

## **About Our Company**

Advocat Inc. provides long-term care services to nursing home patients in eight states, primarily in the Southeast and Southwest United States. Unless the context indicates otherwise, references herein to “Advocat,” “the Company,” “we,” “us” and “our” include Advocat Inc. and all of our subsidiaries.

The long-term care profession encompasses a broad range of non-institutional and institutional services. For those among the elderly requiring temporary or limited special services, a variety of home care options exist. As needs for assistance in activities of daily living develop, assisted living facilities become the most viable and cost effective option. For those among the elderly requiring much more intensive care, skilled nursing facility care becomes the only viable option. We have chosen to focus primarily on our skilled nursing centers and to specialize in this aspect of the long-term care continuum.

Our objective is to become the provider of choice of health care and related services to the elderly in the communities in which we operate. We will continue to implement our operating strategy of (i) providing a broad range of cost-effective elder care services; (ii) increasing occupancy in our nursing centers through physical plant improvements and an increased emphasis on marketing efforts; (iii) improving the quality of payor mix; and (iv) clustering our operations on a regional basis. Interwoven into our objectives and operating strategy is our mission:

- Committed to Compassion
- Striving for Excellence
- Serving Responsibly

## LETTER TO SHAREHOLDERS

Dear Shareholder:

After facing a difficult second and third quarter in 2008, we concluded the year with positive results and a much improved fourth quarter. The year was very challenging because of pressures on Medicare census and rising costs in a declining economy. With this background, we reported earnings of \$0.92 per diluted common share from continuing operations. We are also pleased to report cash flow from operations of \$9.5 million. We spent \$9.7 million in capital expenditures, including over \$5 million on renovation investments which we believe will provide healthy returns on our investments. Additionally, we reduced debt by \$2 million. In 2009, the Company implemented enhanced risk management procedures in Arkansas designed to reduce the number of future professional liability claims, and the Company is also evaluating an electronic medical records system which should improve our ability to defend future professional liability lawsuits.

Revenue for the year increased 17.8% to \$288.8 million. Net income from continuing operations in 2008 was \$5.8 million compared to \$9.5 million in 2007. The reduction in net income was primarily due to a negative swing from a \$1.7 million benefit in professional liability in 2007 to an expense of \$1.7 million in 2008.

### **Fourth Quarter Progress**

Compared sequentially to the third quarter of 2008, we increased revenue 2.9% to \$74.3 million and increased occupancy to 76.0% from 75.3% in the fourth quarter. Net income from continuing operations increased to \$1.3 million in the fourth quarter compared to \$0.7 million in the third quarter. The seven Texas nursing centers we acquired in 2007 increased occupancy and contributed to income in the fourth quarter. We are focused on providing further improvements in operations and profitability at these nursing centers.

### **Renovations**

Our goal is to be recognized as the leading high quality provider in every community where we serve the elderly. Since the average age of our nursing centers is 32 years, we are committed to updating our facilities. By the end of 2008 we completed the renovations of ten facilities, representing 20% of our 50 nursing homes. We also made significant investments to improve the seven nursing centers homes we acquired in Texas.

We are building a new nursing center in Paris, Texas to replace an existing facility. The new facility is expected to be completed in the third quarter of 2009. We will also be finalizing the renovation of another nursing center in the second quarter of 2009. For the eight nursing centers with renovations completed before the beginning of the fourth quarter of 2008, total occupancy improved to 72.0% in the fourth quarter of 2008, compared to 63.2% for the twelve month period prior to the renovation. Also, total Medicare average daily census for these eight nursing centers increased to 98 in the fourth quarter of 2008, compared to 81 for the twelve months prior to the renovation.

### **Outlook**

The nursing home industry is not immune to the economic pressures facing our country. Medicaid funding is very sensitive to state budget pressures, since state budgets are strained, Medicaid and Medicare rate increases for 2009 are still being debated. We believe that serving our elderly will continue to be recognized as one of the most important health care services, providing major cost savings compared to longer hospital confinement. We continue to commit our resources and staff to improved operations and services in our communities.

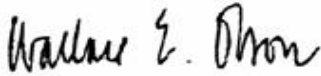
## LETTER TO SHAREHOLDERS

Our goals for 2009 are:

- Continuing the facility renovation projects.
- Improving our quality census, including increased Medicare patient days.
- Redoubling our efforts to improve the operations of the new Texas facilities.
- Implementing strategies intended to achieve a long-term reduction in professional liability exposure.
- Containing costs.
- Pursuing acquisitions and other strategic growth opportunities.

As we announced earlier, we have commenced a search for a seasoned chief operating officer who will have among other responsibilities, a greater role in strategic planning and corporate development activities. One of your Company's greatest strengths is its strong cash flow, and we place a high value on maximizing shareholder return from that cash flow.

We value your interest and investment in Advocat and look forward to reporting on our progress in 2009.



Wallace E. Olson  
Chairman



William R. Council, III  
President and Chief Executive Officer

## Operating and Growth Strategy

Our operating objective is to be the provider of choice of health care and related services to the elderly in the communities in which we operate. To achieve our objective we:

*Provide a broad range of cost-effective services.* Our objective is to provide a variety of services in a broad continuum of care which will meet the needs of the elderly requiring skilled nursing care. Our expanded service offering currently includes skilled nursing, comprehensive rehabilitation services, programming for Life Steps and Lighthouse units (described below), other specialty programming and medical supply and nutritional support services. By addressing varying levels of acuity, we work to meet the needs of the elderly population we serve for a longer period of time and to establish a reputation as the provider of choice in a particular market. Furthermore, we believe we are able to deliver quality services cost-effectively, thereby expanding the elderly population base that can benefit from our services.

*Increase occupancy through physical plant improvements and emphasis on marketing efforts.* We believe we can increase occupancy in our nursing homes through improved physical plants and an increased emphasis on an improved program for attracting and retaining patients. We emphasize strong corporate and regional support for local facility-based marketing efforts.

*Improve quality of payor mix.* We believe we can improve profitability by improving the payor mix of our patients. Quality payor sources include Medicare, HMO, managed care and private pay. These payor sources typically provide a better margin per revenue dollar or patient day.

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

Key elements of our growth strategy are to:

*Increase revenues and profitability at existing facilities.* Our strategy includes increasing center revenues and profitability through increasing occupancy levels, improving quality payor mix, obtaining appropriate reimbursement and containing costs while continuing to provide high quality care. In addition to our facility renovation program, ongoing initiatives to promote higher occupancy levels and improved payor and case mixes at our nursing centers include programs to improve customer service, new contracts for insurance and other services, and units for specialized care services developed at certain centers.

*Improve physical plants.* Our nursing centers have an average age of approximately 32 years as of December 31, 2008. During 2005 we began an initiative to complete strategic renovations of certain facilities to improve occupancy, quality of care and profitability. We developed a plan to identify those facilities with the greatest potential for benefit and began the renovation program during the third quarter of 2005. We have completed major renovations at ten facilities and have a renovation in progress at another facility as of December 31, 2008 that we expect to complete in the first quarter of 2009. We are developing plans for additional renovation projects. Major renovations result in significant cosmetic upgrades, including new flooring, wall coverings, lighting, ceilings and furniture throughout the facility. Renovations also usually include certain external work to improve curb appeal, such as concrete work, landscaping, roof and signage enhancements.

*Development of additional specialty services.* Our strategy includes the development of additional specialty units and programming in facilities that could benefit from these services. The specialty programming will vary depending on the needs of the specific marketplace, and may include Life Steps and Lighthouse Units and other specialty programming. These services allow our facilities to improve 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 homes.* We continue to pursue and investigate opportunities to acquire, lease or develop new facilities, focusing primarily on opportunities within our existing areas of operation. As previously disclosed, we entered into an option agreement to purchase certain assets of a skilled nursing facility in West Virginia. We applied to state regulatory authorities to allow us to operate the facility, and this application was approved in February 2008, subject to rights of appeal by contesting parties. The period for appeal terminated during 2008, and we expect to complete the acquisition of these assets and arrange financing for the construction of a new 90 bed replacement facility in 2009. The existing facility closed in February 2009 and will remain closed until the replacement facility is completed. No assurances can be given that we will be able to complete the acquisition or arrange construction financing on suitable terms for this project.

## Nursing Centers and Services

Advocat provides a broad range of long-term care services to the elderly 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, 2008, our continuing operations include 50 nursing centers containing 5,773 licensed nursing beds and 14 assisted living units.

