on the Company's operations and financial results.

*2016 Sale of Investment in Unconsolidated Affiliate*

On October 28, 2016, the Company and its partners entered into an asset purchase agreement to sell the pharmacy joint venture. The sale resulted in a \$1,366,000 recorded gain for the Company for the year ended December 31, 2016. The transaction also resulted in an immaterial gain contingency. The Company accounts for gain contingencies in accordance with the provisions of ASC 450, *Contingencies*, and, therefore, we do not record gain contingencies and recognize income until realized.

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### **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 center 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 centers 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 center 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 centers 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 centers 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 center.

The transaction resulted in a gain on the disposition of Rose Terrace which, along with the results of operations for these nursing centers, 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 applied 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 \$0, \$0, and \$10,961,000 and net loss of \$51,000, \$225,000, and \$26,000 during the years ended December 31, 2016, 2015, and 2014, respectively. In addition to the West Virginia centers, other discontinued operations that were disposed of prior to 2014 contributed net income (loss) of \$(16,000), \$(903,000), and \$3,284,000 during the years ended December 31, 2016, 2015, and 2014, 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.

### **4. RECEIVABLES**

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

	<b>December 31,</b>	
	<b>2016</b>	<b>2015</b>
Medicare	\$ 20,402,000	\$ 14,415,000
Medicaid and other non-federal government programs	31,208,000	20,133,000
Other patient and resident receivables	20,868,000	17,451,000
	<u>\$ 72,478,000</u>	<u>\$ 51,999,000</u>
Other receivables and advances	<u>\$ 1,193,000</u>	<u>\$ 1,407,000</u>

The other receivables and advances balance include of \$474,000 and \$938,000 related to renovation projects to be funded by Omega at December 31, 2016 and 2015, respectively. See Note 11, "Commitments and Contingencies" for additional discussion of these receivables and leased center construction projects.

Our accounts receivable at December 31, 2016, reflects the change in ownership of the twenty-two newly leased Golden Living centers in Alabama and Mississippi. The Company has entered into an agreement with Golden Living to utilize their billing credentials in order to perform the billing of the Medicare and Medicaid receivables until the change in ownership process has been completed. This agreement allows the Medicare and Medicaid receivables to be billed and collected in the interim. Payer sources could be delayed due to setting up new agreements and credentialing with those payers.

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.



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**5. PROPERTY AND EQUIPMENT**

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

	<b>December 31,</b>	
	<b>2016</b>	<b>2015</b>
Land	\$ 5,761,000	\$ 4,859,000
Buildings and leasehold improvements	85,660,000	76,025,000
Furniture, fixtures and equipment	37,401,000	33,499,000
	<u>128,822,000</u>	<u>114,383,000</u>
Less: accumulated depreciation	(69,022,000)	(62,110,000)
Net property and equipment	<u>\$ 59,800,000</u>	<u>\$ 52,273,000</u>

As discussed further in Note 6, "Long-term Debt, Interest Rate Swap and Capitalized Lease Obligations", 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.

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

Long-term debt consists of the following:

	<b>December 31,</b>	
	<b>2016</b>	<b>2015</b>
Mortgage loan with a syndicate of banks; issued in March 2011, amended May 2013; and further amended February 2016; payable monthly, interest at 4.0% above LIBOR, a portion of which is fixed at 5.79% based on the interest rate swap described below.	\$ 58,792,000	\$ 47,401,000
Acquisition loan with The PrivateBank, issued in February 2016, interest at 4.75% above LIBOR.	6,289,000	—
Revolving credit facility borrowings payable to a bank; entered into in March 2010; amended in March 2011 and further amended May 2013, March 2014, February 2016 and October 2016; secured by receivables of the Company; interest at 4.0% above LIBOR.	<u>15,000,000</u>	<u>12,900,000</u>
	80,081,000	60,301,000
	<u>(6,663,000)</u>	<u>(6,276,000)</u>
Less current portion	<u>\$ 73,418,000</u>	<u>\$ 54,025,000</u>

As of December 31, 2016, the Company's weighted average interest rate on long-term debt, including the impact of the interest rate swap, was approximately 5.17%.

