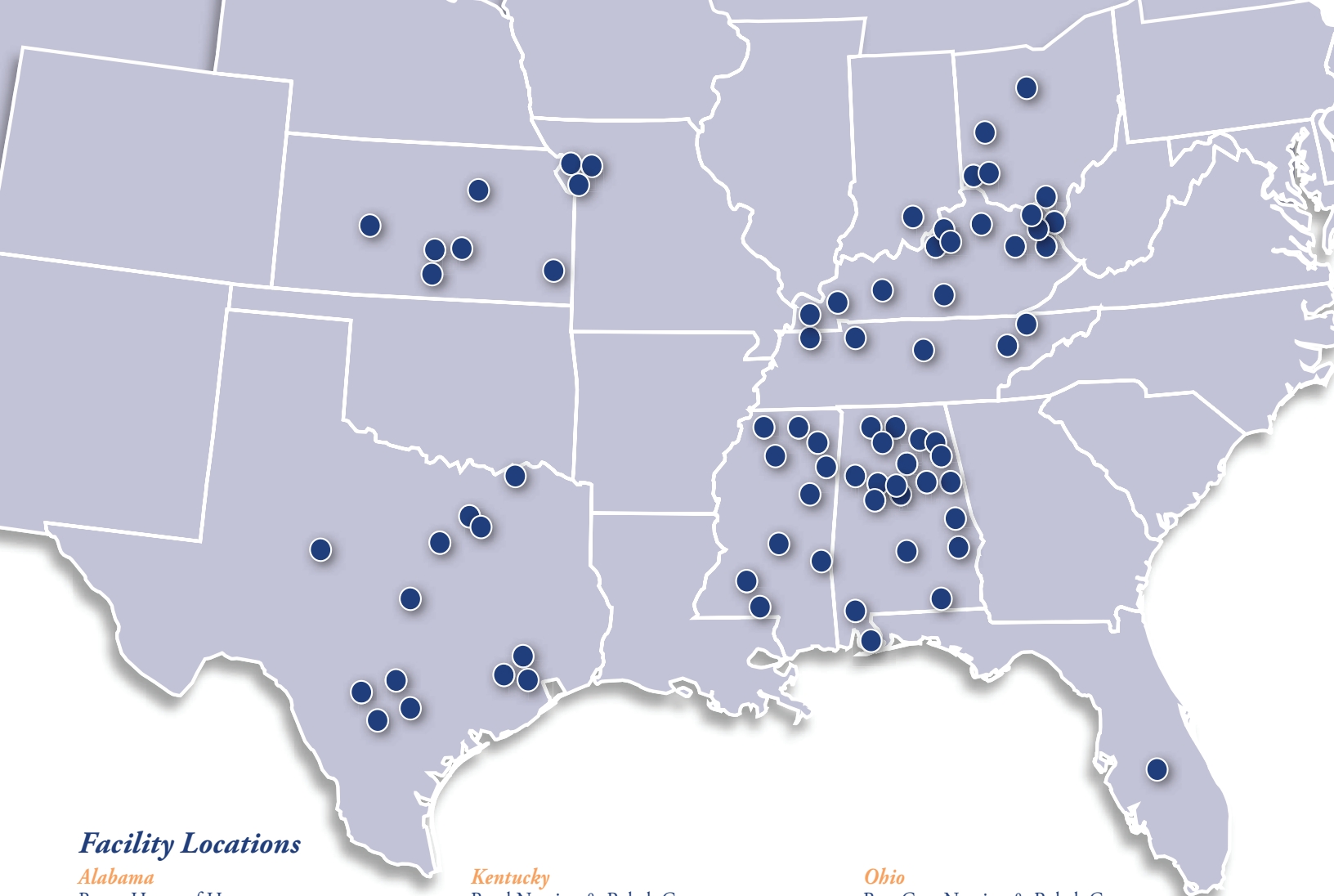




A Trusted Name • Decades of Quality Care

2017 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
 Park Place
 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

*Sold 10/01/2017

Ohio

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
 Diversicare of Luling
 Estates Healthcare & 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

LETTER TO SHAREHOLDERS

Dear Shareholder:

We are pleased to report on our activities and results for 2017.

To summarize our 2017 financial results, annual revenue grew over 2016 by almost \$150 million, representing a 35% year-over-year growth. That growth coupled with our leverage of our overhead expense resulted in a decrease of G&A expense as a percentage of revenue for the year from 7.1% to 5.8%. Reported EBITDA for 2017 was just over \$19.2 million and is an 86.2% increase, or \$8.9 million over 2016.

For the entire portfolio, operating expenses as a percentage of revenue were consistent with historical levels. Additionally, our year-to-date operating expense as a percentage of revenue for 2017 was 79.7% compared to 80.5% in 2016, or an improvement of 80 basis points. The 2015 YTD figure was 80.2%, or 50 basis points higher than 2017.

Occupancy and Skilled Mix

Our average occupancy rate as a percentage of available beds was 84.3% in 2017; the comparable figures were 81.2% in 2016 and 80.4% in 2015.

As for our skilled mix, our Q4 rate was 14.7% and was up 20 basis points over Q3 of 2017 and up 10 basis points over Q4 of 2016. Once again to provide a broader context, our skilled mix percentage for both 2016 and 2017 are very comparable, but both years were about 100 basis points below the 2015 average, which is principally driven by the payer mix of acquired centers and pressure on length of stay for both Medicare and Managed Care patients.

It is also interesting to note is that our rate of admissions in 2017 is up by 5% year-over-year. Contrasting our occupancy rate against the increased admission rate, we are seeing pressure on our lengths of stay per spell of illness. Our Medicare and Managed Care lengths of stay were down 10% and 17% respectively, which is consistent with the pressure the industry is seeing from both payer sources. This pressure is universal to the post-acute industry and is likely to continue. However on the positive side, we believe this trend reflects both our ability to care for more patients and those with higher acuity who inherently have shorter lengths of stay.

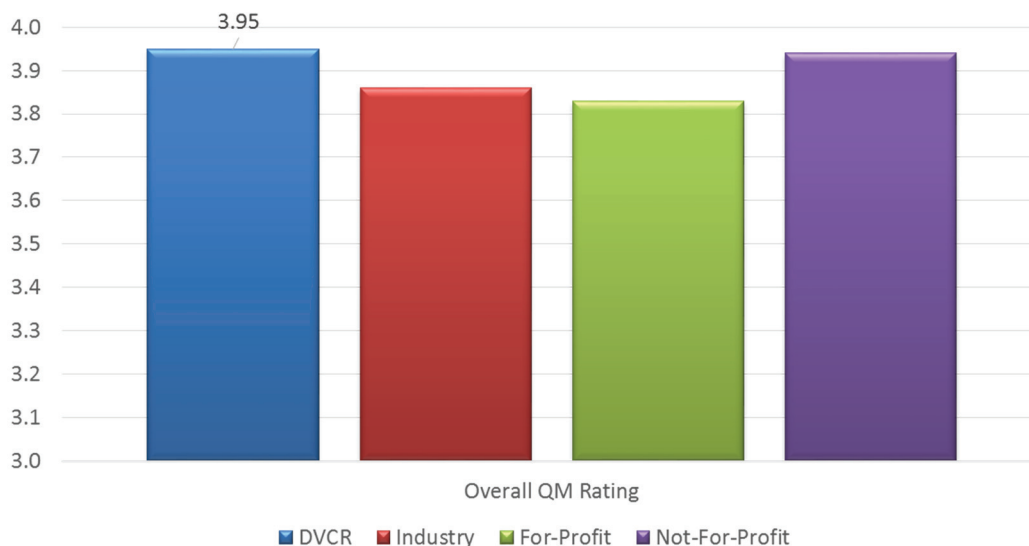
Quality Outcomes

The Quality Measures (QM) outcomes as measured under CMS's 5 Star program are an important reflection of our ability to provide quality care to our patients and residents. Our team has improved our overall QM score of our legacy group from 4.02 to 4.3 year-over-year and continues to lead our for-profit peer group. The Golden Living portfolio we acquired last year now has an overall QM score of 3.0 compared to 2.41 at the time of the acquisition. Our combined QM metrics for our portfolio have improved to 3.95 currently from 3.57 at this time last year.

Another important metric that we routinely monitor through 3rd party services is our Customer Service results. These results are comprised and compared to national customer service outcome data that is specific to the Skilled Nursing industry provider groups across the country. These summary measurements include metrics on overall satisfaction, and the percentage of those who would recommend our services to others. The study also covers separate measurement on both our short term patients and long term residents. We are pleased to report that the results of our outcomes exceed the national benchmarks in all areas of the summary analysis.

During 2017 our overall QM score under the CMS 5 Star Program improved from 3.57 to 3.95. As we have shared in the past, the centers acquired from Golden Living dilute our overall QM score, but we made significant process in 2017 in improving this measure. The QM scores for the centers we acquired from Golden Living have improved from 2.41 at the time of acquisition to 3.0 at the end of 2017.

LETTER TO SHAREHOLDERS



Acquisitions

Following the acquisition of the 22 centers from Golden Living in the fall of 2016, 2017 was a year of integration. Now that the Golden Living Centers are relatively normalized, they are providing a financial contribution to the company. In 2017 we acquired an individual skilled nursing center in Selma, Alabama. This 103 bed facility contributed over \$4.5 million of revenue for the second half of 2017. The centers acquired in 2016 and 2017 contributed revenue growth year-over-year of \$151.1 million. The facility level contribution from these centers increased from \$9.2 million in 2016 to \$40.7 million in 2017.

It is important to remember that billings for our services are suspended during the Change-of-Ownership process, which delays cash flow until this process is complete. Due to size of the 2016 Golden Living acquisition, this reduced cash position limited our ability to continue acquisitions during most of 2017. However, this process is now substantially complete and we were able to move forward with the purchase of Park Place in Selma, Alabama.

During the year we disposed of a center in Carthage, Mississippi. At the time of the disposition, the lease for this center had 18 months remaining and came as part of the 22 centers we acquired from Golden Living. The owner of the center expressed a desire to begin operating the center and offered an early termination fee to end the lease. In the future we will continue to explore opportunities to exit nursing centers that are not a strategic fit for our portfolio or no longer meet our financial expectations.

Regarding acquisitions, to date we have acquired 48 centers and we continue to evaluate a stream of acquisition opportunities ranging from large national portfolios to smaller local operators. Although the combination of leasing and fee-simple purchases has served us well, we will continue to place an emphasis on fee-simple purchases as we evaluate future acquisition opportunities because we have seen value creation in this portion of our portfolio.

Effect of New Tax Law

As we highlighted at the end of 2017, the Tax Cuts and Jobs Act enacted on December 22, 2017, resulted in a non-cash income tax expense of \$5.5 million in the fourth quarter of 2017 to reflect the reevaluation of the Company's net deferred tax assets based on the U.S. Federal Tax Rate of 21.0%. It is important to note that the attributes of our deferred tax assets did not change, only the rate at which those assets are expected to be recognized in the future. Aside from this non-cash reevaluation adjustment, we believe the new corporate income tax rate will benefit the company in future years.

LETTER TO SHAREHOLDERS

Post-Year Activities

We are saddened with the unexpected passing of our dear friend Wally Olson who has been a member of our Board of Directors since 2002. As a significant shareholder, he has been a long-time supporter of the company and active Board Member. Those of us who knew him well will always remember his sharp wit, contagious laughter and his unrelenting support of our primary mission to provide exceptional healthcare and customer service to our patients, residents and family members. We will miss him greatly.

We also announced that Bill O'Neil will not stand for re-election at the annual shareholders meeting. Bill is the last of the original board members present at the time of the company's initial public offering. Bill has been a recognized leader for decades both in Nashville and the national healthcare industry. Although Bill is stepping away from the Board in a few months, he remains our friend and we want to acknowledge and thank Bill for his many contributions and long term support of the company.

Although we will miss both Wally and Bill, we are very excited about our new Board members, Leslie Morgan and Ben Leedle.

Leslie is Wally Olson's daughter and is the managing partner of the Olson Family Partnership, which is a significant shareholder of the Company. Leslie founded, owns, and operates a successful multi-site personal care service company. She is very active in non-profit organizations in her community, has experience in the securities and employee benefits arenas, and brings valuable perspectives to our Board.

Ben Leedle is the former President and CEO of Healthways where he led the company from 2003 to 2015. Under his leadership Healthways was transformed from a small public company focused on diabetes treatment to the number one independent population health management company in the world. Currently Ben is the CEO of BlueZones and serves as a strategic advisor or board member for numerous health care organizations. He has served as chairman of the Nashville Health Care Council and on the American Heart Association Executive Leadership Team.