Our nursing centers range in size from 48 to 320 licensed nursing beds. The following table summarizes certain information with respect to the nursing centers we own or lease as of December 31, 2008:

	<u>Number of Centers</u>	<u>Licensed Nursing Beds (1)</u>	<u>Available Nursing Beds (1)</u>	<u>Assisted Living Units</u>
<b>Operating Locations:</b>				
Alabama	6	711	704	0
Arkansas	12	1,311	1,165	12
Florida	5	502	462	0
Kentucky	6	474	470	2
Ohio	1	151	122	0
Tennessee	5	617	586	0
Texas	13	1,857	1,631	0
West Virginia	<u>2</u>	<u>150</u>	<u>150</u>	<u>0</u>
	<u>50</u>	<u>5,773</u>	<u>5,290</u>	<u>14</u>
<b>Classification:</b>				
Owned	9	942	864	0
Leased	<u>41</u>	<u>4,831</u>	<u>4,426</u>	<u>14</u>
Total	<u>50</u>	<u>5,773</u>	<u>5,290</u>	<u>14</u>

(1) The number of "Licensed beds" is based on the licensed capacity of the facility. The Company reports its occupancy based on licensed beds. The number of "Available Beds" represents "licensed beds" less beds removed from service. "Available beds" is subject to change based upon the needs of the facilities, including configuration of patient rooms and offices, status of beds (private, semi-private, ward, etc.) and renovations.

Our nursing centers provide skilled nursing health care services, including room and board, nutrition services, recreational therapy, social services and housekeeping and laundry services. Our nursing centers dispense medications prescribed by the patients' physicians, and a plan of care is developed by professional nursing staff for each resident. 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 significant 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:

*Life Steps Unit.* Fifteen of our nursing centers have units designated as Life Steps Units, our designation for patients requiring short-term rehabilitation following an incident such as a stroke, joint replacement or bone fracture. These units specialize in short-term rehabilitation with the goal of returning the patient to their previous level of functionality. These units provide enhanced services with emphasis on upgraded amenities including electric beds, televisions, phones at bedside and feature a separate entrance for guests and visitors. The design and programming of the units generally appeals to the younger resident who intends to return home following intensive rehabilitation. 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 rehabilitation typically results in higher levels of reimbursement.

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

*Enhanced Therapy Services.* We have complimented our traditional therapy services with programs that provide electrotherapy, ultrasound and shortwave diathermy therapy treatments that promote pain management, wound healing, continence improvement and contractures management, improving results of therapy treatments for our patients. We currently offer these treatment programs in 34 of our facilities.

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

**Continuous Quality Improvement.** We have in place a Continuous Quality Improvement ("CQI") program, which is focused on identifying opportunities for improvement of all aspects of the care provided in a center, as well as overseeing the initiation and effectiveness of interventions. The CQI program was designed to meet accreditation standards and to exceed state and federal government regulations. We conduct monthly audits to monitor adherence to the standards of care established by the CQI program at each center which we operate. The facility administrator, with assistance from regional nursing personnel, is primarily responsible for adherence to our quality improvement standards. In that regard, the annual operational objectives established by each facility administrator include specific objectives with respect to quality of care. Performance of these objectives is evaluated quarterly by the regional vice president or manager and each facility administrator's incentive compensation is based, in part, on the achievement of the specified quality objectives. A major component of our CQI program is employee empowerment initiatives, with particular emphasis placed on selection, recruitment, retention and recognition programs. Our administrators and managers include employee retention and turnover goals in the annual facility, regional and personal objectives. We also have established a quality improvement committee consisting of nursing representatives from each region and our corporate quality personnel. This committee periodically reviews our quality improvement programs and conducts facility audits.

**Organization.** Our long-term care facilities are currently organized into six regions, each of which is supervised by a regional vice president. The regional vice president is generally supported by specialists in several functions, including nursing, human resources, marketing, receivable management and clerical, all of whom are employed by us. The day-to-day operations of each owned or leased nursing center are supervised 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 facility, and a director of nursing, who supervises a staff of registered nurses, licensed practical nurses and nurse aides. Other personnel include those performing therapy, dietary, activities and social service, housekeeping, laundry and maintenance and office services. All personnel at the leased or owned facilities, including the administrators, are our employees.

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

*Market Information.* Our common stock was traded on NASD's OTC Bulletin Board under the symbol "AVCA" through September 11, 2006. During the third quarter of 2006, our common stock was approved for listing on the NASDAQ Capital Market and began trading there on September 12, 2006 under the symbol "AVCA." The following table sets forth the high and low bid prices of our common stock, as reported by NASDAQ.com, for each quarter in 2007 and 2008:

	<u>Period</u>	<u>High</u>	<u>Low</u>
2007	- 1 <sup>st</sup> Quarter	\$17.89	\$10.73
2007	- 2 <sup>nd</sup> Quarter	13.77	11.07
2007	- 3 <sup>rd</sup> Quarter	12.71	9.25
2007	- 4 <sup>th</sup> Quarter	12.00	9.99
2008	- 1 <sup>st</sup> Quarter	12.54	9.67
2008	- 2 <sup>nd</sup> Quarter	12.44	9.96
2008	- 3 <sup>rd</sup> Quarter	10.86	2.86
2008	- 4 <sup>th</sup> Quarter	4.99	1.55

Our common stock has been traded since May 10, 1994. On February 27, 2009, the closing price for our common stock was \$2.63, as reported by NASDAQ.com.

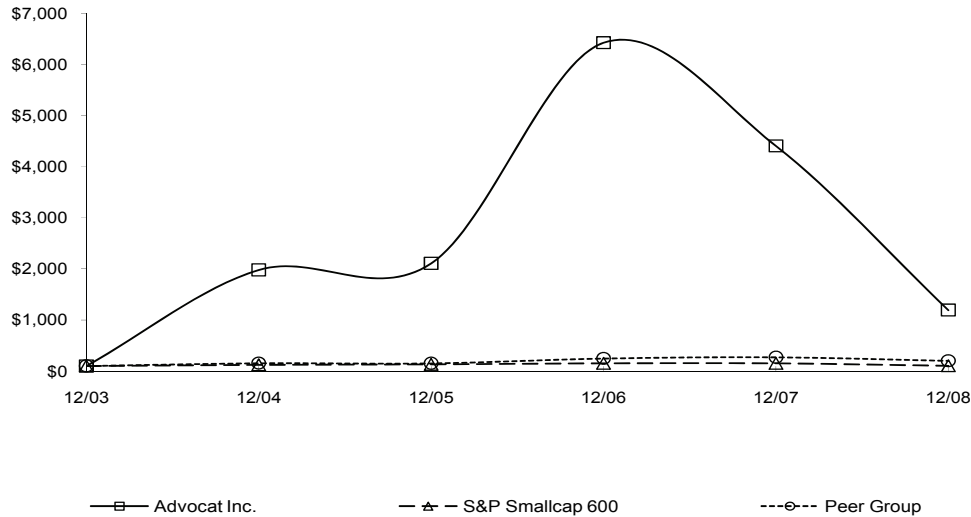
*Holder.* On February 27, 2009, there were approximately 271 holders of record of our common stock. Most of our shareholders have their holdings in the street name of their broker/dealer.

*Dividends.* We have not paid cash dividends on our Common Stock and anticipate that, for the foreseeable future, any earnings will be retained for use in our business and no cash dividends will be paid. We are currently prohibited from issuing dividends under certain of our debt instruments.

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

The graph below compares the cumulative 5-year total return of holders of Advocat Inc.'s common stock with the cumulative total returns of the S & P Smallcap 600 index, and a customized peer group of two companies that includes National Healthcare Corp. and Sun Healthcare Group 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 12/31/2003 to 12/31/2008.

**COMPARISON OF 5 YEAR CUMULATIVE TOTAL RETURN\***  
Among Advocat Inc., The S&P Smallcap 600 Index  
And A Peer Group



\*\$100 invested on 12/31/03 in stock or index, including reinvestment of dividends.  
Fiscal year ending December 31.

Copyright© 2009 S&P, a division of The McGraw-Hill Companies Inc. All rights reserved.

	12/03	12/04	12/05	12/06	12/07	12/08
<b>Advocat Inc.</b>	<b>100.00</b>	<b>1980.00</b>	<b>2108.00</b>	<b>6428.00</b>	<b>4408.00</b>	<b>1194.00</b>
<b>S&amp;P Smallcap 600</b>	<b>100.00</b>	<b>122.65</b>	<b>132.07</b>	<b>152.04</b>	<b>151.58</b>	<b>104.48</b>
<b>Peer Group</b>	<b>100.00</b>	<b>153.94</b>	<b>151.58</b>	<b>246.13</b>	<b>271.15</b>	<b>200.92</b>

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



## SELECTED FINANCIAL DATA

### SELECTED CONSOLIDATED FINANCIAL DATA

The selected financial data of Advocat presented in the following table have been derived from our financial statements, and should be read in conjunction with the annual financial statements and related Notes and Management's Discussion and Analysis of Financial Condition and Results of Operations. The New Texas Facilities are included in selected financial data effective August 11, 2007 for the SMSA acquired facilities and effective November 1, 2007 for the single facility lease in Texas. This selected financial data for all periods shown have been reclassified to present the effects of certain divestitures as discontinued operations.