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 February 26, 2016, 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 April 30, 2013. The Credit Agreement increases the Company's borrowing capacity to \$100,000,000 allocated between a \$72,500,000 Mortgage Loan ("Amended Mortgage Loan") and a \$27,500,000 Revolver ("Amended Revolver"). The Amended Mortgage Loan consists of \$60,000,000 term and \$12,500,000 acquisition loan facilities. Loan acquisition costs associated with the Amended Mortgage Loan and the Amended Revolver were capitalized in the amount of \$2,162,000 and are being amortized over the five-year term of the agreements. Additionally, the Glasgow term loan balance of \$5,000,000 was consolidated into the new Credit Agreement.

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Under the terms of the amended agreements, the syndicate of banks provided the Amended Mortgage Loan with an original balance of \$72,500,000 with a five-year maturity through February 26, 2021, and a \$27,500,000 Amended Revolver through February 26, 2021. The Amended Mortgage Loan has a term of five years, with principal and interest payable monthly based on a 25-year amortization. Interest on the term and acquisition loan facilities are based on LIBOR plus 4.0% and 4.75%, respectively. A portion of the Amended Mortgage Loan is effectively fixed at 5.79% pursuant to an interest rate swap with an initial notional amount of \$30,000,000. As of December 31, 2016, the interest rate related to the Amended Mortgage Loan was 4.75%. The Amended Mortgage Loan is secured by 17 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 and cross-defaulted. The Company's Amended Revolver has an interest rate of LIBOR plus 4.0% 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 October 3, 2016, the Company entered into the Second Amendment to the Third Amended and Restated Revolver ("Second Amendment"). The Second Amendment increased the Amended Revolver capacity from the \$27,500,000 in the original Amended Revolver to \$52,250,000; provided that the maximum revolving facility be reduced to \$42,250,000 on August 1, 2017. The change to the borrowing capacity is a result of the increase in receivables related to new centers that continue to progress through the change in ownership process.

On December 29, 2016, the Company executed a Third Amendment to the Third Amended and Restated Revolver ("Third Amendment"). The Third Amendment modifies the terms of the Loan Agreement by increasing the Company's letter of credit sublimit from \$10,000,000 to \$15,000,000.

As of December 31, 2016, the Company had \$15,000,000 in borrowings outstanding under the Amended Revolver compared to \$12,900,000 outstanding as of December 31, 2015. The outstanding borrowings on the Amended Revolver primarily reflect the Company's approach to accumulated Medicaid and Medicare receivables at recently acquired centers as these centers 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 12 letters of credit with a total value of \$10,230,000 outstanding as of December 31, 2016. Considering the balance of eligible accounts receivable, the letter of credit, the amounts outstanding under the Amended Revolver and the maximum loan amount of \$42,674,000, the balance available for borrowing under the Amended Revolver is \$14,443,000 at December 31, 2016.

The Company's debt agreements contain various financial covenants, the most restrictive of which relates to debt service coverage ratios. The Company is in compliance with all such covenants at December 31, 2016.

In connection with the Company's 2016 and 2015 financing agreements, the Company recorded the following deferred loan costs related to the new financing agreements as a reduction of the debt balances discussed above:

	<u>2016</u>	<u>2015</u>
Write-off of deferred financing costs	\$ 351,000	\$ —
Deferred financing costs capitalized	\$ 2,162,000	\$ 160,000

The deferred financing costs included in the current and long-term balances were \$2,273,000 at December 31, 2016 and \$967,000 at December 31, 2015.

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

2017	\$ 6,663,000
2018	6,740,000
2019	6,820,000
2020	8,196,000
2021	<u>\$ 51,662,000</u>
Total	<u>\$ 80,081,000</u>

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*Interest Rate Swap Cash Flow Hedge*

As part of the debt agreements entered into in April 2013, 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 February 2016, 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 has an amortizing notional amount that was \$29,329,000 as of December 31, 2016. 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 5.79% 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, 2016, the Company determined that the interest rate swap was effective. The interest rate swap valuation model indicated a net liability of \$129,000 at December 31, 2016. The fair value of the interest rate swap is included in "other noncurrent liabilities" on the Company's consolidated balance sheets. The liability related to the change in the interest rate swap included in accumulated other comprehensive income at December 31, 2016 is \$80,000, net of income tax benefit of \$49,000. 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 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*

Upon acquisition of some centers, 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 \$2,052,000 and \$566,000 as of December 31, 2016 and 2015, respectively. These lease agreements provide three to five year terms.

Scheduled payments of the capitalized lease obligations are as follows:

2017	\$ 1,133,000
2018	955,000
2019	75,000
Total	2,163,000
Amounts related to interest	(111,000)
Principal payments on capitalized lease obligation	<u>\$ 2,052,000</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 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.