Looking Ahead

Despite the progress we have made over the last few years, like you we are frustrated with the lack of relative movement in our share price. The market segments for Skilled Nursing, Senior Living, and Real Estate Investment for Senior Housing and Healthcare are depressed for a multitude of reasons. As we noted in our 2017 year-end earnings call, over the past several months, our Board of Directors and Management, with input from outside advisors and our shareholders, have undertaken a review of where the industry is heading, and how our company is positioned within it. At present, uncertainty over changes in the reimbursement system and industry-wide lower census rates and declining lengths of stay are challenges that must be faced by all providers, including Diversicare. Our company also faces issues related to professional liability lawsuits and resolving its ongoing governmental investigations that other providers are not facing or have already resolved, as more fully described in our SEC filings. We also are cognizant of the demographic trends that we believe should be in favor of our industry over the next few years and beyond. Based upon these and other factors, our Board and Management believe that the best path for the company at this time is to continue to execute our acquisition program, remain focused on continual improvement of operational outcomes, continue our portfolio management and risk balancing efforts, and assist others in the industry in lobbying for legislation designed to reduce the regulatory burden and, enhance and stabilize reimbursement. While the Board and Management believe this is the best path currently, the Board is well aware that circumstances may change, and our Directors will be prepared to re-assess its strategic direction as the need arises, as we have done in the past.

In closing, I want to thank 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.

LETTER TO SHAREHOLDERS

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, 2017, our continuing operations consist of 76 nursing centers with 8,456 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 489 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, 2017:

	Number of Centers	Licensed Nursing Beds ⁽¹⁾	Available Nursing Beds ⁽¹⁾
Operating Locations:			
Alabama	20	2,385	2,318
Florida	1	79	79
Indiana	1	158	158
Kansas	6	464	464
Kentucky	13	1,127	1,123
Mississippi	9	1,039	1,004
Missouri	3	339	339
Ohio	5	403	393
Tennessee	5	617	551
Texas	13	1,845	1,662
	<u>76</u>	<u>8,456</u>	<u>8,091</u>
Classification:			
Owned	18	1,607	1,404
Leased	58	6,849	6,687
Total	<u>76</u>	<u>8,456</u>	<u>8,091</u>

⁽¹⁾ 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 489 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 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.

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

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.

Utilization of Electronic Medical Records. We successfully completed the full implementation of EMR in our nursing centers. 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 2017 and 2016:

Period			High	Low	Dividends
2016	— 1 st	Quarter	\$ 9.95	\$ 6.75	\$ 0.055
2016	— 2 nd	Quarter	\$ 8.90	\$ 7.00	\$ 0.055
2016	— 3 rd	Quarter	\$ 10.07	\$ 6.41	\$ 0.055
2016	— 4 th	Quarter	\$ 12.82	\$ 9.98	\$ 0.055
2017	— 1 st	Quarter	\$ 11.91	\$ 8.40	\$ 0.055
2017	— 2 nd	Quarter	\$ 11.20	\$ 8.70	\$ 0.055
2017	— 3 rd	Quarter	\$ 11.60	\$ 8.50	\$ 0.055
2017	— 4 th	Quarter	\$ 12.25	\$ 9.40	\$ 0.055

Our common stock has been traded since May 10, 1994. On February 15, 2018, the closing price for our common stock was \$7.76, as reported by NASDAQ.com.

Holders. On February 15, 2018, there were approximately 261 holders of record. Most of our shareholders have their holdings in the street name of their broker/dealer.

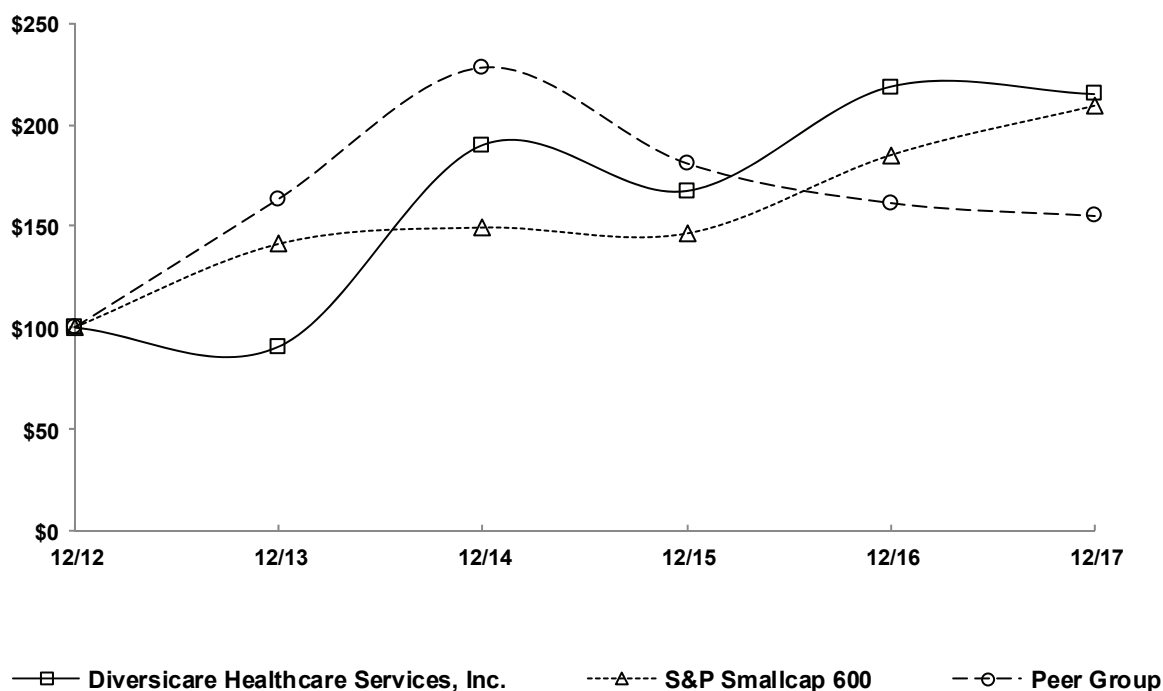
Dividends. For each of the two most recent fiscal years, we have paid a quarterly dividend of \$0.055 per common share. While the Board of Directors intends to continue to pay quarterly dividends, the Board will make the determination of the amount of future cash dividends, if any, to be declared and 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 Ensign Group, Inc., Genesis Healthcare, Inc., Kindred Healthcare Inc and Regional Health Properties, 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 12/31/2012 to 12/31/2017.

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 12/31/12 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 CONSOLIDATION FINANCIAL DATA

	Year Ended December 31,				
	2017	2016	2015	2014	2013
(in thousands, except per share amounts)					
Statement of Operations Data					
REVENUES:					
Patient revenues, net	\$ 574,794	\$ 426,063	\$ 387,595	\$ 344,192	\$ 260,221
EXPENSES:					
Operating	458,122	342,932	311,035	275,605	213,064
Lease and rent expense	54,988	33,364	28,690	26,151	20,396
Professional liability	10,764	8,456	8,122	7,216	5,666
General and administrative	33,311	30,271	24,793	22,133	20,940
Depreciation and amortization	10,902	8,292	7,524	7,078	6,363
Lease termination costs (receipts)	(180)	2,008	—	—	—
Restructuring	—	—	—	—	1,446
	<u>567,907</u>	<u>425,323</u>	<u>380,164</u>	<u>338,183</u>	<u>267,875</u>
OPERATING INCOME (LOSS)	<u>6,887</u>	<u>740</u>	<u>7,431</u>	<u>6,009</u>	<u>(7,654)</u>
OTHER INCOME (EXPENSE):					
Equity in net income (losses) of investment in unconsolidated affiliate	—	273	339	(5)	(183)
Gain on bargain purchase	925	—	—	—	—
Gain on sale of investment in unconsolidated affiliate	733	1,366	—	—	—
Hurricane costs	(232)	—	—	—	—
Interest expense, net	(6,369)	(4,802)	(4,102)	(3,697)	(3,032)
Debt retirement costs	—	(351)	—	—	(320)
	<u>(4,943)</u>	<u>(3,514)</u>	<u>(3,763)</u>	<u>(3,702)</u>	<u>(3,535)</u>
INCOME (LOSS) FROM CONTINUING OPERATIONS BEFORE INCOME TAXES	<u>1,944</u>	<u>(2,774)</u>	<u>3,668</u>	<u>2,307</u>	<u>(11,189)</u>
BENEFIT (PROVISION) FOR INCOME TAXES	<u>(6,743)</u>	<u>1,030</u>	<u>(916)</u>	<u>(857)</u>	<u>4,196</u>
INCOME (LOSS) FROM CONTINUING OPERATIONS	<u>(4,799)</u>	<u>(1,744)</u>	<u>2,752</u>	<u>1,450</u>	<u>(6,993)</u>
DISCONTINUED OPERATIONS, net of taxes	<u>(28)</u>	<u>(67)</u>	<u>(1,128)</u>	<u>3,258</u>	<u>(1,469)</u>
NET INCOME (LOSS)	<u>\$ (4,827)</u>	<u>\$ (1,811)</u>	<u>\$ 1,624</u>	<u>\$ 4,708</u>	<u>\$ (8,462)</u>
INCOME (LOSS) PER COMMON SHARE:					
Basic					
Continuing operations	\$ (0.76)	\$ (0.28)	\$ 0.45	\$ 0.21	\$ (1.26)
Discontinued operations	(0.01)	(0.01)	(0.18)	0.54	(0.25)
Net income (loss) per common share	<u>\$ (0.77)</u>	<u>\$ (0.29)</u>	<u>\$ 0.27</u>	<u>\$ 0.75</u>	<u>\$ (1.51)</u>
Diluted					
Continuing operations	\$ (0.76)	\$ (0.28)	\$ 0.44	0.20	(1.26)
Discontinued operations	(0.01)	(0.01)	(0.18)	0.52	(0.25)
Net income (loss) per common share	<u>\$ (0.77)</u>	<u>\$ (0.29)</u>	<u>\$ 0.26</u>	<u>\$ 0.72</u>	<u>\$ (1.51)</u>
CASH DIVIDENDS DECLARED PER COMMON SHARE	<u>\$ 0.22</u>	<u>\$ 0.22</u>	<u>\$ 0.22</u>	<u>\$ 0.22</u>	<u>\$ 0.22</u>
WEIGHTED AVERAGE COMMON SHARES OUTSTANDING:					
Basic	<u>6,279</u>	<u>6,199</u>	<u>6,100</u>	<u>6,011</u>	<u>5,899</u>
Diluted	<u>6,279</u>	<u>6,199</u>	<u>6,315</u>	<u>6,197</u>	<u>5,899</u>

SELECTED CONSOLIDATION FINANCIAL DATA

	December 31,				
	2017	2016	2015	2014	2013
Balance Sheet Data	(in thousands)				
Working capital	\$ 8,391	\$ 13,521	\$ 13,052	\$ 8,797	\$ 8,044
Total assets	\$ 167,569	\$ 163,051	\$ 137,084	\$ 129,089	\$ 137,744
Long-term debt and capitalized lease obligations, less current portion and deferred financing costs, net	\$ 89,552	\$ 82,133	\$ 60,867	\$ 48,265	\$ 53,577
Preferred Stock - Series C	\$ —	\$ —	\$ —	\$ —	\$ 4,918
Total Shareholders' Equity of Diversicare Healthcare Services, Inc.	\$ 6,462	\$ 11,420	\$ 13,267	\$ 11,754	\$ 8,129
Total Equity	\$ 6,462	\$ 11,420	\$ 13,267	\$ 11,754	\$ 9,566

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, 2017, our continuing operations consist of 76 nursing centers with 8,456 licensed skilled nursing beds and 489 assisted-living and other residential beds. We own 18 and lease 58 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.

Key Performance Metrics

Skilled mix. Skilled mix represents the number of days our Medicare and Managed Care patients are receiving services at the skilled nursing facilities divided by the total number of days patients (less days from assisted living services) from all payor sources are receiving services at the skilled nursing facilities for any given period.

Average rate per day. Average rate per day is the revenue by payor source for a period at the skilled nursing facility divided by actual patient days for the revenue source for a given period.

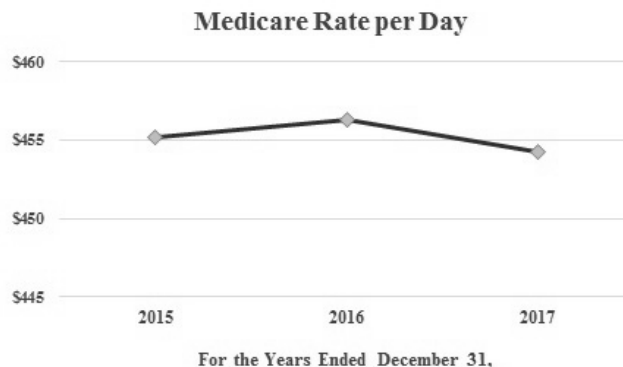
Average daily skilled nursing census. Average daily skilled nursing census is the average number of patients who are receiving skilled nursing care as a percentage of total number of patient days.