	<b>Year Ended December 31,</b>				
	<b>2008</b>	2007	2006	2005	2004
	(in thousands, except per share amounts)				
<b>Statement of Operations Data</b>					
<b>REVENUES:</b>					
Patient revenues, net	<u>\$ 288,797</u>	<u>\$ 245,061</u>	<u>\$ 214,653</u>	<u>\$ 201,234</u>	<u>\$ 188,712</u>
<b>EXPENSES:</b>					
Operating	<u>228,236</u>	187,463	163,386	153,273	145,524
Lease	<u>22,962</u>	20,019	16,082	15,836	15,283
Professional liability	<u>1,658</u>	(1,663)	(5,354)	(4,532)	(2,001)
General and administrative	<u>18,486</u>	17,552	21,032	13,311	11,692
Depreciation and amortization	<u>5,306</u>	4,093	3,614	3,454	3,180
Asset impairment and other charges	<u>—</u>	—	—	—	219
	<u>276,648</u>	<u>227,464</u>	<u>198,760</u>	<u>181,342</u>	<u>173,897</u>
<b>OPERATING INCOME</b>	<u>12,149</u>	<u>17,597</u>	<u>15,893</u>	<u>19,892</u>	<u>14,815</u>
<b>OTHER INCOME (EXPENSE):</b>					
Foreign currency transaction gain (loss)	<u>(1,005)</u>	808	21	161	784
Other income	<u>—</u>	—	207	—	—
Interest income	<u>454</u>	1,016	679	534	286
Interest expense	<u>(2,870)</u>	(3,549)	(3,707)	(3,382)	(3,069)
Debt retirement costs	<u>—</u>	(116)	(194)	—	—
	<u>(3,421)</u>	<u>(1,841)</u>	<u>(2,994)</u>	<u>(2,687)</u>	<u>(1,999)</u>
<b>INCOME FROM CONTINUING OPERATIONS</b>					
BEFORE INCOME TAXES	<u>8,728</u>	15,756	12,899	17,205	12,816
PROVISION (BENEFIT) FOR INCOME TAXES	<u>2,958</u>	6,270	(9,496)	(13,811)	266
<b>NET INCOME FROM CONTINUING OPERATIONS</b>	<u>5,770</u>	9,486	22,395	31,016	12,550
<b>DISCONTINUED OPERATIONS, net of taxes</b>	<u>(35)</u>	(99)	(451)	(5,714)	(9,769)
<b>NET INCOME</b>	<u>\$ 5,735</u>	<u>\$ 9,387</u>	<u>\$ 21,944</u>	<u>\$ 25,302</u>	<u>\$ 2,781</u>
<b>INCOME (LOSS) PER COMMON SHARE:</b>					
Basic-					
Continuing operations	<u>\$ 0.95</u>	\$ 1.56	\$ 3.81	\$ 5.36	\$ 2.16
Discontinued operations	<u>—</u>	(0.02)	(0.07)	(1.00)	(1.72)
Net per common share	<u>\$ 0.95</u>	<u>\$ 1.54</u>	<u>\$ 3.74</u>	<u>\$ 4.36</u>	<u>\$ 0.44</u>
Diluted-					
Continuing operations	<u>\$ 0.92</u>	\$ 1.49	\$ 3.42	\$ 4.76	\$ 1.94
Discontinued operations	<u>—</u>	(0.01)	(0.07)	(0.88)	(1.52)
Net per common share	<u>\$ 0.92</u>	<u>\$ 1.48</u>	<u>\$ 3.35</u>	<u>\$ 3.88</u>	<u>\$ 0.42</u>
<b>WEIGHTED AVERAGE COMMON SHARES:</b>					
Basic	<u>5,693</u>	<u>5,870</u>	<u>5,784</u>	<u>5,725</u>	<u>5,660</u>
Diluted	<u>5,887</u>	<u>6,127</u>	<u>6,507</u>	<u>6,498</u>	<u>6,437</u>
	<b>December 31,</b>				
	<b>2008</b>	2007	2006	2005	2004
	(in thousands)				
<b>Balance Sheet Data</b>					
Working capital (deficit)	<u>\$ 10,885</u>	\$ 15,677	\$ 8,174	\$ (39,970)	\$ (45,489)
Total assets	<u>\$105,870</u>	\$ 110,090	\$ 96,901	\$ 93,762	\$ 72,392
Short-term borrowings and long-term debt					
including current portion	<u>\$ 32,410</u>	\$ 34,455	\$ 31,516	\$ 47,547	\$ 47,024
Preferred Stock – Series B	<u>—</u>	—	—	\$ 4,750	\$ 4,432
Preferred Stock – Series C (including unamortized premium)	<u>\$ 7,891</u>	\$ 9,590	\$ 11,289	—	—
Shareholders' Equity (deficit)	<u>\$ 17,551</u>	\$ 12,744	\$ 3,837	\$ (16,870)	\$ (41,854)

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

### Overview

Advocat Inc. provides long-term care services to nursing center patients in eight states, primarily in the Southeast and Southwest. Our centers provide a range of health care services to their patients and residents. In addition to the nursing, personal care and social services usually provided in long-term care centers, we offer a variety of comprehensive rehabilitation services as well as nutritional support services.

As of December 31, 2008, our continuing operations consist of 50 nursing centers with 5,773 licensed nursing beds and 14 assisted living units. As of December 31, 2008, our continuing operations included nine owned nursing centers and 41 leased nursing centers.

*Acquisitions and New Lease.* Effective August 11, 2007, we purchased the leasehold interests and operations of seven skilled nursing facilities from Senior Management Services of America North Texas, Inc. ("SMSA" or "SMSA Acquisition") for a price of approximately \$10.0 million. Effective November 1, 2007, we entered into an agreement to lease a single facility in Texas from a subsidiary of Omega. Together these facilities are referred to as the "New Texas Facilities."

*Divestitures.* Effective March 31, 2007, we terminated operations at a leased facility in Arkansas that had low occupancy and operated at a loss. The owner of the facility sold the property and we cooperated in an orderly transition to the new owner. In May 2006, we completed the sale of certain assets of eleven assisted living facilities located in North Carolina for a sales price of \$11.0 million. We closed one remaining North Carolina assisted living facility in April 2006 and are continuing our efforts to sell this land. In September 2007, we sold the bed license for the remaining North Carolina assisted living facility for a sales price of \$183,000 and recognized a pretax gain on sale of discontinued operations of \$45,000.

In accordance with Statement of Financial Accounting Standards ("SFAS") No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets," our consolidated financial statements have been reclassified to reflect these divestitures as discontinued operations.

*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 owned and leased. 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 Advocat statements of continuing operations for the years ended December 31, 2008, 2007 and 2006, and sets forth this data as a percentage of revenues for the same years.

	<b>Year Ended December 31,</b>					
	(Dollars in thousands)					
	2008		2007		2006	
Revenues:						
Patient revenues, net	<u>\$ 288,797</u>	<u>100.0%</u>	<u>\$ 245,061</u>	<u>100.0%</u>	<u>\$ 214,653</u>	<u>100.0%</u>
Expenses:						
Operating	228,236	79.0	187,463	76.5	163,386	76.1
Lease	22,962	8.0	20,019	8.2	16,082	7.5
Professional liability	1,658	0.6	(1,663)	(0.7)	(5,354)	(2.5)
General & administrative	18,486	6.4	17,552	7.1	21,032	9.8
Depreciation and amortization	<u>5,306</u>	<u>1.8</u>	<u>4,093</u>	<u>1.7</u>	<u>3,614</u>	<u>1.7</u>
	<u>276,648</u>	<u>95.8</u>	<u>227,464</u>	<u>92.8</u>	<u>198,760</u>	<u>92.6</u>
Operating income	<u>12,149</u>	<u>4.2</u>	<u>17,597</u>	<u>7.2</u>	<u>15,893</u>	<u>7.4</u>
Other income (expense):						
Foreign currency transaction gain (loss)	(1,005)	(0.4)	808	0.3	21	0.0
Other income	—	—	—	—	207	0.1
Interest income	454	0.2	1,016	0.4	679	0.3
Interest expense	(2,870)	(1.0)	(3,549)	(1.5)	(3,707)	(1.7)
Debt retirement costs	—	—	(116)	—	(194)	(0.1)
	<u>(3,421)</u>	<u>(1.2)</u>	<u>(1,841)</u>	<u>(0.8)</u>	<u>(2,994)</u>	<u>(1.4)</u>
Income from continuing operations before income taxes	8,728	3.0	15,756	6.4	12,899	6.0
Provision (benefit) for income taxes	<u>2,958</u>	<u>1.0</u>	<u>6,270</u>	<u>2.5</u>	<u>(9,496)</u>	<u>(4.4)</u>
Net income from continuing operations	<u>\$ 5,770</u>	<u>2.0%</u>	<u>\$ 9,486</u>	<u>3.9%</u>	<u>\$ 22,395</u>	<u>10.4%</u>