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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, "Discontinued Operations", 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 consolidated.

## **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. In June 2016, our shareholders approved an amendment to the Stock Purchase Plan to increase the number of shares of our common stock authorized under the Plan from 150,000 shares to 350,000 shares. No grants can be made under the Stock Purchase Plan after April 25, 2028.

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 2016 and 2015, the Compensation Committee of the Board of Directors approved grants totaling approximately 83,000 and 74,000, respectively, 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. 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.

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The Company recorded non-cash stock-based compensation expense from continuing operations for equity grants and RSU's issued under the Plans of \$1,012,000, \$1,152,000, and \$580,000 during the years ended December 31, 2016, 2015, and 2014, 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, 2016, there was \$537,000 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 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>2016</b>	<b>2015</b>	<b>2014</b>
Expected volatility (range)	N/A <sup>(1)</sup>	44%-49%	N/A <sup>(1)</sup>
Risk free interest rate (range)	N/A <sup>(1)</sup>	1.52%-1.87%	N/A <sup>(1)</sup>
Expected dividends	N/A <sup>(1)</sup>	2.15%	N/A <sup>(1)</sup>
Weighted average expected term (years)	N/A <sup>(1)</sup>	6	N/A <sup>(1)</sup>

- (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, 2016 and 2014. 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's recent exercise history is primarily from options granted in 2005 that were vested at grant date and were significantly in-the-money due 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>2016<sup>(1)</sup></b>	<b>2015</b>	<b>2014<sup>(1)</sup></b>
Weighted average grant date fair value	—	\$ 3.78	—
Total intrinsic value of exercises	\$ 3,000	\$ 249,000	\$ 126,000

- (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, 2016 and 2014. All equity grants during this period were restricted common shares which are valued using an intrinsic valuation method based on market price.

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The following table summarizes information regarding stock options and SOSAR grants outstanding as of December 31, 2016:

<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>
\$10.21 to \$11.59	\$ 10.88	62,000	\$ 3,000	57,000	\$ —
\$2.37 to \$6.21	\$ 5.54	169,000	822,000	169,000	822,000
		<u>231,000</u>		<u>226,000</u>	

As of December 31, 2016, the outstanding equity grants have a weighted average remaining life of 3.94 and those outstanding equity grants that are exercisable have a weighted average remaining life of 3.84. During the year ended December 31, 2016, approximately 1,000 stock option and SOSAR grants were exercised under these plans. All of the equity grants exercised were net settled. The net proceeds from equity grants exercised in 2016 was \$(105,000).

Summarized activity of the equity compensation plans is presented below:

	<b>SOSARs/ Options</b>	<b>Weighted Average Exercise Price</b>
Outstanding, December 31, 2015	232,000	\$ 6.97
Granted	—	—
Exercised	(1,000)	7.24
Expired or cancelled	—	—
Outstanding, December 31, 2016	<u>231,000</u>	<u>\$ 6.97</u>
Exercisable, December 31, 2016	<u>226,000</u>	<u>\$ 6.90</u>

	<b>Restricted Shares</b>	<b>Weighted Average Grant Date Fair Value</b>
Outstanding, December 31, 2015	141,000	\$ 9.07
Granted	83,000	8.87
Dividend Equivalents	4,000	9.21
Vested	(68,000)	7.85
Cancelled	(7,000)	9.80
Outstanding December 31, 2016	<u>153,000</u>	<u>\$ 9.47</u>

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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, 2015	62,000	\$ 9.58
Granted	17,000	8.87
Dividend Equivalents	2,000	9.19
Vested	(27,000)	6.13
Cancelled	—	—
Outstanding December 31, 2016	54,000	\$ 11.10

### **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 was 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 was 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.