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 our facilities' quality metrics, 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 and divestitures. We have experienced success in these initiatives and expect to continue to build on these improvements. In light of challenges facing the industry and the Company specifically, including the unresolved governmental investigation, we believe that now is not the time to attempt to engage in a company-wide strategic transaction.

Improving skilled mix and average Medicare rate:

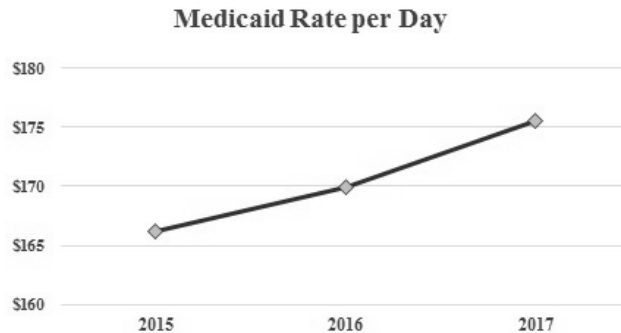
One of our key performance indicators is skilled mix. Our strategic operating initiatives of improving our skilled mix and our average Medicare rate required investing in nursing and clinical care to treat more acute patients along with nursing center-based marketing representatives to attract these 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 years ended December 31, 2017, 2016 and 2015 was 15.1%, 15.2% and 16.2%, respectively. The graph below illustrates our average Medicare rate per day:



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

Utilizing Electronic Medical Records to improve Medicaid acuity capture:

As another part of our strategic operating initiatives, we successfully completed a full implementation of EMR in our nursing centers to improve Medicaid acuity capture, primarily in our states where the Medicaid payments are acuity based. We completed the implementation 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.

Effective July 1, 2017, the Company acquired a 103-bed skilled nursing center in Selma, Alabama, for an aggregate purchase price of \$8,750,000, pursuant to an Asset Purchase Agreement with Park Place Nursing and Rehabilitation Center, LLC, Dunn Nursing Home, Inc., Wood Properties of Selma LLC, and Homewood of Selma, LLC. Additionally, on October 1, 2016 and November 1, 2016, we assumed the operations of ten centers in Mississippi and 12 centers in Alabama, respectively. These transactions are further discussed in Note 2 "Business Development and Other Significant Transactions" to the consolidated financial statements.

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 September 2017, we ceased operations at our Carthage, Mississippi, facility, thus terminating our lease with Trend Health and Rehab of Carthage, LLC. Additionally, in May 2016, we ceased operations at our Avon, Ohio, facility, thus terminating our lease with Avon Ohio, LLC. These transactions were not reported as discontinued operations as described in Note 2 "Business Development and Other Significant Transactions" to the consolidated financial statements.

Basis of Financial Statements

Our patient revenues consist of the fees charged for the care of patients in the nursing centers we own and lease. Our operating expenses include the costs, other than lease, depreciation and amortization expenses, incurred in the operation of the nursing centers we own and lease. Our general and administrative expenses consist of the costs of the corporate office and regional support functions. Our interest, depreciation and amortization expenses include all such expenses across the range of our operations.

**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, 2017, 2016 and 2015, and sets forth this data as a percentage of revenues for the same year:

	Year Ended December 31,					
	(Dollars in thousands)					
	2017		2016		2015	
Revenues:						
Patient revenues, net	\$ 574,794	100.0 %	\$ 426,063	100.0 %	\$ 387,595	100.0 %
Expenses:						
Operating	458,122	79.7 %	342,932	80.5 %	311,035	80.2 %
Lease and rent expense	54,988	9.6 %	33,364	7.8 %	28,690	7.4 %
Professional liability	10,764	1.9 %	8,456	2.0 %	8,122	2.1 %
General & administrative	33,311	5.8 %	30,271	7.1 %	24,793	6.4 %
Depreciation and amortization	10,902	1.9 %	8,292	1.9 %	7,524	1.9 %
Lease termination costs (receipts)	(180)	— %	2,008	0.5 %	—	— %
	<u>567,907</u>	<u>98.9 %</u>	<u>425,323</u>	<u>99.8 %</u>	<u>380,164</u>	<u>98.0 %</u>
Operating income	<u>6,887</u>	<u>1.1 %</u>	<u>740</u>	<u>0.2 %</u>	<u>7,431</u>	<u>2.0 %</u>
Other income (expense):						
Equity in net income of unconsolidated affiliate	—	— %	273	0.1 %	339	0.1 %
Gain on bargain purchase	925	0.2 %	—	— %	—	— %
Gain on sale of investment in unconsolidated affiliate	733	0.1 %	1,366	0.3 %	—	— %
Hurricane costs	(232)	— %	—	— %	—	— %
Interest expense, net	(6,369)	(1.1)%	(4,802)	(1.1)%	(4,102)	(1.1)%
Debt retirement costs	—	— %	(351)	(0.1)%	—	— %
	<u>(4,943)</u>	<u>(0.8)%</u>	<u>(3,514)</u>	<u>(0.8)%</u>	<u>(3,763)</u>	<u>(1.0)%</u>
Income (loss) from continuing operations before income taxes	1,944	0.3 %	(2,774)	(0.6)%	3,668	1.0 %
Benefit (provision) for income taxes	(6,743)	(1.2)%	1,030	0.2 %	(916)	(0.2)%
Income (loss) from continuing operations	<u>\$ (4,799)</u>	<u>(0.9)%</u>	<u>\$ (1,744)</u>	<u>(0.4)%</u>	<u>\$ 2,752</u>	<u>0.8 %</u>

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

	December 31,		
	2017	2016	2015
Licensed Nursing Center Beds:			
Owned	1,607	1,504	1,370
Leased	6,849	6,949	4,690
Total	<u>8,456</u>	<u>8,453</u>	<u>6,060</u>
Facilities:			
Owned	18	17	15
Leased	58	59	40
Total	<u>76</u>	<u>76</u>	<u>55</u>

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

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:

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 78.3%, 78.1% and 77.6% for 2017, 2016, and 2015, 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 collectability 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 1.6%, 1.7%, and 1.9% for 2017, 2016, and 2015, 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. The deductibles for these policies are covered through the insurance subsidiary.

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 \$20.1 million as of December 31, 2017, including \$1.4 million for settlements that are expected to be paid in 2018, 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.

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

The Company's cash expenditures for self-insured professional liability costs from continuing operations were \$6.6 million, \$4.5 million and \$3.3 million for the years ended December 31, 2017, 2016 and 2015, respectively.

Although we retain a third-party actuarial firm to assist us, professional and general liability claims are inherently uncertain, and the liability associated with anticipated claims is very difficult to estimate. Professional liability cases have a long cycle from the date of an incident to the date a case is resolved, and final determination of our actual liability for claims incurred in any given period is a process that takes years. As a result, our actual liabilities may vary significantly from the accrual, and the amount of the accrual has and may continue to fluctuate by a material amount in any given quarter 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 \$10.8 million, \$8.5 million and \$8.1 million for the years ended December 31, 2017, 2016 and 2015, respectively. These amounts are material in relation to our reported income (loss) from continuing operations for the related periods of \$(4.8) million, \$(1.7) million and \$2.8 million, respectively. The total liability recorded at December 31, 2017 was \$20.1 million, compared to current assets of \$72.7 million and total assets of \$167.6 million.

Accrual for Other Self-Insured Claims

With respect to workers' compensation insurance, substantially all of our employees became covered under either a prefunded deductible policy or state-sponsored programs. 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 insured for workers' compensation exposure. For the period from July 1, 2008 through December 31, 2017, 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 \$200,000 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 2017, 2016, or 2015. 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 acquisition date fair value of assets acquired and the liabilities assumed. These valuations are subject to adjustments during the measurement period, generally not to exceed twelve-months from the acquisition date. Such valuations require us to make significant estimates, judgments and assumptions, including projections of future events and operating performance.

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

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 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, 2017, 2016, and 2015, we recorded charges of approximately \$1.0 million, \$1.0 million and \$1.2 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

Deferred tax assets and liabilities are established for temporary differences between the financial reporting basis and the tax basis of our assets and liabilities at tax rates in effect when such temporary differences are expected to reverse. We generally expect to fully utilize our deferred tax assets; however, when necessary, we record a valuation allowance to reduce our net deferred tax assets to the amount that is more likely than not to be realized.

In determining the need for a valuation allowance or the need for and magnitude of liabilities for uncertain tax positions, we make certain estimates and assumptions. These estimates and assumptions are based on, among other things, knowledge of operations, markets, historical trends and likely future changes and, when appropriate, the opinions of advisors with knowledge and expertise in certain fields. Due to certain risks associated with our estimates and assumptions, actual results could differ.

As a result of the Tax Act, we revaluated our net deferred tax assets, which led to an increase in our income tax expense by \$5.5 million for the year ended December 31, 2017. The Company considers the accounting for the deferred tax re-measurements and other items to be complete, but ongoing accounting guidance and interpretation could result in adjustments to the consolidated financial statements. The Tax Act will decrease the corporate income tax rate from 35.0% to 21.0% beginning on January 1, 2018.

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

Contractual Obligations and Commercial Commitments

We have certain contractual obligations of continuing operations as of December 31, 2017, summarized by the period in which payment is due, as follows (dollar amounts in thousands):

Contractual Obligations	Total	Less than 1 year	1 to 3 Years	3 to 5 Years	After 5 Years
Long-term debt obligations ⁽¹⁾	\$ 103,464	\$ 17,906	\$ 25,982	\$ 59,576	\$ —
Settlement obligations ⁽²⁾	1,369	1,369	—	—	—
Elimination of Preferred Stock Conversion feature ⁽³⁾	515	515	—	—	—
Operating leases ⁽⁴⁾	1,065,640	58,046	119,988	123,475	764,131
Required capital expenditures under operating leases ⁽⁵⁾	11,911	1,216	2,433	2,433	5,829
Total	\$ 1,182,899	\$ 79,052	\$ 148,403	\$ 185,484	\$ 769,960

- (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 \$8.2 million between December 31, 2016 and December 31, 2017, which is related to assumption of operations for the Golden Living centers and purchase of the center in Selma, Alabama. See Note 5, "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, 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 \$0.1 million 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 decreased \$66.2 million between December 31, 2016 and December 31, 2017.
- (5) Includes annual expenditure requirements under operating leases. Our required capital expenditures decreased \$1.3 million between December 31, 2016 and December 31, 2017.

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, 2017. The terms of such agreements are for one year and automatically renew for one year if not terminated by us or the employee. In addition, upon the occurrence of any triggering event, those certain members of management may elect to require that we purchase equity awards granted to them for a purchase price equal to the difference in the fair market value of our common stock at the date of termination versus the stated equity award exercise price. Based on the closing price of our common stock on December 31, 2017, there is \$0.4 million in contingent liabilities for the repurchase of the equity grants. No amounts have been accrued for these contingent liabilities.

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. The following discussion only relates to our continuing operations.