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

	<b>December 31,</b>		
	2008	2007	2006
Licensed Nursing Home Beds:			
Owned	942	942	942
Leased	4,831	4,831	3,463
Total	<u>5,773</u>	<u>5,773</u>	<u>4,405</u>
Assisted Living Units:			
Owned	—	17	17
Leased	14	49	49
Total	<u>14</u>	<u>66</u>	<u>66</u>
Total Beds/Units:			
Owned	942	959	959
Leased	4,845	4,880	3,512
Total	<u>5,787</u>	<u>5,839</u>	<u>4,471</u>
Facilities:			
Owned	9	9	9
Leased	41	41	33
Total	<u>50</u>	<u>50</u>	<u>42</u>
Average Occupancy:			
Nursing centers	75.3% <sup>(1)</sup>	77.6% <sup>(2)</sup>	78.8%
Assisted living units	<u>64.3%</u>	<u>63.1</u>	<u>60.0</u>
Total	<u>75.2%</u>	<u>77.4%</u>	<u>78.5%</u>

<sup>(1)</sup> On a same center basis, occupancy was 77.9% for 2008.

<sup>(2)</sup> On a same center basis, occupancy was 78.8% for 2007.

## 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 to vary significantly from period to period. Our accounting policies that fit this definition include the following:

### **Revenues**

#### *Patient Revenues*

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 84.8%, 86.9% and 87.0% for 2008, 2007 and 2006, respectively). Medicare intermediaries make retroactive adjustments based on changes in allowed claims. In addition, certain of the states in which we operate require complicated detailed cost reports which are subject to review and adjustments. In the opinion of management, adequate provision has been made for adjustments that may result from such reviews. Retroactive adjustments, if any, are recorded when objectively determinable, generally within three years of the close of a reimbursement year depending upon the timing of appeals and third-party settlement reviews or audits.

#### *Allowance for Doubtful Accounts*

We evaluate the collectibility of our accounts receivable by reviewing current agings of accounts receivable, historical collections data and other factors. As a percentage of revenue, our provision for doubtful accounts was approximately 0.8%, 0.4% and 0.8% for 2008, 2007 and 2006, respectively. During 2007, bad debt expense was lower due to better than expected collections experience. 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*

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 \$15.0 million as of December 31, 2008. 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 related legal costs incurred and expected to be incurred. All losses are projected on an undiscounted basis.

We retain the Actuarial Division of Willis of Tennessee, Inc. ("Willis"), a third-party actuarial firm, to estimate the appropriate accrual for incurred general and professional liability claims. The actuary, Willis, primarily uses historical data regarding the frequency and cost of our past claims over a multi-year period and information regarding our number of occupied beds to develop its estimates of our ultimate professional liability cost for current periods. The actuary estimates our professional liability accrual for past periods by using currently-known information to adjust the initial reserve that was created for that period.

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

On a quarterly basis, we obtain reports of claims and lawsuits that we have incurred from 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 and provided to the actuary. The actuary uses this information to determine the timing of claims reporting and the development of reserves, and compares the information obtained to its original estimates of liability. Based on the actual claim information obtained and on estimates regarding the number and cost of additional claims anticipated in the future, the reserve estimate for a particular prior period may be revised upward or downward on a quarterly basis. Final determination of our actual liability for claims incurred in any given period is a process that takes years. The following summarizes our accrual for professional liability and other claims for each policy year as of the end of the period:

Policy Year Ending March 9,	<b>Accrual at December 31,</b>	
	<b>2008</b>	<b>2007</b>
2009	<b>\$ 3,837,000</b>	\$ —
2008	<b>5,769,000</b>	5,134,000
2007	<b>3,202,000</b>	7,625,000
2006	<b>1,102,000</b>	4,757,000
2005	<b>774,000</b>	2,339,000
2004 and earlier	<b>275,000</b>	820,000
	<b><u>\$ 14,959,000</u></b>	<b><u>\$ 20,675,000</u></b>

Our cash expenditures for self-insured professional liability costs were \$6.8 million and \$2.8 million for the years ending December 31, 2008 and 2007, respectively. In December 2008, we entered into agreements to settle seven professional liability cases for \$4.3 million including \$0.4 million paid from insurance proceeds. These settlements will be paid in installments from December 2008 through March 2010, with an initial payment of \$1.6 million in December 2008 and quarterly payments of \$0.4 million to \$0.5 million beginning the first quarter of 2009 and continuing through the first quarter of 2010. As of December 31, 2008, we are obligated to pay installments that total \$3.5 million related to the December 2008 and other outstanding case settlements. The remaining obligation for these claims is fully accrued and included in the accrual for professional liability claims. In addition to these settlement payments, we will have throughout the year additional cash expenditures for other settlements and self-insured professional liability costs.

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. As a result, our actual liabilities may vary significantly from the accrual, and the amount of the accrual has and may continue to fluctuate by a material amount in any given quarter.

Professional liability costs are material to our financial position and 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 \$1.7 million, negative \$1.7 million and negative \$5.4 million, for the years ended December 31, 2008, 2007 and 2006, respectively, with negative amounts representing net benefits resulting from downward revisions in previous estimates. These amounts are material in relation to our reported net income from continuing operations for the related periods of \$5.8 million, \$9.5 million and \$22.4 million, respectively. We believe that the primary reason that we experienced the net benefits during 2006 and 2007 is that we were able during the period to settle outstanding claims on more favorable terms than we have historically. These settlements impact our professional liability in two ways. They reduce the amount of anticipated liability that was recorded in prior periods, and they may result in a lower estimate of the anticipated liability expense for unreported claims in more recent periods. However, the fact that these settlements have reduced our professional liability expense does not guarantee that future claims will be resolved on favorable terms and we may incur professional liability expenses in the future significantly in excess of those currently recorded, which could have a material adverse impact on our financial position and cash flows. The total liability recorded at December 31, 2008, was \$15.0 million, compared to current assets of \$38.9 million and total assets of \$105.9 million. 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.

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

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

From June 30, 2003 until June 30, 2007, we were party to workers' compensation insurance programs that provided coverage for claims incurred, with premium adjustments on incurred losses. We accounted for premium expense under these policies based on our estimate of the level of claims expected to be incurred and at December 31, 2007, we had recorded estimated premium refunds due totaling approximately \$1.2 million. During the year ended December 31, 2008, we received the proceeds of these insurance refunds. Any adjustments of future premiums for workers' compensation policies and differences between actual settlements and reserves for self-insured obligations are included in expense in the period finalized.

From July 1, 2007 through June 30, 2008 we had a guaranteed cost policy for workers' compensation insurance, under which expense was equal to the premiums paid. As a result, there will be no premium refunds associated with this new policy.

For the period from July 1, 2008 through June 30, 2009 we entered into a prefunded deductible workers' compensation 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 our estimate of the level of claims subject to the policy deductibles expected to be insured. Any differences in estimated claims costs and actual amounts are included in expense in the period finalized.

We are self-insured for health insurance benefits for certain employees and dependents for amounts up to \$150,000 per individual annually under a self insurance plan. Effective January 1, 2009 the self-insured threshold rose to \$160,000 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 liability for reported claims and estimates for incurred but unreported claims is \$1.2 million at December 31, 2008. 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 dependants.

### **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 such as significant physical changes in the property, significant adverse changes in general economic conditions, and significant deteriorations of the underlying cash flows or fair values of the property. The need to recognize an impairment is based on estimated future cash flows from a property compared to the carrying value of that property. If recognition of an impairment is necessary, it is measured as the amount by which the carrying amount of the property exceeds the fair value of the property. We did not record any asset impairments in 2008, 2007 or 2006. If our estimates or assumptions with respect to a property change in the future, we may be required to record impairment charges for our assets.