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The following table reflects activity in the Series C Preferred Stock:

	<b>Series C Preferred Stock</b>		
	<b>2016</b>	<b>2015</b>	<b>2014</b>
Balance at the beginning of the period	\$ —	\$ —	\$ 4,918,000
Redemption of preferred stock	—	—	(4,918,000)
Balance at the end of the period	\$ —	\$ —	\$ —

**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>2016</b>	<b>2015</b>	<b>2014</b>
Numerator: Income (loss) attributable to Diversicare Healthcare Services, Inc. common shareholders:			
Income (loss) from continuing operations	\$ (1,744,000)	\$ 2,752,000	\$ 1,450,000
Less: net loss attributable to noncontrolling interests	—	—	25,000
Income (loss) from continuing operations attributable to Diversicare Healthcare Services, Inc.	(1,744,000)	2,752,000	1,475,000
Preferred stock dividends	—	—	(220,000)
Income (loss) from continuing operations attributable to Diversicare Healthcare Services, Inc. common shareholders	(1,744,000)	2,752,000	1,255,000
Income (loss) from discontinued operations, net of income taxes	(67,000)	(1,128,000)	3,258,000
Net income (loss) attributable to Diversicare Healthcare Services, Inc. common shareholders	\$ (1,811,000)	\$ 1,624,000	\$ 4,513,000
Denominator: Basic Weighted Average Common Shares Outstanding:	6,199,000	6,100,000	6,011,000
Basic net income per common share			
Income (loss) from continuing operations	\$ (0.28)	\$ 0.45	\$ 0.21
Income (loss) from discontinued operations			
Operating loss, net of taxes	(0.01)	(0.18)	(0.25)
Gain on disposal, net of taxes	—	—	0.79
Discontinued operations, net of taxes	(0.01)	(0.18)	0.54
Basic net income (loss) per common share	\$ (0.29)	\$ 0.27	\$ 0.75



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	<u>2016</u>	<u>2015</u>	<u>2014</u>
Numerator: Income (loss) from continuing operations attributable to Diversicare Healthcare Services, Inc. common shareholders	(1,744,000)	2,752,000	1,255,000
Income (loss) from discontinued operations, net of income taxes	(67,000)	(1,128,000)	3,258,000
Net income (loss) attributable to Diversicare Healthcare Services, Inc. common shareholders	<u>\$ (1,811,000)</u>	<u>\$ 1,624,000</u>	<u>\$ 4,513,000</u>
Basic weighted average common shares outstanding	6,199,000	6,100,000	6,011,000
Incremental shares from assumed exercise of options, SOSARS and Restricted Stock Units	—	215,000	186,000
Denominator: Diluted Weighted Average Common Shares Outstanding:	<u>6,199,000</u>	<u>6,315,000</u>	<u>6,197,000</u>
Diluted net income per common share			
Income (loss) from continuing operations	\$ (0.28)	\$ 0.44	\$ 0.20
Income (loss) from discontinued operations			
Operating loss, net of taxes	(0.01)	(0.18)	(0.25)
Gain on disposal, net of taxes	—	—	0.77
Discontinued operations, net of taxes	<u>(0.01)</u>	<u>(0.18)</u>	<u>0.52</u>
Diluted net income (loss) per common share	<u>\$ (0.29)</u>	<u>\$ 0.26</u>	<u>\$ 0.72</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>2016</u>	<u>2015</u>	<u>2014</u>
SOSARs/Options Excluded	31,000	62,000	57,000

The weighted average common shares for basic and diluted earnings for common shares was the same due to the losses in 2016.

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**10. INCOME TAXES**

*Overview*

For the year ended December 31, 2016, the Company recorded a benefit for income taxes from continuing operations of \$1,030,000, and a provision for income taxes from continuing operations of \$916,000 and \$857,000 for the years ended December 31, 2015 and 2014, respectively. The provision (benefit) for income taxes of continuing operations is composed of the following components:

	<b>Year Ended December 31,</b>		
	<b>2016</b>	<b>2015</b>	<b>2014</b>
Current provision (benefit) :			
Federal	\$ 17,000	\$ 1,191,000	\$ 10,000
State	522,000	947,000	10,000
	<u>539,000</u>	<u>2,138,000</u>	<u>20,000</u>
Deferred provision (benefit):			
Federal	(1,284,000)	(783,000)	798,000
State	(285,000)	(439,000)	39,000
	<u>(1,569,000)</u>	<u>(1,222,000)</u>	<u>837,000</u>
Provision (benefit) for income taxes of continuing operations	<u>\$ (1,030,000)</u>	<u>\$ 916,000</u>	<u>\$ 857,000</u>

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>2016</b>	<b>2015</b>	<b>2014</b>
Provision (benefit) for federal income taxes at statutory rates	\$ (889,000)	\$ 1,247,000	\$ 784,000
Provision for state income taxes, net of federal benefit	120,000	688,000	76,000
Valuation allowance changes affecting the provision for income taxes	(45,000)	(534,000)	(66,000)
Employment tax credits	(529,000)	(1,249,000)	(169,000)
Nondeductible expenses	453,000	862,000	123,000
Stock based compensation expense	(62,000)	(105,000)	3,000
Other	(78,000)	7,000	106,000
Provision (benefit) for income taxes of continuing operations	<u>\$ (1,030,000)</u>	<u>\$ 916,000</u>	<u>\$ 857,000</u>