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

(in thousands)	Year Ended December 31,			
	2017	2016	Change	%
PATIENT REVENUES, net	\$ 574,794	\$ 426,063	\$ 148,731	34.9 %
EXPENSES:				
Operating	458,122	342,932	115,190	33.6 %
Lease and rent expense	54,988	33,364	21,624	64.8 %
Professional liability	10,764	8,456	2,308	27.3 %
General and administrative	33,311	30,271	3,040	10.0 %
Depreciation and amortization	10,902	8,292	2,610	31.5 %
Lease termination costs (receipts)	(180)	2,008	(2,188)	(109.0)%
Total expenses	<u>567,907</u>	<u>425,323</u>	<u>142,584</u>	<u>33.5 %</u>
OPERATING INCOME	6,887	740	6,147	830.7 %
OTHER INCOME (EXPENSE):				
Equity in net income of investment in unconsolidated affiliate	—	273	(273)	(100.0)%
Gain on bargain purchase	925	—	925	100.0 %
Gain on sale of investment in unconsolidated affiliate	733	1,366	(633)	(46.3)%
Hurricane costs	(232)	—	(232)	(100.0)%
Interest expense, net	(6,369)	(4,802)	(1,567)	(32.6)%
Debt retirement costs	—	(351)	351	100.0 %
	<u>(4,943)</u>	<u>(3,514)</u>	<u>(1,429)</u>	<u>(40.7)%</u>
INCOME (LOSS) FROM CONTINUING OPERATIONS BEFORE INCOME TAXES	1,944	(2,774)	4,718	170.1 %
BENEFIT (PROVISION) FOR INCOME TAXES	(6,743)	1,030	(7,773)	(754.7)%
LOSS FROM CONTINUING OPERATIONS	<u>\$ (4,799)</u>	<u>\$ (1,744)</u>	<u>\$ (3,055)</u>	<u>(175.2)%</u>

**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 and rent expense	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 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)%
PROVISION FOR INCOME TAXES	1,030	(916)	1,946	212.4 %
INCOME (LOSS) FROM CONTINUING OPERATIONS	\$ (1,744)	\$ 2,752	\$ (4,496)	(163.4)%

Year Ended December 31, 2017 Compared With Year Ended December 31, 2016

Patient Revenues

Patient revenues were \$574.8 million in 2017 and \$426.1 million in 2016, an increase of \$148.7 million or 34.9%. 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):

	Year Ended December 31,		
	2017	2016	Change
Same-store revenue	\$ 386,576	\$ 388,890	\$ (2,314)
2016 acquisition revenue	183,665	37,173	146,492
2017 acquisition revenue	4,553	—	4,553
Total revenue	\$ 574,794	\$ 426,063	148,731

The overall increase in revenue of \$148.7 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 \$146.5 million and Park Place during the third quarter of 2017 of \$4.6 million. The increase from the acquisition activity was partially offset by a decrease in same-store revenue of \$2.3 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:

	Year Ended December 31,	
	2017	2016
Skilled nursing occupancy	79.7%	78.1%
As a percent of total census:		
Medicaid census	69.1%	68.1%
Medicare census	11.2%	11.7%
Managed Care census	3.9%	3.5%
As a percent of total revenues:		
Medicaid revenues	52.4%	50.6%
Medicare revenues	25.9%	27.5%
Managed Care revenues	7.4%	6.8%
Average rate per day:		
Medicare	\$ 454.22	\$ 456.30
Medicaid	\$ 175.58	\$ 169.91
Managed Care	\$ 381.46	\$ 385.71

The average Medicaid rate per patient day for same-store nursing centers in 2017 increased 1.7% compared to 2016, resulting in an increase in revenue of \$3.3 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 2017 increased 1.6% compared to 2016, resulting in an increase in revenue of \$1.5 million also related to our ability to attract and provide care for patients with increased acuity levels.

Our total average daily census increased by approximately 33.9% for the full portfolio compared to 2016 on a consolidated basis, but was primarily attributable to the aforementioned acquisition activity. On a same-store basis, our Medicare, Medicaid and Private average daily census for 2017 decreased compared to 2016, resulting in decreases in revenue of \$5.0 million, \$1.4 million and \$2.2 million, respectively. Conversely, our Managed Care average daily census increased in 2017 compared to 2016 by \$2.0 million.

Our same-store centers for 2017 experienced one less day of operations compared to 2016, resulting in a decrease in revenue of \$1.0 million or 2.7%.

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

Operating Expense

Operating expense increased to \$458.1 million in 2017 from \$342.9 million in 2016, driven primarily by the \$115.9 million in operating costs from the Golden Living nursing centers added in 2016, and \$3.6 million from the center acquired in 2017. Operating expense decreased to 79.7% of revenue in 2017, compared to 80.5% of revenue in 2016.

	Year Ended December 31,		
	2017	2016	Change
Same-store operating expenses	\$ 310,571	\$ 314,944	\$ (4,373)
2016 acquisition operating expenses	143,911	27,988	115,923
2017 acquisition operating expenses	3,640	—	3,640
Total operating expenses	<u>\$ 458,122</u>	<u>\$ 342,932</u>	<u>115,190</u>

The largest component of operating expenses is wages, which increased to \$268.4 million in 2017 from \$199.6 million in 2016, an increase of \$68.8 million, or 34.4%.

On a same-store center basis, operating expenses decreased \$4.4 million, which is primarily attributable to a decrease in our bad debt expense by \$1.1 million and a provider tax refund of \$2.8 million from the state of Kentucky. Our same-store nursing and ancillary and dietary expenses decreased by \$0.1 million and \$0.3 million, respectively. Conversely, these positive variances were slightly offset by an increase in salaries and related taxes of \$1.0 million in 2017. However, due to one less day of operations in 2017, we experienced \$0.5 million less in salaries and related taxes.

Lease Expense

Lease expense increased to \$55.0 million in 2017 from \$33.4 million in 2016, an increase of \$21.6 million, or 64.8%. The increase in lease expense was driven by \$22.1 million from the assumption of the Golden Living centers in the fourth quarter of 2016. This was slightly offset from the termination of the Carthage, Mississippi lease in September 2017.

Professional Liability

Professional liability expense was \$10.8 million in 2017 compared to \$8.5 million in 2016, an increase of \$2.3 million, or 27.3%. As centers have been acquired in 2016 and 2017, 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 72 professional liability lawsuits as of December 31, 2017, compared to 67 as of December 31, 2016. Our cash expenditures for professional liability costs of continuing operations were \$6.6 million and \$4.5 million for 2017 and 2016, 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 \$33.3 million in 2017 compared to \$30.3 million in 2016, an increase of \$3.0 million, or 10.0%. The overall increase in general and administrative expenses were attributable to a \$3.7 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 expenses decreased by \$0.7 million in 2017 compared to 2016, which is attributable to the 2016 acquisitions.

Depreciation and Amortization

Depreciation and amortization expense was approximately \$10.9 million in 2017 and \$8.3 million in 2016. The Company incurred an increase of \$2.1 million in depreciation and amortization expenses related to capital expenditures for the assumed Golden Living operations in the fourth quarter of 2016.

Lease termination costs (receipts)

The Company ceased operations at our Carthage, Mississippi, center in September 2017, which resulted in a \$0.2 million cash termination receipt, net of legal costs. Lease termination costs were \$2.0 million in 2016 due to the termination of the Avon, Ohio operating lease in May 2016.

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

Gain on bargain purchase

The Company acquired the operations and assets of a center in Selma, Alabama in July 2017. In connection with the business combination, we recognized a \$0.9 million gain on bargain purchase.

Gain on sale of investment in unconsolidated affiliate

The sale of the pharmacy joint venture resulted in a \$1.4 million gain in the fourth quarter of 2016. Subsequently, we recognized an additional gain of \$0.7 million in the first quarter of 2017, related to the continuing liquidation of remaining net assets affiliated with the partnership.

Interest Expense, Net

Interest expense has increased to \$6.4 million in 2017 compared to \$4.8 million in 2016, an increase of \$1.6 million. The increase was primarily attributable to higher debt balances in 2017 as a result of additional borrowings made during the change in ownership processes for the newly acquired centers in Alabama and Mississippi, and the amendment of the term loan facility that occurred in June 2017.

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 income before taxes of \$1.9 million in 2017, as compared to loss before taxes of \$2.8 million in 2016. The provision for income taxes was \$6.7 million in 2017, an effective rate of 346.9% and the provision for income taxes was \$1.0 million in 2016, an effective rate of 37.1%. The higher effective tax rate reflects the impact of our revaluation of our net deferred tax assets of \$5.5 million as a result of the Tax Act. The basic and diluted loss per common share from continuing operations were \$0.76 and \$0.76 in 2017, respectively, compared to a basic and diluted loss per common share from continuing operations of \$0.28 and \$0.28 in 2016, respectively.

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):

	Year Ended December 31,		
	2016	2015	Change
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.

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:

	Year Ended December 31,	
	2016	2015
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.

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.

	Year Ended December 31,		
	2016	2015	Change
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.

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

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.

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.

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

Liquidity and Capital Resources

Liquidity

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

Net cash provided by operating activities of continuing operations totaled \$13.4 million in 2017, compared to net cash used in operating activities of continuing operations of \$2.1 million in 2016 and net cash provided by operating activities of continuing operations of \$10.3 million in 2015. One primary driver of the increase in cash provided by operating activities from continuing operations is related to the Company completing the Change in Ownership ("CHOW") process for the nursing centers acquired in the fourth quarter of 2016, which increased the cash inflows from these centers. Operating activities of centers we no longer operate used cash of \$1.3 million, \$3.5 million and \$7.0 million in 2017, 2016 and 2015, respectively.

Our cash expenditures related to professional liability claims of continuing operations were \$6.6 million, \$4.5 million and \$3.3 million for 2017, 2016 and 2015, 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 centers we no longer operate were \$1.3 million, \$3.6 million, and \$8.2 million for 2017, 2016 and 2015, respectively. The Company will continue to defend, and make cash payments when required related to, professional liability claims asserted against centers we no longer operate. 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 \$17.4 million, \$9.8 million and \$13.1 million in 2017, 2016 and 2015, respectively. The cash used in 2017 is primarily attributable to the asset purchase of Park Place in Selma, Alabama in July 2017 for \$8.8 million, and capital expenditures related to our 2016 acquisitions. 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. We have used \$9.7 million, \$6.0 million, and \$4.6 million in 2017, 2016 and 2015, respectively, for capital expenditures of continuing operations.

Financing activities of continuing operations provided cash of \$4.6 million, \$15.1 million and \$10.6 million in 2017, 2016 and 2015. Cash provided by financing activities in 2017 is primarily due to draws on the Company's revolving credit facility of \$21.0 million, acquisition revolver of \$8.5 million and amending our credit facility resulting in proceeds of \$7.5 million. The proceeds received were offset by repayments of \$30.2 million. Cash provided by financing activities 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. Financing activities reflect common stock of \$1.4 million 2017, \$1.4 million in 2016, and \$1.3 million in 2015.

Dividends

On February 22, 2018, 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.

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. The deductibles for these policies are covered through the insurance subsidiary.

As of December 31, 2017, we have recorded total liabilities for reported professional liability claims and estimates for incurred, but unreported claims of \$20.1 million. Our calculation of this estimated liability is based on the Company's best estimates of the likelihood of 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, 2017, we had \$89.6 million of outstanding long-term debt and capital lease obligations. The \$89.6 million total includes \$1.4 million in capital lease obligations. The balance of the long-term debt is comprised of \$64.6 million owed on our collateralized mortgage debt, \$16.0 million currently outstanding on the revolving credit facility, and \$7.5 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. The Amended Mortgage Loan balance was \$72.1 million as of December 31, 2017, consisting of \$64.6 million on the term loan facility with an interest rate of 5.5% and \$7.5 million on the acquisition loan facility with an interest rate of 6.25%. The Amended Mortgage Loan is secured by 18 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, 2017, the Company had \$16.0 million borrowings outstanding under the Amended Revolver compared to \$15.0 million outstanding as of December 31, 2016. 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 \$6.2 million to serve as a security deposit for our Omega and Golden Living leases, respectively. 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, 2017, the letters of credit, the amounts outstanding under the revolving credit facility and the maximum loan amount of \$39.3 million, the balance available for borrowing under the Amended Revolver is \$9.9 million at December 31, 2017.

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, 2017.

Our calculated compliance with financial covenants is presented below:

	Requirement	Level at December 31, 2017
Minimum fixed charge coverage ratio	1.05:1.00	1.07:1.05
Minimum adjusted EBITDA	\$13.0 million	\$18.3 million
EBITDAR (mortgaged centers)	\$10.0 million	\$16.3 million
Current ratio (as defined in agreement)	1.00:1.00	1.22:1.00

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 \$1.4 million, \$2.1 million, and \$0.6 million as of December 31, 2017, 2016, and 2015, 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.

Gross accounts receivable attributable to patient services of continuing operations totaled \$79.2 million at December 31, 2017 compared to \$72.5 million at December 31, 2016, representing approximately 49 days and 47 days revenue in accounts receivable, respectively. The balance as of December 31, 2017 reflects a full year of ownership of the twenty-two newly leased Golden Living centers in Alabama and Mississippi. The Company has completed the change in ownership process and is utilizing our billing credentials to perform the billing of the Medicare and Medicaid receivables.

The allowance for bad debt was \$14.2 million and \$10.3 million at December 31, 2017 and 2016, 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 2018 to be relatively the same or slightly lower than the increases in 2017. We expect salary and wage increases for our skilled health care providers to continue to be higher than average salary and wage increases, as is common in the healthcare industry.