### **Business Combinations**

We account for our acquisitions in accordance with SFAS No. 141, "Business Combinations" and related interpretations. The SMSA Acquisition in 2007 has been accounted for as a purchase business combination. Purchase accounting requires that we make certain valuations based on our experience, including determining the fair value and useful lives of assets acquired and the expected settlement amount of liabilities assumed based upon their respective fair values. These valuations are subject to change during the twelve month period subsequent to the acquisition date. Such valuations require us to make significant estimates, judgments and assumptions, including projections of future events and operating performance. In December 2007, the FASB issued SFAS No. 141 (revised 2007), "Business Combinations" ("SFAS No. 141R"). SFAS No. 141R revises the principles and requirements for how an acquirer recognizes and measures a business combination in its financial statements, as well as providing revised disclosures of the business combination. The provisions of SFAS No. 141R will be effective for us beginning January 1, 2009. During the fourth quarter of 2008, we expensed \$0.2 million in acquisition costs for a potential acquisition transaction in West Virginia that was in process but not completed as of December 31, 2008. Under SFAS No. 141, these costs were considered part of the purchase price and as such were capitalized, but under SFAS No. 141R these costs are expensed as incurred.

## 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 after January 1, 2006 on a straight-line basis over the vesting period. We calculated the recognized and unrecognized stock-based compensation 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. During 2008, 2007 and 2006, we recorded charges of approximately \$0.9 million, \$0.6 million and \$5.2 million, respectively, in stock-based compensation. The 2006 charge related to vested stock option grants awarded in December 2005 that were approved by shareholders at our annual meeting on June 1, 2006. For several years prior to 2006, we did not have available stock to be granted under a shareholder approved plan. Similar to the 2008 and 2007 expense amounts, we anticipate that expenses related to future grants will be significantly smaller than in 2006 due to longer vesting schedules and smaller number of shares granted. Stock-based compensation expense is a non-cash expense and such amounts are included as a component of general and administrative expense or operating expense based upon the classification of cash compensation paid to the related employees.

### **Income Taxes**

We determine deferred tax assets and liabilities based upon differences between financial reporting and tax bases of assets and liabilities and measure them using the enacted tax laws that will be in effect when the differences are expected to reverse. In 2006, we recorded a deferred tax benefit to release approximately \$14.6 million of the previously recorded valuation allowance on deferred tax assets. During 2006, we assessed the valuation allowance on deferred tax assets and concluded that it is more likely than not that a significant portion of our remaining net deferred tax assets will be realized due to our achieved earnings trend and improved liquidity and financial position. We considered many factors, including recent cumulative earnings experience by taxing jurisdiction, expectations of future taxable income, the carryforward periods available, and the comprehensive refinancing of debt in August 2006. Prior to the refinancing, we had net working capital deficits, short-term debt maturities and were in default under debt agreements. As a result of the above factors, we believe that we have addressed the uncertainties surrounding our ability to realize the benefits of our deferred tax assets in future periods. We continue to maintain a valuation allowance of approximately \$1.0 million to reduce the deferred tax assets by the amount we believe is more likely than not to not be utilized through the turnaround of existing temporary differences, future earnings, or a combination thereof. In future periods, we will continue to assess the need for and adequacy of the remaining valuation allowance. Effective January 1, 2007, the Company adopted FASB Interpretation No. 48, "Accounting for Uncertainty in Income Taxes – An Interpretation of FASB Statement No. 109" ("FIN 48" or "the interpretation"). The interpretation provides guidance on financial statement recognition and measurement of tax positions taken, or expected to be taken, in tax returns. The initial adoption of the interpretation had no impact on the Company's financial statements.

**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, 2008, summarized by the period in which payment is due, as follows (dollar amounts in thousands):

<u>Contractual Obligations</u>	<u>Total</u>	<u>Less than 1 year</u>	<u>2 to 3 Years</u>	<u>4 to 5 Years</u>	<u>After 5 Years</u>
Long-term debt obligations (1)	\$ 35,468	\$ 3,425	\$ 27,914	\$ 4,129	\$ —
Settlement Obligations (2)	\$ 3,495	\$ 3,035	\$ 460	\$ —	\$ —
Series C Preferred Stock (3)	\$ 5,521	\$ 344	\$ 5,177	\$ —	\$ —
Elimination of Preferred Stock					
Conversion feature (4)	\$ 6,696	\$ 687	\$ 1,374	\$ 1,374	\$ 3,261
Operating leases	\$ 605,933	\$ 22,154	\$ 43,670	\$ 45,495	\$ 494,614
Required capital expenditures under mortgage loans (5)	\$ 617	\$ 229	\$ 245	\$ 143	—
Required capital expenditures under operating leases (6)	<u>\$ 29,295</u>	<u>\$ 815</u>	<u>\$ 1,630</u>	<u>\$ 1,635</u>	<u>\$ 25,215</u>
Total	<u>\$ 687,025</u>	<u>\$ 30,689</u>	<u>\$ 80,470</u>	<u>\$ 52,776</u>	<u>\$ 523,090</u>

- (1) Long-term debt obligations include scheduled future payments of principal and interest of long-term debt.
- (2) Settlement obligations relate to professional liability cases settled in 2008 that will be paid in installments through March 2010. The liabilities are included in our self insurance reserves.
- (3) Series C Preferred Stock includes quarterly dividend payments and redemption value at the preferred shareholder's earliest redemption date.
- (4) Payments for the elimination of preferred stock conversion feature.
- (5) Includes annual expenditure requirements for capital maintenance under mortgage loan covenants.
- (6) Includes annual capital expenditure requirements under operating leases.

We have employment agreements with certain members of management that provide for the payment to these members of amounts up to 2.5 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 \$2.0 million as of December 31, 2008. The terms of such agreements are from one to three years 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 stock on December 31, 2008, the maximum contingent liability for the repurchase of the equity grants is approximately \$0.2 million. No amounts have been accrued for this contingent liability.

**Payor Sources**

We classify our revenues from patients into three major categories: Medicaid, Medicare and private pay. In addition to traditional Medicaid revenues, we include within the Medicaid classification revenues from other programs established to provide benefits to those in need of financial assistance in the securing of medical services. Medicare revenues include revenues received under both Part A and Part B of the Medicare program. We classify payments from individuals who pay directly for services without government assistance as private pay revenue. The private pay classification also includes revenues from commercial insurers, HMOs, and other charge-based payment sources. Veterans Administration payments are included in private pay and are made pursuant to renewable contracts negotiated with these payors.

Medicare represented approximately 31.5%, 31.2%, and 30.6% of our net revenues during 2008, 2007, and 2006, respectively. Approximately 53.3%, 55.7%, and 56.4% of our net revenues were derived from Medicaid during 2008, 2007, and 2006, respectively. Private pay represented approximately 15.2%, 13.1% and 13.0% of our net revenues during 2008, 2007, and 2006, respectively.



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

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

**Results of Operations**

As discussed in the overview at the start of Management's Discussion and Analysis of Financial Condition and Results of Operations, we have completed certain divestitures as well as a recent acquisition and a new lease agreement. We have reclassified our consolidated financial statements to present the divestitures as discontinued operations for all periods presented. We have also defined our same center operations in light of these divestitures, acquisition and new lease agreement. Same center information excludes the operations of the New Texas Facilities and all discontinued operations.

<b>(in thousands)</b>	<b>Year Ended December 31,</b>			
	<b>2008</b>	2007	Change	%
PATIENT REVENUES, net	<u>\$ 288,797</u>	\$ 245,061	\$ 43,736	17.8%
EXPENSES:				
Operating	228,236	187,463	40,773	21.7 %
Lease	22,962	20,019	2,943	14.7 %
Professional liability	1,658	(1,663)	3,321	199.7 %
General and administrative	18,486	17,552	934	5.3 %
Depreciation and amortization	5,306	4,093	1,213	29.6 %
Total expenses	<u>276,648</u>	<u>227,464</u>	<u>49,184</u>	<u>21.6 %</u>
OPERATING INCOME	<u>12,149</u>	<u>17,597</u>	<u>(5,448)</u>	<u>(31.0)%</u>
OTHER INCOME (EXPENSE):				
Foreign currency transaction gain (loss)	(1,005)	808	(1,813)	(224.4)%
Interest income	454	1,016	(562)	(55.3)%
Interest expense	(2,870)	(3,549)	679	19.1 %
Debt retirement costs	—	(116)	116	100.0 %
	<u>(3,421)</u>	<u>(1,841)</u>	<u>(1,580)</u>	<u>(85.8)%</u>
INCOME FROM CONTINUING OPERATIONS BEFORE INCOME TAXES	8,728	15,756	(7,028)	(44.6)%
PROVISION FOR INCOME TAXES	<u>2,958</u>	<u>6,270</u>	<u>(3,312)</u>	<u>(52.8)%</u>
NET INCOME FROM CONTINUING OPERATIONS	<u>\$ 5,770</u>	<u>\$ 9,486</u>	<u>\$ (3,716)</u>	<u>(39.2)%</u>