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*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>2016</b>	<b>2015</b>
Current deferred tax assets:		
Allowance for doubtful accounts	3,772,000	3,049,000
Accrued liabilities	5,011,000	5,895,000
	8,783,000	8,944,000
Less valuation allowance	(272,000)	(319,000)
	8,511,000	8,625,000
Current deferred tax liabilities:		
Prepaid expenses	(867,000)	(626,000)
	<u>\$ 7,644,000</u>	<u>\$ 7,999,000</u>
	<b>December 31,</b>	
	<b>2016</b>	<b>2015</b>
Noncurrent deferred tax assets:		
Net operating loss and other carryforwards	\$ 1,260,000	\$ 1,040,000
Credit carryforwards	3,162,000	2,612,000
Deferred lease costs	107,000	167,000
Depreciation	2,122,000	1,184,000
Tax goodwill and intangibles	(1,296,000)	(1,172,000)
Stock-based compensation	629,000	534,000
Accrued rent	3,118,000	3,055,000
Kentucky and Kansas acquisition costs	6,000	113,000
Impairment of long-lived assets	269,000	267,000
Interest rate swap	49,000	237,000
Hedge Ineffectiveness	(69,000)	—
Noncurrent self-insurance liabilities	4,633,000	4,185,000
Other	11,000	—
	14,001,000	12,222,000
Less valuation allowance	(460,000)	(460,000)
	<u>\$ 13,541,000</u>	<u>\$ 11,762,000</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.

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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, 2016, the Company has a cumulative pre-tax income from continuing operations of \$3,201,000, which includes \$2,774,000 of loss attributable to the year ended December 31, 2016. 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 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 centers in Ohio in 2016 and West Virginia in 2014. The operations in the state of 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.

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, 2016, the Company had \$7,385,000 of net operating losses, which expire at various dates beginning in 2019 and continue through 2036. 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 \$2,519,000. 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 \$47,000 in 2016, 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, 2016. In 2015 and 2014, the Company recorded a deferred tax provision to adjust approximately \$315,000 and \$215,000, 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 \$732,000 at December 31, 2016 to reduce the deferred tax assets by the amount management believes is more likely than not to not 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, \$737,000 and \$550,000 in Work Opportunity Tax Credits during 2016, 2015 and 2014, 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 2031 and continue through 2036.

The Company received a notice of an audit by the Internal Revenue Service related to the 2012 tax year, which was closed in 2015. As of December 31, 2016, the Company's tax years for 2013 forward are subject to examination by tax authorities.

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**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, 2017, are as follows:

2017	\$	57,051,000
2018		58,076,000
2019		59,165,000
2020		60,231,000
2021		61,191,000
Thereafter		836,102,000
	\$	<u>1,131,816,000</u>

Under these lease agreements, the Company's lease payments are subject to periodic annual escalations as described below and in Note 1, "Business and Summary of Significant Accounting Policies". Total lease expense for continuing operations was \$33,364,000, \$28,690,000 and \$26,151,000 for 2016, 2015 and 2014, respectively. The accrued liability related to straight line rent was \$7,920,000 and \$7,830,000 at December 31, 2016 and 2015, respectively, and is included in "Other noncurrent liabilities" on the accompanying consolidated balance sheets.

**Omega Master Lease**

The Company leases 35 nursing centers from Omega, 15 of which are subject to 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 centers leased from Omega. The Lease amendment extended the term to September 30, 2018 and provided a renewal option of an additional twelve years, and the Company must notify Omega by September 30, 2017 about exercising the renewal option. 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%. 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 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 centers at an amount currently equal to \$440 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 \$1,700,000. 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 centers 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 centers 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 \$4,792,000 as a security deposit for the Company's leases with Omega, as described in Note 6, "Long-term Debt, Interest Rate Swap and Capitalized Lease Obligations".

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*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 centers will be increased to reflect the amount of capital improvements to the respective centers 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.