Off-Balance Sheet Arrangements

We have eleven letters of credit outstanding totaling approximately \$13.4 million as of December 31, 2017. 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 and Mississippi, as well as successfully operate all of our centers,
- our ability to increase census and occupancy rates at our centers,
- changes in governmental reimbursement,
- government regulation,
- the impact of the Affordable Care Act, efforts to repeal or significantly modify the Affordable Care Act, and other health care reform initiatives,
- any increases in the cost of borrowing under our credit agreements,
- our ability to comply with covenants contained in those credit agreements,
- our ability to comply with the terms of our master lease agreements,
- our ability to renew or extend our leases at or prior to the end of the existing lease terms,
- 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,
- the costs of investing in our business initiatives and development,
- our ability to control costs,
- our ability to attract and retain qualified healthcare professionals,
- changes to our valuation of deferred tax assets,
- 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, 2017, we had outstanding borrowings of approximately \$88.1 million, \$52.1 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 \$0.6 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, 2017. Based on this evaluation, the principal executive and financial officers have determined that such disclosure controls and procedures are effective to ensure that information required to be disclosed in our filings under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in the Securities Exchange Commission's rules and forms.

Management's Report on Internal Control over Financial Reporting

Our management is responsible for establishing and maintaining adequate internal control over financial reporting (as defined in Rule 13a-15(f) under the Securities Exchange Act of 1934, as amended). Our management conducted an evaluation of the effectiveness of our internal control over financial reporting based on the framework in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (2013 framework). Based on this evaluation, management concluded that our internal control over financial reporting was effective as of December 31, 2017. 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, 2017 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

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

Opinion on the Consolidated Financial Statements

We have audited the accompanying consolidated balance sheets of Diversicare Healthcare Services, Inc. and subsidiaries as of December 31, 2017 and 2016, 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, 2017, and the related notes (collectively referred to as the "consolidated financial statements"). In our opinion, the consolidated financial statements present fairly, in all material respects, the financial position of the Company and subsidiaries at December 31, 2017 and 2016, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2017, in conformity with accounting principles generally accepted in the United States of America.

Basis for Opinion

These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on the Company's consolidated financial statements based on our audits. We are a public accounting firm registered with the Public Company Accounting Oversight Board (United States) ("PCAOB") and are required to be independent with respect to the Company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

We conducted our audits in accordance with the standards of the PCAOB. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement, whether due to error or fraud. The Company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. As part of our audits we are required to obtain an understanding of internal control over financial reporting 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.

Our audits included performing procedures to assess the risks of material misstatement of the consolidated financial statements, whether due to error or fraud, and performing procedures that respond to those risks. Such procedures included examining, on a test basis, evidence regarding the amounts and disclosures in the consolidated financial statements. Our audits also included evaluating the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements. We believe that our audits provide a reasonable basis for our opinion.

We have served as the Company's auditor since 2002.

BDO USA, LLP

Nashville, Tennessee
March 1, 2018

DIVERSICARE HEALTHCARE SERVICES, INC. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS
DECEMBER 31, 2017 AND 2016
(in thousands, except per share amounts)

ASSETS		2017	2016	LIABILITIES AND SHAREHOLDERS' EQUITY		2017	2016
CURRENT ASSETS:				CURRENT LIABILITIES:			
Cash and cash equivalents	\$	3,524	\$ 4,263	Current portion of long-term debt and capitalized lease obligations, less deferred financing costs, net	\$	13,065	\$ 7,715
Receivables, less allowance for doubtful accounts of \$14,235 and \$10,326, respectively		64,929	62,152	Trade accounts payable		14,080	12,972
Other receivables		375	1,193	Current liabilities of discontinued operations		461	427
Prepaid expenses and other current assets		3,248	3,623	Accrued expenses:			
Income tax refundable		537	431	Payroll and employee benefits		20,013	20,108
Current assets of discontinued operations		45	28	Self-insurance reserves, current portion		8,792	9,401
Total current assets		<u>72,658</u>	<u>71,690</u>	Provider taxes		3,090	3,114
				Other current liabilities		<u>4,766</u>	<u>4,432</u>
				Total current liabilities		<u>64,267</u>	<u>58,169</u>
PROPERTY AND EQUIPMENT, at cost		147,549	128,822	NONCURRENT LIABILITIES:			
Less accumulated depreciation and amortization		(78,345)	(69,022)	Long-term debt and capitalized lease obligations, less current portion and deferred financing costs, net		74,603	72,145
		<u>69,204</u>	<u>59,800</u>	Self-insurance reserves, noncurrent portion		13,458	11,766
				Other noncurrent liabilities		<u>8,779</u>	<u>9,551</u>
				Total noncurrent liabilities		<u>96,840</u>	<u>93,462</u>
OTHER ASSETS:				COMMITMENTS AND CONTINGENCIES			
Deferred income taxes, net		15,154	21,185	SHAREHOLDERS' EQUITY:			
Deferred leasehold costs		137	193	Common stock, authorized 20,000 shares, \$.01 par value, 6,687 and 6,592 shares issued, and 6,455 and 6,361 shares outstanding, respectively		67	66
Other noncurrent assets		3,725	3,108	Treasury stock at cost, 232 shares of common stock		(2,500)	(2,500)
Acquired leasehold interest, net		<u>6,691</u>	<u>7,075</u>	Paid-in capital		22,720	21,935
Total other assets		<u>25,707</u>	<u>31,561</u>	Accumulated deficit		(14,534)	(8,276)
				Accumulated other comprehensive income		<u>709</u>	<u>195</u>
				Total shareholders' equity		<u>6,462</u>	<u>11,420</u>
						<u>\$ 167,569</u>	<u>\$ 163,051</u>

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

DIVERSICARE HEALTHCARE SERVICES, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF OPERATIONS
(in thousands, except per share amounts)

	Years Ended December 31,		
	2017	2016	2015
PATIENT REVENUES, net	\$ 574,794	\$ 426,063	\$ 387,595
EXPENSES:			
Operating	458,122	342,932	311,035
Lease and rent expense	54,988	33,364	28,690
Professional liability	10,764	8,456	8,122
General and administrative	33,311	30,271	24,793
Depreciation and amortization	10,902	8,292	7,524
Lease termination costs (receipts)	(180)	2,008	—
Total expenses	567,907	425,323	380,164
OPERATING INCOME	6,887	740	7,431
OTHER INCOME (EXPENSE):			
Equity in net income of investment in unconsolidated affiliate	—	273	339
Gain on bargain purchase	925	—	—
Gain on sale of investment in unconsolidated affiliate	733	1,366	—
Hurricane costs	(232)	—	—
Interest expense, net	(6,369)	(4,802)	(4,102)
Debt retirement costs	—	(351)	—
	(4,943)	(3,514)	(3,763)
INCOME (LOSS) FROM CONTINUING OPERATIONS BEFORE INCOME TAXES	1,944	(2,774)	3,668
BENEFIT (PROVISION) FOR INCOME TAXES	(6,743)	1,030	(916)
INCOME (LOSS) FROM CONTINUING OPERATIONS	(4,799)	(1,744)	2,752
LOSS FROM DISCONTINUED OPERATIONS:			
Operating loss, net of income tax benefit of \$43, \$41 and \$375, respectively	(28)	(67)	(1,128)
LOSS FROM DISCONTINUED OPERATIONS	(28)	(67)	(1,128)
NET INCOME (LOSS)	\$ (4,827)	\$ (1,811)	\$ 1,624
NET INCOME (LOSS) PER COMMON SHARE:			
Per common share – basic			
Continuing operations	\$ (0.76)	\$ (0.28)	\$ 0.45
Discontinued operations	(0.01)	(0.01)	(0.18)
	\$ (0.77)	\$ (0.29)	\$ 0.27
Per common share – diluted			
Continuing operations	\$ (0.76)	\$ (0.28)	\$ 0.44
Discontinued operations	(0.01)	(0.01)	(0.18)
	\$ (0.77)	\$ (0.29)	\$ 0.26
DIVIDENDS DECLARED PER SHARE OF COMMON STOCK	\$ 0.22	\$ 0.22	\$ 0.22
WEIGHTED AVERAGE COMMON SHARES OUTSTANDING:			
Basic	6,279	6,199	6,100
Diluted	6,279	6,199	6,315

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

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

	Years Ended December 31,		
	2017	2016	2015
NET INCOME (LOSS)	\$ (4,827)	\$ (1,811)	\$ 1,624
OTHER COMPREHENSIVE INCOME (LOSS):			
Change in fair value of cash flow hedge, net of tax	976	1,082	556
Less: reclassification adjustment for amounts recognized in net income (loss)	(462)	(500)	(448)
Total other comprehensive income	514	582	108
COMPREHENSIVE INCOME (LOSS)	<u>\$ (4,313)</u>	<u>\$ (1,229)</u>	<u>\$ 1,732</u>

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

DIVERSICARE HEALTHCARE SERVICES, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY
(in thousands)

	Common Stock		Treasury Stock			Accumulated Deficit	Accumulated Other Comprehensive Income (Loss)	Total Shareholders' Equity
	Shares Issued	Amount	Shares	Amount	Paid-in Capital			
BALANCE, DECEMBER 31, 2014	6,388	\$ 64	232	\$ (2,500)	\$ 19,970	\$ (5,285)	\$ (495)	\$ 11,754
Net income	—	—	—	—	—	1,624	—	1,624
Common stock dividends declared	—	—	—	—	45	(1,392)	—	(1,347)
Issuance/redemption of equity grants, net	125	1	—	—	78	—	—	79
Interest rate cash flow hedge	—	—	—	—	—	—	108	108
Tax impact of equity grant exercises	—	—	—	—	62	—	—	62
Stock based compensation	—	—	—	—	987	—	—	987
BALANCE, DECEMBER 31, 2015	6,513	65	232	(2,500)	21,142	(5,053)	(387)	13,267
Net loss	—	—	—	—	—	(1,811)	—	(1,811)
Common stock dividends declared	—	—	—	—	46	(1,412)	—	(1,366)
Issuance/redemption of equity grants, net	79	1	—	—	(106)	—	—	(105)
Interest rate cash flow hedge	—	—	—	—	—	—	582	582
Tax impact of equity grant exercises	—	—	—	—	65	—	—	65
Stock based compensation	—	—	—	—	788	—	—	788
BALANCE, DECEMBER 31, 2016	6,592	66	232	(2,500)	21,935	(8,276)	195	11,420
Net loss	—	—	—	—	—	(4,827)	—	(4,827)
Common stock dividends declared	—	—	—	—	47	(1,431)	—	(1,384)
Issuance/redemption of equity grants, net	95	1	—	—	(95)	—	—	(94)
Interest rate cash flow hedge	—	—	—	—	—	—	514	514
Stock based compensation	—	—	—	—	833	—	—	833
BALANCE, DECEMBER 31, 2017	6,687	\$ 67	232	\$ (2,500)	\$ 22,720	\$ (14,534)	\$ 709	\$ 6,462

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

DIVERSICARE HEALTHCARE SERVICES, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
(in thousands)

	Years Ended December 31,		
	2017	2016	2015
CASH FLOWS FROM OPERATING ACTIVITIES:			
Net income (loss)	\$ (4,827)	\$ (1,811)	\$ 1,624
Loss from discontinued operations	(28)	(67)	(1,128)
Income (loss) from continuing operations	(4,799)	(1,744)	2,752
Adjustments to reconcile income (loss) from continuing operations to net cash provided by (used in) operating activities:			
Depreciation and amortization	10,902	8,292	7,524
Provision for doubtful accounts	8,958	7,163	7,507
Deferred income tax provision (benefit)	5,997	(1,569)	(1,222)
Provision for self-insured professional liability, net of cash payments	1,342	1,968	3,200
Stock based compensation	1,027	1,012	1,152
Debt retirement costs	—	351	—
Provision for leases, net of cash payments	(936)	(1,773)	(1,749)
Lease termination costs, net of cash payments	—	1,863	—
Equity in net income of investment in unconsolidated affiliate	—	(271)	(335)
Gain on sale of investment in unconsolidated affiliate	(733)	(1,366)	—
Gain on bargain purchase	(925)	—	—
Deferred bonus	761	350	—
Other	523	576	396
Changes in other assets and liabilities affecting operating activities:			
Receivables, net	(10,721)	(25,551)	(9,883)
Prepaid expenses and other assets	385	(1,620)	(60)
Trade accounts payable and accrued expenses	1,589	10,224	1,009
Net cash provided by (used in) continuing operations	13,370	(2,095)	10,291
Net cash used in discontinued operations	(1,310)	(3,523)	(7,014)
Net cash provided by (used in) operating activities	12,060	(5,618)	3,277
CASH FLOWS FROM INVESTING ACTIVITIES:			
Purchases of property and equipment	(9,730)	(6,022)	(4,646)
Nursing center acquisitions	—	(7,550)	—
Acquisition of property and equipment through business combination	(8,750)	—	(10,900)
Proceeds from sale of unconsolidated affiliate	1,100	2,068	—
Change in restricted cash	—	1,658	2,489
Deposits and other deferred balances	—	—	(9)
Net cash used in continuing operations	(17,380)	(9,846)	(13,066)
Net cash used in discontinued operations	—	—	—
Net cash used in investing activities	(17,380)	(9,846)	(13,066)
CASH FLOWS FROM FINANCING ACTIVITIES:			
Repayment of debt obligations	(30,154)	(73,374)	(15,342)
Proceeds from issuance of debt	37,067	92,789	27,945
Financing costs	(195)	(2,162)	(160)
Issuance and redemption of employee equity awards	(94)	(105)	79
Payment of common stock dividends	(1,384)	(1,366)	(1,347)
Payment for preferred stock restructuring	(659)	(640)	(619)
Net cash provided by continuing operations	4,581	15,142	10,556
Net cash used in discontinued operations	—	—	—
Net cash provided by financing activities	4,581	15,142	10,556