<b>(in thousands)</b>	<b>Year Ended December 31,</b>			
	2007	2006	Change	%
PATIENT REVENUES, net	\$ 245,061	\$ 214,653	\$ 30,408	14.2 %
EXPENSES:				
Operating	187,463	163,386	24,077	14.7 %
Lease	20,019	16,082	3,937	24.5 %
Professional liability	(1,663)	(5,354)	3,691	68.9 %
General and administrative	17,552	21,032	(3,480)	(16.5)%
Depreciation and amortization	4,093	3,614	479	13.3 %
Total expenses	<u>227,464</u>	<u>198,760</u>	<u>28,704</u>	<u>14.4 %</u>
OPERATING INCOME	<u>17,597</u>	<u>15,893</u>	<u>1,704</u>	<u>10.7 %</u>
OTHER INCOME (EXPENSE):				
Foreign currency transaction gain	808	21	787	3,747.6 %
Other income	—	207	(207)	(100.0)%
Interest income	1,016	679	337	49.6 %
Interest expense	(3,549)	(3,707)	158	4.3 %
Debt retirement costs	(116)	(194)	78	40.2 %
	<u>(1,841)</u>	<u>(2,994)</u>	<u>1,153</u>	<u>38.5 %</u>
INCOME FROM CONTINUING OPERATIONS BEFORE INCOME TAXES	15,756	12,899	2,857	22.1 %
PROVISION (BENEFIT) FOR INCOME TAXES	<u>6,270</u>	<u>(9,496)</u>	<u>15,766</u>	<u>166.0 %</u>
NET INCOME FROM CONTINUING OPERATIONS	<u>\$ 9,486</u>	<u>\$ 22,395</u>	<u>\$ (12,909)</u>	<u>(57.6)%</u>

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

As a supplement to the tables above, the following table presents the unaudited statements of income from continuing operations before income taxes and related data on a same center basis, excluding the effects of the acquired facilities and discontinued operations.

<u>SAME CENTER</u> (in thousands)	<u>Year Ended December 31,</u>			
	2008	2007	Change	%
PATIENT REVENUES, net	<u>\$ 235,792</u>	<u>\$ 225,449</u>	<u>\$ 10,343</u>	<u>4.6 %</u>
EXPENSES:				
Operating	180,806	170,429	10,377	6.1 %
Lease	18,909	18,506	403	2.2 %
Professional liability	1,499	(1,854)	3,353	180.9 %
General and administrative	17,615	16,866	749	4.4 %
Depreciation and amortization	4,225	3,783	442	11.7 %
Total expenses	<u>223,054</u>	<u>207,730</u>	<u>15,324</u>	<u>7.4 %</u>
OPERATING INCOME	<u>12,738</u>	<u>17,719</u>	<u>(4,981)</u>	<u>(28.1)%</u>
OTHER INCOME (EXPENSE):				
Foreign currency transaction gain (loss)	(1,005)	808	(1,813)	(224.4)%
Interest income	454	1,016	(562)	(55.3)%
Interest expense	(2,312)	(3,174)	862	27.2 %
Debt retirement costs	—	(116)	116	100.0 %
	<u>(2,863)</u>	<u>(1,466)</u>	<u>(1,397)</u>	<u>(95.3)%</u>
INCOME FROM CONTINUING OPERATIONS BEFORE INCOME TAXES	<u>\$ 9,875</u>	<u>\$ 16,253</u>	<u>\$ (6,378)</u>	<u>(39.2)%</u>

<u>SAME CENTER</u> (in thousands)	<u>Year Ended December 31,</u>			
	2007	2006	Change	%
PATIENT REVENUES, net	<u>\$ 225,449</u>	<u>\$ 214,653</u>	<u>\$ 10,796</u>	<u>5.0 %</u>
EXPENSES:				
Operating	170,429	163,386	7,043	4.3 %
Lease	18,506	16,082	2,424	15.1 %
Professional liability	(1,854)	(5,354)	3,500	65.4 %
General and administrative	16,866	21,032	(4,166)	(19.8)%
Depreciation and amortization	3,783	3,614	169	4.7 %
Total expenses	<u>207,730</u>	<u>198,760</u>	<u>8,970</u>	<u>4.5 %</u>
OPERATING INCOME	<u>17,719</u>	<u>15,893</u>	<u>1,826</u>	<u>11.5 %</u>
OTHER INCOME (EXPENSE):				
Foreign currency transaction gain	808	21	787	3,747.6 %
Other income	—	207	(207)	(100.0)%
Interest income	1,016	679	337	49.6 %
Interest expense	(3,174)	(3,707)	533	14.4 %
Debt retirement costs	(116)	(194)	78	40.2 %
	<u>(1,466)</u>	<u>(2,994)</u>	<u>1,528</u>	<u>51.0 %</u>
INCOME FROM CONTINUING OPERATIONS BEFORE INCOME TAXES	<u>\$ 16,253</u>	<u>\$ 12,899</u>	<u>\$ 3,354</u>	<u>26.0 %</u>

**Year Ended December 31, 2008 Compared with Year Ended December 31, 2007**

As noted in the overview, during 2007 we completed the SMSA Acquisition and entered into a lease for an additional facility in Texas. All results for the New Texas Facilities are included from the effective date of acquisition or inception of lease. Accordingly, the data referenced in comparisons below for the New Texas Facilities is comparing the full year of 2008 to a partial period in 2007.

In addition, we entered into certain divestiture transactions in recent periods, and our consolidated financial statements have been reclassified to present such transactions as discontinued operations. Accordingly, the related revenue, expenses, assets, liabilities and cash flows have been reported separately, and the discussion below addresses principally the results of our continuing operations.

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

*Patient Revenues.* Patient revenues increased to \$288.8 million in 2008 from \$245.1 million in 2007, an increase of \$43.7 million, or 17.8%. Revenues related to the New Texas Facilities were \$53.0 million in 2008 and \$19.6 million in 2007. Same center patient revenues increased to \$235.8 million in 2008 from \$225.5 million in 2007, an increase of \$10.3 million, or 4.6%. This increase is primarily due to Medicare rate increases, increased Medicaid rates in certain states and increased private pay and managed care rates and census, partially offset by the effects of lower Medicare and Medicaid census.

The following table summarizes key revenue and census statistics for continuing operations for each period and segregates effects of the New Texas Facilities:

	Year Ended December 31,	
	2008	2007
Skilled nursing occupancy:		
Same center	<b>77.9%</b>	78.8%
New Texas Facilities	<b>66.8%</b>	67.4%
Total continuing operations	<b>75.3%</b>	77.6%
Medicare census as percent of total:		
Same center	<b>13.7%</b>	13.8%
New Texas Facilities	<b>11.7%</b>	12.9%
Total continuing operations	<b>13.3%</b>	13.7%
Medicare revenues as percent of total:		
Same center	<b>31.4%</b>	30.8%
New Texas Facilities	<b>32.4%</b>	35.3%
Total continuing operations	<b>31.5%</b>	31.2%
Medicaid revenues as percent of total:		
Same center	<b>54.9%</b>	56.7%
New Texas Facilities	<b>46.5%</b>	44.3%
Total continuing operations	<b>53.3%</b>	55.7%
Medicare average rate per day:		
Same center	<b>\$383.15</b>	\$351.80
New Texas Facilities	<b>\$400.05</b>	\$390.54
Total continuing operations	<b>\$386.30</b>	\$355.11
Medicaid average rate per day:		
Same center	<b>\$145.37</b>	\$140.13
New Texas Facilities	<b>\$114.87</b>	\$110.69
Total continuing operations	<b>\$139.45</b>	\$137.79

On a same center basis, the Company's average rate per day for Medicare Part A patients increased 8.9% in 2008 compared to 2007 as a result of annual inflation adjustments and increased acuity levels of Medicare patients in our nursing centers, as indicated by RUG level scores, which were higher in 2008 than in 2007. Our average rate per day for Medicaid patients increased 3.7% in 2008 compared to 2007 as a result of increasing patient acuity levels and other rate increases in certain states.