The Company completed an expansion to one of its centers by making use of fifteen licensed beds it acquired in 2005. This expansion project was funded by Omega with the renovation funding previously described. Accordingly, the costs incurred to expand the center 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>2016</b>	<b>2015</b>
Leasehold improvement	\$ 921,000	\$ 921,000
Accumulated Amortization	(737,000)	(631,000)
Net	<u>\$ 184,000</u>	<u>\$ 290,000</u>

**Golden Living Master Lease**

The Company leases 20 nursing centers from Golden Living under a Master Lease. On October 1, 2016, the Company and Golden Living entered into a Master Lease agreement to lease eight centers located in Mississippi. On November 1, 2016, the Company and Golden Living entered into an Amended and Restated Master Lease ("Golden Living Lease Amendment") to extend the term of its centers leased from Golden Living and lease an additional twelve centers located in Alabama. The Amended Lease is triple net and has an initial term of ten years with two separate five year options to extend the term. Base rent for the amended lease is \$24,675,000 for the first year and escalates 2% annually thereafter. 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 10 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 Master Lease requires the Company to fund annual capital expenditures related to the leased centers at an amount currently equal to \$500 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 \$11,560,000. 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 centers to Golden Living. The assets to be transferred to Golden Living 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 center 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 \$2,056,000 as a security deposit for the Company's leases with Golden Living, as described in Note 6, "Long-term Debt, Interest Rate Swap and Capitalized Lease Obligations".

**Other Operating Leases**

In addition to the Omega and Golden Living Master Leases, the Company currently leases 24 other nursing centers which primarily operate under individual leases. The lease terms for these centers range from two years to twenty years including renewal options. While the individual lease terms vary from center to center, the majority of the leases 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.

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**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 \$19,977,000 as of December 31, 2016. 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.

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 \$4,456,000, \$3,328,000, and \$4,757,000 for the years ended December 31, 2016, 2015 and 2014, 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 estimated insurance recovery receivables are included within "Other Current Assets" on the Consolidated Balance Sheet. As of December 31, 2016 and 2015, there are no estimated insurance recovery receivables.

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.

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*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, 2007 until June 30, 2008, the Company is completely self-insured for workers' compensation exposure. 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 \$171,000 at December 31, 2016. The Company has a non-current receivable for workers' compensation policies covering previous years of \$1,310,000 as of December 31, 2016. 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, 2016, 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 \$1,019,000 at December 31, 2016. 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 \$1,789,000 as of December 31, 2016. 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 of termination versus the stated equity award exercise price. Based on the closing price of our common stock on December 31, 2016, there is \$461,000 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 center. 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, 2016, we are engaged in 67 professional liability lawsuits, which are reserved for as discussed above. Seven 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.



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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).

In October 2014, the Company learned that the investigation was started by the filing under seal of a false claims action against the two centers that were the subject of the original CID. In connection with this matter, between July 2013 and early February 2016, the Company has received three civil investigative demands (a form of subpoena) for documents and information relating to our practices and policies for rehabilitation, and other services, our preadmission evaluation forms ("PAEs") required by TennCare and our Pre-Admission Screening and Resident Reviews ("PASRRs"). We have responded to those requests. The DOJ has also issued CID's for testimony from current and former employees of the Company. The DOJ's civil investigation of the Company's practices and policies for rehabilitation now covers all of the Company's centers, but thus far only documents from six of our centers have been requested.

In June 2016, the Company received an authorized investigative demand (a form of subpoena) for documents in connection with a criminal investigation by the DOJ related to our practices with respect to PAEs and PASRRs, and the Company has provided documents responsive to this subpoena and continues to provide additional information as requested. The Company cannot predict the outcome of these investigations or the related lawsuits, and the outcome could have a materially adverse effect on the Company, including the imposition of treble damages, criminal charges, fines, penalties and/or a corporate integrity agreement. The Company is committed to provide caring and professional services to its patients and residents in compliance with applicable laws and regulations.

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 "Center"). The complaint alleges that the defendants breached their statutory and contractual obligations to the patients of the Center over the five-year period 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 pending DOJ investigation or the purported class action against the Arkansas centers. 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.