DIVERSICARE HEALTHCARE SERVICES, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
(in thousands)

(Continued)

	Years Ended December 31,		
	2017	2016	2015
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	\$ (739)	\$ (322)	\$ 767
CASH AND CASH EQUIVALENTS, beginning of period	4,263	4,585	3,818
CASH AND CASH EQUIVALENTS, end of period	<u>\$ 3,524</u>	<u>\$ 4,263</u>	<u>\$ 4,585</u>
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:			
Cash payments of interest, net of amounts capitalized	<u>\$ 5,404</u>	<u>\$ 3,965</u>	<u>\$ 3,629</u>
Cash payments of income taxes	<u>\$ 847</u>	<u>\$ 549</u>	<u>\$ 205</u>
SUPPLEMENTAL INFORMATION ON NON-CASH INVESTING AND FINANCING TRANSACTIONS:			
Acquisition of equipment through capital lease	<u>\$ 507</u>	<u>\$ 1,851</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, 2017, 2016, and 2015

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, 2017, our continuing operations consist of 76 nursing centers with 8,456 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 489 licensed assisted living and other residential beds. Our continuing operations include centers in Alabama, Florida, Indiana, Kansas, Kentucky, Mississippi, Missouri, Ohio, Tennessee, and Texas. The number of centers and beds denoted in these consolidated financial statements are unaudited.

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 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 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, 2017, 2016 and 2015, the Company recorded \$99,000, \$38,000 and \$141,000 of net unfavorable estimated settlements from federal and state programs for periods prior to the beginning of fiscal 2017, 2016 and 2015, respectively.

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.

DIVERSICARE HEALTHCARE SERVICES, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
DECEMBER 31, 2017, 2016, and 2015

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 \$8,958,000, \$7,163,000, and \$7,507,000 for 2017, 2016 and 2015, respectively. The provision for doubtful accounts of continuing operations was 1.6%, 1.7%, and 1.9% of net revenue during 2017, 2016, and 2015, respectively.

Lease Expense

As of December 31, 2017, the Company operates 58 nursing centers under operating leases, including 35 owned by Omega, 20 owned by Golden Living and three owned by other parties. The Company's operating leases generally require the Company to pay stated rent, subject to increases based on changes in the Consumer Price Index, a minimum percentage increase, or increases in the net revenues of the leased properties. The Company's Omega 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" and Note 9, "Commitments and Contingencies" for a discussion regarding the Company's Master Leases with Omega and Golden Living 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. Operating expenses for the year ended December 31, 2017 are net of approximately \$2.2 million received during 2017 related to a settlement of provider taxes appealed by the Company.

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.

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.

DIVERSICARE HEALTHCARE SERVICES, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
DECEMBER 31, 2017, 2016, and 2015

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 5, "Long-term Debt, Interest Rate Swap and Capitalized Lease Obligations" for further discussion. As a result of our January 2016 adoption of Accounting Standards Update ("ASU") No. 2015-03 issued by the Financial Accounting Standards Board ("FASB"), 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, 2017, 2016 and 2015, respectively.

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

	December 31,	
	2017	2016
Intangible assets	\$ 10,652,000	\$ 10,652,000
Accumulated amortization	(3,961,000)	(3,577,000)
Net intangible assets	<u>\$ 6,691,000</u>	<u>\$ 7,075,000</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:

2018	\$ 384,000
2019	384,000
2020	384,000
2021	384,000
2022	384,000
Thereafter	<u>4,771,000</u>
	<u>\$ 6,691,000</u>

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 and consists of an estimate of the future costs to be incurred for the known claims.

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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 Tax Cuts and Job Act (the Tax Act), which was enacted in December 2017, increased the Company's income tax expense by \$5,476,000 for the year ended December 31, 2017, which was a result of our revaluation of our net deferred tax assets. The Company considers the accounting for the deferred tax re-measurements and other items to be complete, but ongoing accounting guidance and interpretation could result in adjustments to the consolidated financial statements. The Tax Act will decrease the corporate income tax rate from 35.0% to 21.0% beginning on January 1, 2018. See Note 8, "Income Taxes" for further detail.

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

Where the Company believes that a tax position is supportable for income tax purposes, the item is included in its income tax returns. Where treatment of a position is uncertain, liabilities are recorded based upon the Company's evaluation of the "more likely than not" outcome considering the technical merits of the position. While the judgments and estimates made by the 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 8, "Income Taxes" for additional information related to the provision for income taxes.

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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 5, "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, 2017 and 2016:

December 31, 2017	Fair Value Measurements - Assets (Liabilities)			
	Total	Level 1	Level 2	Level 3
Interest rate swap	\$ 211,000	\$ —	\$ 211,000	\$ —
December 31, 2016	Fair Value Measurements - Assets (Liabilities)			
	Total	Level 1	Level 2	Level 3
Interest rate swap	\$ (129,000)	\$ —	\$ (129,000)	\$ —

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

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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 7, "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 \$1,027,000, \$1,012,000 and \$1,152,000 during the years ended December 31, 2017, 2016 and 2015, 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 6, "Shareholders' Equity, Stock Plans and Preferred Stock" for additional disclosures about the Company's stock based compensation plans.

Accumulated Other Comprehensive Income

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 (loss) 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 outlines a single comprehensive model for recognizing revenue and supersedes most existing revenue recognition guidance, including guidance specific to the healthcare industry. For public companies, Topic 606 is effective for annual and interim reporting periods beginning after December 15, 2017. The Company adopted the requirements of this standard effective January 1, 2018. The Company elected to apply the modified retrospective approach with the cumulative transition effect recognized in beginning retained earnings as of the date of adoption. The Company performed analysis into the application of the portfolio approach as a practical expedient to group patient contracts with similar characteristics, such that revenue for a given portfolio would not be materially different than if it were evaluated on a contract-by-contract basis. As part of the impact assessment, the Company evaluated any variable consideration and potential constraints on the estimate of variable consideration. The Company is required to update its estimate of the transaction price at the end of each reporting period, and any amounts allocated to a satisfied performance obligation are recognized as revenue or a reduction of revenue in the period in which the transaction price changes. Changes in the Company's expectation of the amount it will receive from the patient or third-party payors will be recorded in revenue unless there is a specific event that suggests the patient or third-party payor no longer has the ability and intent to pay the amount due and, therefore, the changes in its estimate of variable consideration better represent an impairment, or bad debt. Additionally, the new guidance requires enhanced disclosures about the nature, amount, timing, and uncertainty of revenue and cash flows arising from patient contracts, including revenue recognition policies to identify performance obligations, assets recognized from costs incurred to obtain and fulfill a contract, and significant judgments in measurement and recognition. The implementation has been completed and the impact to the consolidated financial statements for periods subsequent to adoption is not material.

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. The Company adopted ASU No. 2015-17 as of January 1, 2017, and the new standard was applied on a retrospective basis. The adoption of this guidance resulted in a \$7,644,000 reclassification between current deferred income taxes and non-current deferred income taxes as of December 31, 2016.

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.

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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. We adopted this standard as of January 1, 2017. The adoption did not have a material impact on our financial position, results of operations or cash flows.

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 more timely 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 required the Company to adopt these provisions in the first quarter of fiscal 2018 using a retrospective approach. 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, which will be the Company's fiscal year 2018. The adoption of ASU 2016-18 is not expected to have a material impact on the Company's consolidated statements of cash flows.

In January 2017, the FASB issued ASU No. 2017-01, Business Combinations (Topic 805) - Clarifying the Definition of a Business, which provides guidance to assist entities with evaluating whether transactions should be accounted for as acquisitions (or disposals) of assets or businesses. The adoption is effective for annual and interim periods beginning after December 15, 2017, with early adoption permitted in certain circumstances. The Company is still evaluating the effect, if any, the standard will have on the Company's consolidated financial condition and results of operations. The Company will evaluate future acquisitions under this guidance, which may result in future acquisitions being asset acquisitions.

In May 2017, the FASB issued ASU No. 2017-09, Compensation - Stock Compensation (Topic 718): Scope of Modification Accounting. The amended standard specifies the modification accounting applicable to any entity which changes the terms or conditions of a share-based payment award. The new guidance is effective for all entities after December 15, 2017. Early adoption is permitted. The Company does not presently believe adoption of this new standard will be material to its consolidated financial statements.

In August 2017, the FASB issued ASU No. 2017-12, Derivatives and Hedging - Targeted Improvements to Accounting for Hedging Activities, which is intended to simplify and amend the application of hedge accounting to more clearly portray the economics of an entity's risk management strategies in its financial statements. The new guidance will make more financial and nonfinancial hedging strategies eligible for hedge accounting and reduce complexity in fair value hedges of interest rate risk. The new guidance also changes how companies assess effectiveness and amends the presentation and disclosure requirements. The new guidance eliminates the requirement to separately measure and report hedge ineffectiveness and generally the entire change

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in the fair value of a hedging instrument will be required to be presented in the same income statement line as the hedged item. The new guidance also eases certain documentation and assessment requirements and modifies the accounting for components excluded from the assessment of hedge effectiveness. The new guidance is effective for public entities for fiscal years beginning after December 15, 2018, including interim periods within those years. Early adoption is permitted in any interim period or fiscal year before the effective date. The Company is evaluating the effect this guidance will have on our consolidated financial statements and related disclosures.

2. BUSINESS DEVELOPMENT AND OTHER SIGNIFICANT TRANSACTIONS

2017 Acquisition

During the year ended December 31, 2017, the Company expanded its operations to acquire a center that complements its current portfolio. On June 8, 2017, the Company entered into an Asset Purchase Agreement (the "Purchase Agreement") with Park Place Nursing and Rehabilitation Center, LLC, Dunn Nursing Home, Inc., Wood Properties of Selma LLC, and Homewood of Selma, LLC to acquire a 103-bed skilled nursing center in Selma, Alabama, for an aggregate purchase price of \$8,750,000. In connection with the funding of the acquisition, on June 30, 2017, the Company amended the terms of its Second Amended and Restated Term Loan Agreement to increase the facility by \$7,500,000, which is described in Note 5 "Long-Term Debt, Interest Rate Swap and Capitalized Lease Obligations." The acquisition of the business closed on July 1, 2017. In accordance with ASC 805, this transaction was accounted for as a business combination, which resulted in the expensing of \$140,000 of acquisition costs and a \$925,000 recorded gain on bargain purchase for the Company for the year ended December 31, 2017. The operating results of the acquired center have been included in the Company's consolidated statement of operations since the acquisition date. Supplemental pro forma information regarding the acquisition is not material to the consolidated financial statements. The allocation of the purchase price to the net assets acquired is as follows:

	Park Place
Purchase Price	\$ 8,750,000
Gain on bargain purchase	925,000
	<u>\$ 9,675,000</u>
Allocation:	
Building	\$ 8,435,000
Land	760,000
Land Improvements	145,000
Furniture, Fixtures and Equipment	335,000
	<u>\$ 9,675,000</u>

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.

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. See Note 9 "Commitments and Contingencies."

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

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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. See Note 9 "Commitments and Contingencies."

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. The Company accounted for these transactions as asset acquisitions and, as a result, allocated the purchase price, including acquisition costs, to the net assets acquired based on relative fair value at the acquisition date. 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 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>

2017 Lease Termination

On September 30, 2017, the Company entered into an Agreement with Trend Health and Rehab of Carthage, LLC ("Trend Health") to terminate the lease and the Company's right of possession of the center in Carthage, Mississippi. In consideration of the early termination of the lease, Trend Health provided the Company with a \$250,000 cash termination payment which is included in lease termination receipts in the accompanying consolidated statements of operations for the year ended December 31, 2017, net of costs to terminate. For accounting purposes, this transaction was not reported as a discontinued operation as this disposal did not represent a strategic shift that has (or will have) a major effect on the Company's operations and financial results.