*Operating expense.* Operating expense increased to \$228.2 million in 2008 from \$187.5 million in 2007, an increase of \$40.7 million, or 21.7%. Operating expense related to the New Texas Facilities was \$47.4 million in 2008 and \$17.1 million in 2007. Same center operating expense increased to \$180.8 million in 2008 from \$170.4 million in 2007, an increase of \$10.4 million, or 6.1%. This increase is primarily attributable to cost increases related to wages and other cost increases discussed below. On a same center basis, operating expense increased to 76.7% of revenue in 2008, compared to 75.6% of revenue in 2007.

The largest component of operating expenses is wages, which increased to \$135.9 million in 2008 from \$111.8 million in 2007, an increase of \$24.1 million, or 21.5%. Wages related to the New Texas Facilities were approximately \$29.0 million in 2008 and \$9.7 million in 2007. Same center wages increased approximately \$4.8 million, or 4.7%, primarily due to increases in wages as a result of competitive labor markets in most of the

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

areas in which we operate, regular merit and inflationary raises for personnel (increase of approximately 4.2% for the year), and labor costs associated with increases in patient acuity levels. Effective January 1, 2009 we have instituted a wage freeze for our corporate and regional management teams, with reduced wage increases for the balance of our employees, and estimate these wage policy changes will help us save approximately \$0.7 million in operating expense in 2009. These policies will be reevaluated as business and economic conditions improve.

Bad debt expense was \$0.7 million higher in 2008 compared to 2007 on a same center basis. During 2007, bad debt expense was lower due to better than expected collections experience.

Workers' compensation insurance expense was approximately \$0.7 million higher in 2008 compared to 2007. We had better claims experience in 2007 and have had increases in claims costs related to certain prior year claims during 2008, resulting in higher expense.

Employee health insurance costs were approximately \$0.5 million, or 10.2% higher in 2008 compared to 2007 on a same center basis. The Company was self-insured for the first \$150,000 in claims per employee each year. Employee health insurance costs can vary significantly from year to year.

Operating costs were impacted by higher food and utility expenses. Food costs were approximately \$0.5 million higher on a same center basis, an increase in expense per patient day of 10.2%. Utility costs were approximately \$0.4 million higher, or approximately 8.3%.

Our three Houston area nursing centers incurred additional costs in 2008 as a result of Hurricane Ike. We incurred approximately \$0.2 million in incremental operating costs. In addition, during the fourth quarter of 2008, we expensed \$0.2 million in acquisition costs for a potential acquisition in West Virginia that was in process but not completed as of December 31, 2008. Under SFAS No. 141, these costs were considered part of the purchase price and appropriately capitalized, but under SFAS No. 141R they are expensed as incurred. During 2008, in connection with this potential West Virginia acquisition, we advanced \$0.2 million to the operator of the existing facility amounts in excess of the agreed upon purchase price. We accounted for these advances in excess of the purchase price as operating expenses during 2008.

The remaining increases in same center operating expense are primarily due to the effects of increases in patient acuity levels as indicated by RUG level scores, which were higher in 2008, resulting in greater costs to care for these patients.

*Lease expense.* Lease expense increased to \$23.0 million in 2008 from \$20.0 million in 2007. Lease expense related to the New Texas Facilities was \$4.1 million for 2008 and \$1.5 million in 2007. Same center lease expense increased to \$18.9 million in 2008 from \$18.5 million in 2007, primarily due to increases for lessor funded property renovations.

*Professional liability.* Professional liability in 2008 was an expense of \$1.7 million, compared to a benefit of \$1.7 million in 2007, an increase in expense of \$3.4 million. Professional liability expense related to the New Texas Facilities was \$0.2 million in both 2008 and 2007. Our cash expenditures for professional liability costs were \$6.8 million and \$2.8 million for 2008 and 2007, respectively. These cash expenditures can fluctuate from year to year. During 2008, our total recorded liabilities for self-insured professional liability declined to \$15.0 million at December 31, 2008 from \$20.7 million at December 31, 2007.

*General and administrative expense.* General and administrative expense increased to \$18.5 million in 2008 from \$17.6 million in 2007, an increase of \$0.9 million or 5.3%. As a percentage of revenue, general and administrative expense decreased to 6.4% in 2008 from 7.2% in 2007. General and administrative expense related to the New Texas Facilities was \$0.9 million in 2008 and \$0.7 million in 2007, including \$0.3 million for post acquisition integration costs in 2007. Same center general and administrative expense increased to \$17.6 million in 2008 from \$16.9 million in 2007, an increase of \$0.7 million, or 4.4%. Compensation costs increased by approximately \$0.9 million, including normal merit and inflationary increases and new positions added to improve operating and financial controls. Effective January 1, 2009 we have instituted a wage freeze for our corporate and regional management teams, with reduced wage increases for the balance of our employees, and estimate these wage policy changes will help us save approximately \$0.2 million in general and administrative expense in 2009. These policies

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

will be reevaluated as business and economic conditions improve. Travel costs increased by approximately \$0.3 million. Stock-based compensation costs increased by approximately \$0.2 million. These increases were partially offset by a decrease in incentive compensation expense of \$1.2 million.

*Depreciation and amortization.* Depreciation and amortization expense was approximately \$5.3 million in 2008 and \$4.1 million in 2007. Depreciation and amortization related to the New Texas Facilities was \$1.1 million in 2008 and \$0.3 million in 2007. Same center depreciation and amortization increased approximately \$0.4 million, primarily due to \$0.2 million in amortization of new accounting software.

*Foreign currency transaction gain (loss).* A foreign currency transaction loss of \$1.0 million was recorded in 2008, compared to a gain of \$0.8 million in 2007. Such gains and losses result primarily from foreign currency translation of a note receivable from the sale of our Canadian operations in 2004.

*Interest expense.* Interest expense decreased to \$2.9 million in 2008 from \$3.5 million in 2007. The effects of additional borrowings to complete the SMSA Acquisition were offset by principal payments made during 2007 and 2008, the effects of lower interest rates following our refinancing transactions in 2007, and reductions in variable interest rates during the periods.

*Income from continuing operations before income taxes; income from continuing operations per common share.* As a result of the above, continuing operations reported income before income taxes of \$8.7 million in 2008 compared to \$15.8 million in 2007. The provision for income taxes was \$3.0 million in 2008, an effective rate of 33.9%, compared to \$6.3 million in 2007, an effective rate of 39.8%. Our 2008 income taxes have been reduced by tax credits generated under the Work Opportunity Tax Credit program. The basic and diluted income per common share from continuing operations were \$0.95 and \$0.92, respectively, in 2008, as compared to a basic and diluted income per common share from continuing operations of \$1.56 and \$1.49, respectively, in 2007.

*Income from discontinued operations.* We have completed certain divestitures and have reclassified our consolidated financial statements to present these divestitures as discontinued operations for all periods presented. Operating loss of discontinued operations, net of taxes, was approximately \$35,000 in 2008, compared to \$91,000 in 2007. The disposition of discontinued operations and completions of lease terminations resulted in no gain or loss in 2008 and a loss of \$8,000, net of taxes, in 2007.

### **Year Ended December 31, 2007 Compared With Year Ended December 31, 2006**

During 2007, we completed the SMSA Acquisition and entered into a lease for an additional facility in Texas. All results for the New Texas Facilities are included from the effective date of acquisition or inception of lease.

In addition, we have entered into certain divestiture transactions in recent periods, and our consolidated financial statements have been reclassified to present such transactions as discontinued operations. Accordingly, the related revenue, expenses, assets, liabilities and cash flows have been reported separately, and the discussion below addresses principally the results of our continuing operations.

*Patient Revenues.* Patient revenues increased to \$245.1 million in 2007 from \$214.7 million in 2006, an increase of \$30.4 million, or 14.2%. Revenues related to the New Texas Facilities were \$19.6 million in 2007. Same center patient revenues increased to \$225.5 million in 2007 from \$214.7 million in 2006, an increase of \$10.8 million, or 5.0%. This increase is primarily due to increased Medicaid rates in certain states and Medicare rate increases.

**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 the year and segregates effects of the New Texas Facilities:

	Year Ended December 31,	
	2007	2006
Skilled nursing occupancy:		
Same center	78.8%	78.8%
New Texas Facilities	67.4%	n/a
Total continuing operations	77.6%	78.8%
Medicare census as percent of total:		
Same center	13.8%	14.0%
New Texas Facilities	12.9%	n/a
Total continuing operations	13.7%	14.0%
Medicare revenues as percent of total:		
Same center	30.8%	30.6%
New Texas Facilities	35.3%	n/a
Total continuing operations	31.2%	30.6%
Medicaid revenues as percent of total:		
Same center	56.7%	56.4%
New Texas Facilities	44.3%	n/a
Total continuing operations	55.7%	56.4%
Medicare average rate per day:		
Same center	\$351.80	\$324.48
New Texas Facilities	\$390.54	n/a
Total continuing operations	\$355.11	\$324.48
Medicaid average rate per day:		
Same center	\$140.12	\$133.78
New Texas Facilities	\$110.69	n/a
Total continuing operations	\$137.79	\$133.78

On a same center basis, the Company's average rate per day for Medicare Part A patients increased 8.4% in 2007 compared to 2006 as a result of annual inflation adjustments and the acuity levels of Medicare patients in our nursing centers, which were higher in 2007 than in 2006. Our average rate per day for Medicaid patients increased 4.7% in 2007 compared to 2006 as a result of increasing patient acuity levels, certain state increases to offset minimum wage adjustments, effects of stock based compensation charges and other rate increases in certain states.