## **12. QUARTERLY FINANCIAL INFORMATION (UNAUDITED)**

Selected quarterly financial information for each of the quarters in the years ended December 31, 2016 and 2015 is as follows:

<b>2016</b>	<b>Quarter</b>			
	<b>First</b>	<b>Second</b>	<b>Third</b>	<b>Fourth</b>
Patient revenues, net	\$ 97,945,000	\$ 95,805,000	\$ 97,313,000	\$ 135,000,000
Professional liability expense <sup>(1)</sup>	2,066,000	1,934,000	1,977,000	2,479,000
Income (loss) from continuing operations	(74,000)	(2,150,000)	(958,000)	1,438,000
Loss from discontinued operations	(37,000)	—	(17,000)	(13,000)
Net income (loss) attributable to Diversicare Healthcare Services, Inc. common shareholders	\$ (111,000)	\$ (2,150,000)	\$ (975,000)	\$ 1,425,000
Basic net income (loss) per common share for Diversicare Healthcare Services, Inc. common shareholders:				
Income (loss) from continuing operations	\$ (0.01)	\$ (0.35)	\$ (0.16)	\$ 0.24
Loss from discontinued operations	(0.01)	—	—	—
Net income (loss) per common share for Diversicare Healthcare Services, Inc. common shareholders	\$ (0.02)	\$ (0.35)	\$ (0.16)	\$ 0.24

**DIVERSICARE HEALTHCARE SERVICES, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**DECEMBER 31, 2016, 2015, and 2014**

<b>2016</b>	<b>Quarter</b>			
	<b>First</b>	<b>Second</b>	<b>Third</b>	<b>Fourth</b>
Diluted net income (loss) per common share for Diversicare Healthcare Services, Inc. common shareholders:				
Income (loss) from continuing operations	\$ (0.01)	\$ (0.35)	\$ (0.16)	\$ 0.24
Loss from discontinued operations	(0.01)	—	—	—
Net income (loss) per common share for Diversicare Healthcare Services, Inc. common shareholders	\$ (0.02)	\$ (0.35)	\$ (0.16)	\$ 0.24

- (1) The Company's quarterly results are significantly affected by the amounts recorded for professional liability expense, as discussed further in Note 11, "Commitments and Contingencies". The amount of expense recorded for professional liability in each quarter of 2016 is set forth in the table above.

<b>2015</b>	<b>Quarter</b>			
	<b>First</b>	<b>Second</b>	<b>Third</b>	<b>Fourth</b>
Patient revenues, net	\$ 95,225,000	\$ 96,288,000	\$ 98,105,000	\$ 97,977,000
Professional liability expense <sup>(1)</sup>	2,155,000	1,926,000	2,069,000	1,972,000
Income (loss) from continuing operations	5,000	807,000	669,000	1,271,000
Loss from discontinued operations	(263,000)	(299,000)	(238,000)	(328,000)
Net income (loss) attributable to Diversicare Healthcare Services, Inc. common shareholders	\$ (258,000)	\$ 508,000	\$ 431,000	\$ 943,000

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

Income from continuing operations	\$ —	\$ 0.13	\$ 0.11	\$ 0.21
Loss from discontinued operations	(0.04)	(0.05)	(0.04)	(0.05)
Net income (loss) per common share for Diversicare Healthcare Services, Inc. common shareholders	\$ (0.04)	\$ 0.08	\$ 0.07	\$ 0.16

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

Income from continuing operations	\$ —	\$ 0.13	\$ 0.11	\$ 0.20
Loss from discontinued operations	(0.04)	(0.05)	(0.04)	(0.05)
Net income (loss) per common share for Diversicare Healthcare Services, Inc. common shareholders	\$ (0.04)	\$ 0.08	\$ 0.07	\$ 0.15

- (1) The Company's quarterly results are significantly affected by the amounts recorded for professional liability expense, as discussed further in Note 11, "Commitments and Contingencies". The amount of expense recorded for professional liability in each quarter of 2015 is set forth in the table above.

## ***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, 2016. 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  
Managing Partner of Marlin Capital Partners, LLC

#### **Wallace E. Olson**

Chairman, Compensation Committee  
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.**

Private Investor

#### **Robert A. McCabe, Jr.**

Chairman, Governance and Nominating Committee  
Chairman of the Board of Pinnacle Financial Partners



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. Forward-looking statements are predictive in nature and are frequently identified by the use of terms such as "may," "will," "should," "expect," "believe," "estimate," "intend," and similar words indicating possible future expectations, events or actions. 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 integrate the operations of our new nursing centers in Alabama, Mississippi, Kansas and Kentucky, as well as successfully operate all of our centers, our ability to increase census at our centers, changes in governmental reimbursement, including the impact of the CMS final rule that has resulted in a reduction in Medicare reimbursement 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 extend or replace our current credit facility, 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 HIPAA and 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.