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 as this disposal did not represent 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 gain in the fourth quarter of 2016. Subsequently, we recognized an additional gain of \$733,000 in the first quarter of 2017, related to the continuing liquidation of remaining net assets affiliated with the partnership.

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3. RECEIVABLES

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

	December 31,	
	2017	2016
Medicare	\$ 20,007,000	\$ 20,402,000
Medicaid and other non-federal government programs	29,453,000	31,208,000
Other patient and resident receivables	29,704,000	20,868,000
	<u>79,164,000</u>	<u>72,478,000</u>
Less: allowance for doubtful accounts	(14,235,000)	(10,326,000)
Accounts receivable, net	<u>64,929,000</u>	<u>62,152,000</u>
Other receivables and advances	<u>\$ 375,000</u>	<u>\$ 1,193,000</u>

The other receivables and advances balance includes \$474,000 related to renovation projects to be funded by Omega at December 31, 2016. None of the other receivables and advances balance at December 31, 2017 included funds related to Omega renovation projects. See Note 9, "Commitments and Contingencies" for additional discussion of these receivables and leased center construction projects.

Our accounts receivable at December 31, 2017, reflects a full year of ownership of the twenty-two newly leased Golden Living centers in Alabama and Mississippi. The Company has completed the change in ownership process and is utilizing our billing credentials to perform the billing of the Medicare and Medicaid receivables.

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.

4. PROPERTY AND EQUIPMENT

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

	December 31,	
	2017	2016
Land	\$ 6,521,000	\$ 5,761,000
Buildings and leasehold improvements	98,140,000	85,660,000
Furniture, fixtures and equipment	42,888,000	37,401,000
	<u>147,549,000</u>	<u>128,822,000</u>
Less: accumulated depreciation	(78,345,000)	(69,022,000)
Net property and equipment	<u>\$ 69,204,000</u>	<u>\$ 59,800,000</u>

As discussed further in Note 5, "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.

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

Long-term debt consists of the following:

	December 31,	
	2017	2016
Mortgage loan with a syndicate of banks; 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.	\$ 64,567,000	\$ 58,792,000
Acquisition loan with Canadian Imperial Bank of Commerce, interest at 4.75% above LIBOR.	7,500,000	6,289,000
Revolving credit facility borrowings payable to a bank; secured by receivables of the Company; interest at 4.0% above LIBOR.	16,000,000	15,000,000
Loan to finance equipment	40,000	—
	<u>88,107,000</u>	<u>80,081,000</u>
Less current portion	<u>(13,065,000)</u>	<u>(7,715,000)</u>
	75,042,000	72,366,000
Less deferred financing costs, net	(1,884,000)	(2,273,000)
Plus capitalized lease obligations	1,445,000	2,052,000
Long-term debt	<u>\$ 74,603,000</u>	<u>\$ 72,145,000</u>

As of December 31, 2017, the Company's weighted average interest rate on long-term debt, including the impact of the interest rate swap, was approximately 5.66%.

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 \$195,000 and are being amortized over the five-year term of the agreements, which are included in debt.

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. The Amended Mortgage Loan balance was \$72,067,000 as of December 31, 2017, consisting of \$64,567,000 on the term loan facility with an interest rate of 5.5% and \$7,500,000 on the acquisition loan facility with an interest rate of 6.25%. The Amended Mortgage Loan is secured by 18 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 ("Second Revolver Amendment") to amend the Amended Revolver. The Second Amendment increased the Amended Revolver capacity from the \$27,500,000 in the Amended Revolver to \$52,250,000; provided that the maximum revolving facility be reduced to \$42,250,000 on August 1, 2017. Subsequently, on June 30, 2017, the Company executed a Fourth Amendment (the "Fourth Revolver Amendment") to amend the Amended Revolver, which modifies the capacity of the revolver to remain at \$52,250,000.

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

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Effective June 30, 2017, the Company entered into a Second Amendment (the "Second Term Amendment") to amend the Amended Mortgage Loan. The Second Term Amendment amends the terms of the Amended Mortgage Loan Agreement by increasing the Company's term loan facility by \$7,500,000.

As of December 31, 2017, the Company had \$16,000,000 in borrowings outstanding under the Amended Revolver compared to \$15,000,000 outstanding as of December 31, 2016. The outstanding borrowings on the revolver were used primarily to compensate for 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 11 letters of credit with a total value of \$13,408,000 outstanding as of December 31, 2017. Considering the balance of eligible accounts receivable, the letter of credit, the amounts outstanding under the Amended Revolver and the maximum loan amount of \$39,348,000, the balance available for borrowing under the Amended Revolver is \$9,940,000 at December 31, 2017.

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, 2017.

In connection with the Company's 2017 and 2016 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>2017</u>	<u>2016</u>
Write-off of deferred financing costs	\$ —	\$ 351,000
Deferred financing costs capitalized	\$ 195,000	\$ 2,162,000

The deferred financing costs included in the current and long-term debt balances were \$1,884,000 at December 31, 2017 and \$2,273,000 at December 31, 2016.

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

2018	\$ 11,902,000
2019	9,463,000
2020	8,052,000
2021	58,690,000
Total	<u>\$ 88,107,000</u>

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 \$28,565,000 as of December 31, 2017. 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, 2017, the Company determined that the interest rate swap was effective. The interest rate swap valuation model indicated a net asset of \$211,000 at December 31, 2017. The fair value of the interest rate swap is included in "other noncurrent liabilities" on the Company's consolidated balance sheets. The asset related to the change in the interest rate swap included in accumulated other comprehensive income at December 31, 2017 is \$131,000, net of income tax benefit of \$80,000. 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*.

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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 \$1,445,000 and \$2,052,000 as of December 31, 2017 and 2016, respectively. These lease agreements provide three to five year terms.

Scheduled payments of the capitalized lease obligations are as follows:

2018	\$ 1,211,000
2019	289,000
Total	<u>1,500,000</u>
Amounts related to interest	<u>(55,000)</u>
Principal payments on capitalized lease obligation	<u>\$ 1,445,000</u>

6. SHAREHOLDERS' EQUITY, STOCK PLANS AND PREFERRED STOCK

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 Advocac 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. In June 2017, our shareholders approved an amendment to the Long-Term Incentive Plan to increase the number of shares of our common stock authorized under the Plan from 380,000 shares to 680,000 shares. No grants can be made under the 2010 Plan after May 31, 2027.

Equity Grants and Valuations

During 2017 and 2016, the Compensation Committee of the Board of Directors approved grants totaling approximately 88,000 and 83,000, 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.

The Company recorded non-cash stock-based compensation expense from continuing operations for equity grants and RSU's issued under the Plans of \$1,027,000, \$1,012,000, and \$1,152,000 during the years ended December 31, 2017, 2016, and 2015, 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, 2017, there was \$593,000 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.

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

	Year Ended December 31,		
	2017	2016	2015
Expected volatility (range)	N/A ⁽¹⁾	N/A ⁽¹⁾	44%-49%
Risk free interest rate (range)	N/A ⁽¹⁾	N/A ⁽¹⁾	1.52%-1.87%
Expected dividends	N/A ⁽¹⁾	N/A ⁽¹⁾	2.15%
Weighted average expected term (years)	N/A ⁽¹⁾	N/A ⁽¹⁾	6

⁽¹⁾ The Company did not issue any options or other equity grants that would require application of the Black-Scholes-Merton equity grant valuation model during the years ended December 31, 2017 and 2016. 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.

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:

	Year Ended December 31,		
	2017⁽¹⁾	2016⁽¹⁾	2015
Weighted average grant date fair value	\$ —	\$ —	\$ 3.78
Total intrinsic value of exercises	\$ 2,000	\$ 3,000	\$ 249,000

⁽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, 2017 and 2016. All equity grants during this period were restricted common shares which are valued using an intrinsic valuation method based on market price.

The following table summarizes information regarding stock options and SOSAR grants outstanding as of December 31, 2017:

Range of Exercise Prices	Weighted Average Exercise Prices	Grants Outstanding	Intrinsic Value-Grants Outstanding	Grants Exercisable	Intrinsic Value-Grants Exercisable
\$10.21 to \$10.88	\$ 10.63	44,000	\$ —	44,000	\$ —
\$2.37 to \$6.21	\$ 5.56	167,000	\$ 741,000	167,000	\$ 741,000
		<u>211,000</u>		<u>211,000</u>	

As of December 31, 2017, the outstanding equity grants have a weighted average remaining life of 3.25 and those outstanding equity grants that are exercisable have a weighted average remaining life of 3.25 years. During the year ended December 31, 2017, 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 2017 was \$(94,000).

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Summarized activity of the equity compensation plans is presented below:

	SOSARs/ Options	Weighted Average Exercise Price
Outstanding, December 31, 2016	231,000	\$ 6.97
Granted	—	—
Exercised	(1,000)	3.91
Expired or cancelled	(19,000)	10.73
Outstanding, December 31, 2017	211,000	\$ 6.64
Exercisable, December 31, 2017	211,000	\$ 6.64

	Restricted Shares	Weighted Average Grant Date Fair Value
Outstanding, December 31, 2016	153,000	\$ 9.47
Granted	88,000	9.98
Dividend Equivalents	4,000	10.26
Vested	(77,000)	9.06
Cancelled	(4,000)	10.10
Outstanding December 31, 2017	164,000	\$ 9.95

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

	Restricted Share Units	Weighted Average Grant Date Fair Value
Outstanding, December 31, 2016	54,000	\$ 11.1
Granted	26,000	9.98
Dividend Equivalents	1,000	10.26
Vested	(37,000)	12.11
Cancelled	—	—
Outstanding December 31, 2017	44,000	\$ 9.59

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.

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7. 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:

	Years Ended December 31,		
	2017	2016	2015
Numerator: Income (loss):			
Income (loss) from continuing operations	\$ (4,799,000)	\$ (1,744,000)	\$ 2,752,000
Loss from discontinued operations, net of income taxes	(28,000)	(67,000)	(1,128,000)
Net income (loss)	<u>\$ (4,827,000)</u>	<u>\$ (1,811,000)</u>	<u>\$ 1,624,000</u>
Denominator: Basic Weighted Average Common Shares Outstanding:	<u>6,279,000</u>	<u>6,199,000</u>	<u>6,100,000</u>
Basic net income per common share			
Income (loss) from continuing operations	\$ (0.76)	\$ (0.28)	\$ 0.45
Income (loss) from discontinued operations			
Operating loss, net of taxes	(0.01)	(0.01)	(0.18)
Discontinued operations, net of taxes	(0.01)	(0.01)	(0.18)
Basic net income (loss) per common share	<u>\$ (0.77)</u>	<u>\$ (0.29)</u>	<u>\$ 0.27</u>
	2017	2016	2015
Numerator: Income (loss) from continuing operations	\$ (4,799,000)	\$ (1,744,000)	\$ 2,752,000
Loss from discontinued operations, net of income taxes	(28,000)	(67,000)	(1,128,000)
Net income (loss)	<u>\$ (4,827,000)</u>	<u>\$ (1,811,000)</u>	<u>\$ 1,624,000</u>
Basic weighted average common shares outstanding	6,279,000	6,199,000	6,100,000
Incremental shares from assumed exercise of options, SOSARS and Restricted Stock Units	—	—	215,000
Denominator: Diluted Weighted Average Common Shares Outstanding:	<u>6,279,000</u>	<u>6,199,000</u>	<u>6,315,000</u>
Diluted net income per common share			
Income (loss) from continuing operations	\$ (0.76)	\$ (0.28)	\$ 0.44
Income (loss) from discontinued operations			
Operating loss, net of taxes	(0.01)	(0.01)	(0.18)
Discontinued operations, net of taxes	(0.01)	(0.01)	(0.18)
Diluted net income (loss) per common share	<u>\$ (0.77)</u>	<u>\$ (0.29)</u>	<u>\$ 0.26</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:

	2017	2016	2015
SOSARS/Options Excluded	45,000	31,000	62,000

The weighted average common shares for basic and diluted earnings for common shares was the same due to the losses in 2017 and 2016.

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8. INCOME TAXES

Overview

On December 22, 2017, the President of the United States signed into law the Tax Cuts and Jobs Act tax reform legislation. This legislation creates significant change in U.S. tax law, including a reduction in the corporate tax rates, changes to net operating loss carryforwards and carrybacks, and a repeal of the corporate alternative minimum tax. The legislation did reduce the U.S. corporate tax rate from the current rate of 34% to 21% for tax periods beginning after December 31, 2017. As a result of the enacted law, the Company was required to revalue deferred tax assets and liabilities at the enacted federal and state rate in effect during their scheduled reversals, the federal of which is 21%. This revaluation of deferred tax assets resulted in an expense of \$5,476,000 to income tax expense in continuing operations and a corresponding reduction in the deferred tax assets. Net operating losses generated prior to tax periods beginning after December 31, 2017 will not be limited in usage. However, net operating losses generated during tax periods beginning after December 31, 2017 will have limitations, but will carry-forward indefinitely. The other provisions of the Tax Cuts and Jobs Act do not have an expected material impact on the fiscal 2018 consolidated financial statements.

The Company considers the accounting for the deferred tax re-measurements and other items to be complete, but ongoing accounting guidance and interpretation could result in adjustments to the consolidated financial statements. The impact of the enactment of the Tax Act for fiscal year 2017 is reflected in the table below.

The provision (benefit) for income taxes on continuing operations for the years ended December 31, 2017, 2016 and 2015 is summarized as follows:

	Year Ended December 31,		
	2017	2016	2015
Current provision (benefit) :			
Federal	\$ 274,000	\$ 17,000	\$ 1,191,000
State	472,000	522,000	947,000
	<u>746,000</u>	<u>539,000</u>	<u>2,138,000</u>
Deferred provision (benefit):			
Federal	6,585,000	(1,284,000)	(783,000)
State	(588,000)	(285,000)	(439,000)
	<u>5,997,000</u>	<u>(1,569,000)</u>	<u>(1,222,000)</u>
Provision (benefit) for income taxes of continuing operations	<u>\$ 6,743,000</u>	<u>\$ (1,030,000)</u>	<u>\$ 916,000</u>

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

	Year Ended December 31,		
	2017	2016	2015
Provision (benefit) for federal income taxes at statutory rates	\$ 711,000	\$ (889,000)	\$ 1,247,000
Provision for state income taxes, net of federal benefit	421,000	120,000	688,000
Valuation allowance changes affecting the provision for income taxes	(372,000)	(45,000)	(534,000)
Employment tax credits	(217,000)	(529,000)	(1,249,000)
Nondeductible expenses	496,000	453,000	862,000
Stock based compensation expense	(35,000)	(62,000)	(105,000)
Effect of Tax Cuts and Jobs Creation Act	5,476,000	—	—
Other	263,000	(78,000)	7,000
Provision (benefit) for income taxes of continuing operations	<u>\$ 6,743,000</u>	<u>\$ (1,030,000)</u>	<u>\$ 916,000</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:

	December 31,	
	2017	2016
Deferred tax assets (liabilities):		
Net operating loss and other carryforwards	\$ 495,000	\$ 1,260,000
Credit carryforwards	3,237,000	3,162,000
Allowance for doubtful accounts	3,626,000	3,772,000
Prepaid expenses	(731,000)	(867,000)
Deferred lease costs	32,000	107,000
Depreciation	1,190,000	2,122,000
Tax goodwill and intangibles	(972,000)	(1,296,000)
Stock-based compensation	476,000	629,000
Accrued liabilities	773,000	5,011,000
Accrued rent	1,892,000	3,118,000
Kentucky and Kansas acquisition costs	4,000	6,000
Impairment of long-lived assets	186,000	269,000
Interest rate swap	(14,000)	49,000
Hedge Ineffectiveness	(106,000)	(69,000)
Noncurrent self-insurance liabilities	5,443,000	4,633,000
Other	—	11,000
	<u>15,531,000</u>	<u>21,917,000</u>
Less valuation allowance	<u>(377,000)</u>	<u>(732,000)</u>
	<u><u>\$ 15,154,000</u></u>	<u><u>\$ 21,185,000</u></u>

Deferred Tax Valuation Allowance

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

When assessing all available evidence, we consider the weight of the evidence, both positive and negative, based on the objectivity of the underlying evidence and the extent to which it can be verified. For the three-year period ended December 31, 2017, the Company has a cumulative pre-tax income from continuing operations of \$2,838,000, which includes \$1,944,000 of income attributable to the year ended December 31, 2017. 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 Mississippi in 2017 and Ohio in 2016.

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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, 2017, the Company had \$6,480,000 of net operating losses, which expire at various dates beginning in 2019 and continue through 2021. 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 \$1,614,000. 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 \$357,000 in 2017, 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, 2017. In 2016 and 2015, the Company recorded a deferred tax provision to adjust approximately \$47,000 and \$315,000, 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 did not record a valuation allowance as of December 31, 2017.

Under the Work Opportunity Tax Credit ("WOTC") program, the Company recorded \$210,000, \$550,000 and \$737,000 in Work Opportunity Tax Credits during 2017, 2016 and 2015, respectively.

The Company received a notice of an audit by the Internal Revenue Service related to the 2012 tax year, which was closed in 2016. As of December 31, 2017, the Company's tax years for 2013 forward are subject to examination by tax authorities.

9. 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, 2018, are as follows:

2018	\$	58,046,000
2019		59,511,000
2020		60,476,000
2021		61,336,000
2022		62,140,000
Thereafter		764,178,000
	\$	<u>1,065,687,000</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 \$54,988,000, \$33,364,000 and \$28,690,000 for 2017, 2016 and 2015, respectively. The accrued liability related to straight line rent was \$6,983,000 and \$7,920,000 at December 31, 2017 and 2016, 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, and another 8 centers are incorporated by amendment to the Master Lease, bringing the total to 23 centers. 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 under the Master Lease. The Lease amendment extended the term to September 30, 2018 and provided a renewal option of an additional twelve years, and the Company had to notify Omega by September 30, 2017 about exercising the renewal option, which is further discussed below. Consistent with prior terms, the Master 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.

DIVERSICARE HEALTHCARE SERVICES, INC. AND SUBSIDIARIES
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The Master Lease requires the Company to fund annual capital expenditures related to the leased centers at an amount currently equal to \$450 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 \$2,545,000. 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 5, "Long-term Debt, Interest Rate Swap and Capitalized Lease Obligations".

On September 25, 2017, the Company entered into an agreement (the "Agreement") with Omega on certain terms of a new master lease to lease the 35 centers currently owned by Omega and operated by the Company. When finalized, the new master lease contemplated by the Agreement will consolidate the leases for all 35 centers under one new master lease upon the expiration of its current Master Lease on September 30, 2018. The lease will have an initial term of 12 years with two 10 year options to renew, provide a carryforward of monthly lease payment in place on October 1, 2018 and a fixed annual base rent escalator of 2.15%. The common date of annual lease escalators will be consolidated to October 1st of each year beginning on October 1, 2019. The Lease will provide for up to \$35 million of landlord funded capital expenditure fund, which is subject to the impact on annual rent, and it will have a mechanism for agreed upon divestitures of centers. The lease will provide a security deposit of three months, as consistent with the existing Master Lease and will require minimum lease coverage ratio of 1.10x and annual minimum capital expenditure requirements with aggregate and per facility minimums.

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:

	December 31	
	2017	2016
Leasehold improvement	\$ 921,000	\$ 921,000
Accumulated Amortization	(842,000)	(737,000)
Net	<u>\$ 79,000</u>	<u>\$ 184,000</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.

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The Master Lease requires the Company to fund annual capital expenditures related to the leased centers at an amount currently equal to \$510 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 \$9,366,000. 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 \$6,169,000 as a security deposit for the Company's leases with Golden Living, as described in Note 5, "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 15 other nursing centers which primarily operate under individual leases with Omega and other third parties. The lease terms for these centers range from seven years to nineteen 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.

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. The deductibles for these policies are covered through the insurance subsidiary.

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 \$20,057,000 as of December 31, 2017. 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.

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

The Company's cash expenditures for self-insured professional liability costs from continuing operations were \$6,593,000, \$4,456,000, and \$3,328,000 for the years ended December 31, 2017, 2016 and 2015, 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, 2017 and 2016, 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.

Other Insurance

With respect to workers' compensation insurance, substantially all of our employees became covered under either a prefunded deductible policy or state-sponsored programs. 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 insured for workers' compensation exposure. For the period from July 1, 2008 through December 31, 2017, 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 \$867,000 at December 31, 2017. The Company has a non-current receivable for workers' compensation policies covering previous years of \$1,113,000 as of December 31, 2017. 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, 2017, the Company is self-insured for health insurance benefits for certain employees and dependents for amounts up to \$200,000 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 \$1,326,000 at December 31, 2017. 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 \$1,842,000 as of December 31, 2017. 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, 2017, there is \$422,000 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.

DIVERSICARE HEALTHCARE SERVICES, INC. AND SUBSIDIARIES
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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, 2017, we are engaged in 72 professional liability lawsuits, which are reserved for as discussed above. Five lawsuits are currently scheduled for trial or arbitration during the next twelve months, and it is expected that additional cases will be set for trial or hearing. The ultimate results of any of our professional liability claims and disputes cannot be predicted. We have limited, and sometimes no, professional liability insurance with regard to most of these claims. A significant judgment entered against us in one or more of these legal actions could have a material adverse impact on our financial position and cash flows.

In July 2013, the Company learned that the United States Attorney for the Middle District of Tennessee ("DOJ") had commenced a civil investigation of potential violations of the False Claims Act ("FCA").

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.

10. SUBSEQUENT EVENT

Effective February 27, 2018, the Company executed a Fifth Amendment to the Amended Revolver and a Third Amendment to the Amended Mortgage Loan. Under the terms of the Amendments, the minimum fixed charge coverage ratio shall not be less than 1.01 to 1.00 for the quarter ending March 31, 2018 and for each quarter thereafter. There were no other changes to the terms of these loan agreements.

DIVERSICARE HEALTHCARE SERVICES, INC. AND SUBSIDIARIES
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11. QUARTERLY FINANCIAL INFORMATION (UNAUDITED)

Selected quarterly financial information for each of the quarters in the years ended December 31, 2017 and 2016 is as follows:

2017	Quarter			
	First	Second	Third	Fourth
Patient revenues, net	\$ 141,500,000	\$ 142,550,000	\$ 146,377,000	\$ 144,367,000
Professional liability expense ⁽¹⁾	2,670,000	2,724,000	2,617,000	2,753,000
Income (loss) from continuing operations	1,348,000	381,000	(581,000)	(5,947,000)
Income (loss) from discontinued operations	(15,000)	(28,000)	1,000	14,000
Net income (loss)	\$ 1,333,000	\$ 353,000	\$ (580,000)	\$ (5,933,000)
Basic net income (loss) per common share:				
Income (loss) from continuing operations	\$ 0.22	\$ 0.06	\$ (0.09)	\$ (0.94)
Loss from discontinued operations	—	—	—	—
Net income (loss) per common share	\$ 0.22	\$ 0.06	\$ (0.09)	\$ (0.94)
Diluted net income (loss) per common share:				
Income (loss) from continuing operations	\$ 0.21	\$ 0.06	\$ (0.09)	\$ (0.94)
Loss from discontinued operations	—	—	—	—
Net income (loss) per common share	\$ 0.21	\$ 0.06	\$ (0.09)	\$ (0.94)

- ⁽¹⁾ The Company's quarterly results are significantly affected by the amounts recorded for professional liability expense, as discussed further in Note 9, "Commitments and Contingencies". The amount of expense recorded for professional liability in each quarter of 2017 is set forth in the table above.

DIVERSICARE HEALTHCARE SERVICES, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
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2016	Quarter			
	First	Second	Third	Fourth
Patient revenues, net	\$ 97,945,000	\$ 95,805,000	\$ 97,313,000	\$ 135,000,000
Professional liability expense ⁽¹⁾	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)	\$ (111,000)	\$ (2,150,000)	\$ (975,000)	\$ 1,425,000
Basic net income (loss) per common share:				
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	\$ (0.02)	\$ (0.35)	\$ (0.16)	\$ 0.24
Diluted net income (loss) per common share:				
Income from continuing operations	\$ (0.01)	\$ (0.35)	\$ (0.16)	\$ 0.24
Loss from discontinued operations	(0.01)	—	—	—
Net income (loss) per common share	\$ (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 9, "Commitments and Contingencies". The amount of expense recorded for professional liability in each quarter of 2016 is set forth in the table above.

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Corporate Data

Corporate Offices

Diversicare Healthcare Services, Inc.
1621 Galleria Boulevard
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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, 2017. 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 (as of March 2, 2018)

Chad A. McCurdy

Chairman of the Board
Managing Partner of Marlin Capital Partners, LLC

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

Ben R. Leedle, Jr.

Chief Executive Officer of Blue Zones, LLC

Robert A. McCabe, Jr.

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

Leslie K. Morgan

Private Investor

William C. O'Neil, Jr.

Chairman, Compensation Committee
Private Investor



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