*Operating expense.* Operating expense increased to \$187.5 million in 2007 from \$163.4 million in 2006, an increase of \$24.1 million, or 14.7%. Operating expense related to the New Texas Facilities was \$17.1 million in 2007. Same center operating expense increased to \$170.4 million in 2007 from \$163.4 million in 2006, an increase of \$7.0 million, or 4.3%. This increase is primarily attributable to cost increases related to wages and benefits, partially offset by reductions in bad debt expenses and costs of workers' compensation insurance. On a same center basis, operating expense decreased to 75.6% of revenue in 2007, compared to 76.1% of revenue in 2006.

The largest component of operating expenses is wages, which increased to \$111.7 million in 2007 from \$97.5 million in 2006, an increase of \$14.2 million, or 14.6%. Wages related to the New Texas Facilities were approximately \$9.7 million. Same center wages increased approximately \$4.5 million, or 4.6%, primarily due to increases in wages as a result of competitive labor markets in most of the areas in which we operate, regular merit and inflationary raises for personnel (increase of approximately 3.8% for the period), and labor costs associated with increases in patient acuity levels. Although overall Medicare census declined slightly, the acuity levels of the Company's patients, as indicated by RUG level scores, were higher than in 2006, resulting in greater costs to care for these patients.

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

Employee health insurance costs were approximately \$0.6 million higher in 2007 compared to 2006 on a same center basis, an increase of approximately 14.3%. During 2007 and 2006, the Company was self insured for the first \$150,000 in claims per employee each year. Employee health insurance costs can vary significantly from year to year.

These increased costs were partially offset by reductions in bad debt expense and workers' compensation insurance. Bad debt expense was \$0.6 million lower in 2007 compared to 2006 on a same center basis. Costs of workers' compensation insurance were approximately \$0.7 million lower in 2007 compared to 2006 on a same center basis due to better than expected claims experience.

The remaining increases in operating expense are primarily due to the effects of increases in patient acuity levels.

*Lease expense.* Lease expense increased to \$20.0 million in 2007 from \$16.1 million in 2006. Lease expense related to the New Texas Facilities was \$1.5 million for 2007. Same center lease expense increased to \$18.5 million in 2007 from \$16.1 million in 2006. Effective October 1, 2006, we renewed a master lease covering 28 nursing centers. This resulted in an increase in lease expense of \$2.0 million during 2007 for the effects of recording scheduled rent increases on a straight-line basis over the term of the renewal period. This increase has no effect on cash rent payments at the start of the lease term, and will only result in additional cash outlay as the 3 percent annual increases take effect each year. In addition, there was an increase in lease expense of \$0.5 million resulting from rent increases for lessor funded property renovations.

*Professional liability.* Professional liability in 2007 was a benefit of \$1.7 million, compared to a benefit of \$5.4 million in 2006, a decrease in benefit of \$3.7 million. Professional liability expense related to the New Texas Facilities was \$0.2 million. Our cash expenditures for professional liability costs were \$2.8 million and \$3.4 million for 2007 and 2006, respectively. These cash expenditures can fluctuate from year to year. During 2007, our total recorded liabilities for self-insured professional liability declined to \$20.7 million at December 31, 2007, down from \$25.7 million at December 31, 2006.

*General and administrative expense.* General and administrative expense decreased to \$17.6 million in 2007 from \$21.0 million in 2006, a decrease of \$3.4 million or 16.5%. General and administrative expense related to the New Texas Facilities was \$0.7 million in 2007 and included \$0.3 million incurred for post acquisition integration costs. Same center general and administrative expense decreased to \$16.9 million in 2007 from \$21.0 million in 2006, a decrease of \$4.1 million, or 19.8%.

The majority of the decrease in general and administrative expense is related to non-cash stock-based compensation, which was \$4.4 million lower in 2007. Prior to 2007, such charges were reported as a separate income statement caption, but were reclassified for current and prior periods in the 2007 financial statements. Costs of compliance with the requirements of Section 404 of the Sarbanes-Oxley Act of 2002 were \$0.7 million lower in 2007 compared to 2006.

Partially offsetting these reduced costs were increased compensation costs of approximately \$0.9 million, resulting from normal merit and inflationary increases (\$0.3 million, approximately 4.3%), new positions added to improve marketing, operational and financial controls (\$0.3 million), and higher incentive compensation costs (\$0.3 million) as a result of operating performance.

*Depreciation and amortization.* Depreciation and amortization expense was approximately \$4.1 million in 2007 and \$3.6 million in 2006. The increase in 2007 is primarily due to depreciation and amortization expenses related to the New Texas Facilities.

*Foreign currency transaction gain.* A foreign currency transaction gain of \$808,000 was recorded in 2007, compared to \$21,000 in 2006. These gains result primarily from foreign currency translation of a note receivable from the sale of our Canadian operations in 2004.

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

*Interest expense.* Interest expense decreased to \$3.5 million in 2007 from \$3.7 million in 2006, a decrease of \$0.2 million or 4.3%. Interest expense decreased as a result of payments of debt from proceeds of the sale of discontinued operations, principal payments made in connection with a refinancing transaction in August 2006, and other principal payments. These decreases were partially offset by debt increases associated with our SMSA Acquisition, which resulted in interest expense increases of approximately \$0.3 million in 2007, and fees for letters of credit issued in 2007.

*Debt retirement costs.* Debt retirement costs of \$0.1 and \$0.2 million in 2007 and 2006, respectively, are related to unamortized deferred finance costs of refinanced loans that were written off following the refinancing transactions we completed in August 2007 and August 2006.

*Income from continuing operations before income taxes; income from continuing operations per common share.* As a result of the above, continuing operations reported income before income taxes of \$15.8 million in 2007 compared to \$12.9 million in 2006. The provision for income taxes was \$6.3 million in 2007, compared to a benefit for income taxes of \$9.5 million in 2006. Our effective tax rate differs materially from the statutory rate in 2006 mainly due to changes in our valuation allowance for net deferred tax assets. During 2006, we recorded a deferred tax benefit to reduce deferred tax asset valuation allowances, based on improvements in our financial position and our updated forecast of income available to support the turnaround of existing net operating loss carryforward credits. In future periods, we will continue to assess the need for and adequacy of the remaining valuation allowance. The basic and diluted income per common share from continuing operations were \$1.56 and \$1.49, respectively, in 2007, as compared to a basic and diluted income per common share from continuing operations of \$3.81 and \$3.42, respectively, in 2006.

*Income from discontinued operations.* We have completed certain divestitures and have reclassified our consolidated financial statements to present these divestitures as discontinued operations for all periods presented. Operating loss of discontinued operations, net of taxes, was approximately \$91,000 in 2007, compared to a loss of \$337,000 in 2006. The disposition of discontinued operations and completions of lease terminations resulted in a loss of \$8,000, net of taxes, in 2007, compared to a loss of \$114,000 in 2006.

### **Liquidity and Capital Resources**

#### *Liquidity*

Net cash provided by operating activities of continuing operations totaled \$9.5 million, \$12.7 million and \$15.4 million in 2008, 2007 and 2006, respectively. Discontinued operations provided cash of \$22,000 in 2007 and \$0.3 million in 2006 and used \$35,000 of cash in 2008.

Investing activities of continuing operations used cash of \$9.1 million and \$14.1 million in 2008 and 2007, respectively, and provided \$6.0 million of cash in 2006. These amounts primarily represent proceeds from the sale of discontinued operations, cash used for purchases of property, plant and equipment, and cash used for the SMSA Acquisition in 2007. We have used between \$4.1 million and \$9.7 million for capital expenditures of continuing operations in each of the three calendar years ending December 31, 2008. Capital expenditures during 2008 included approximately \$2.8 million for renovation projects funded with internal cash flow and approximately \$0.4 million to complete certain facility improvements we identified during the process of acquiring the New Texas Facilities. The capital expenditures we made during 2007 were driven by three projects or initiatives that totaled \$3.6 million of the \$6.8 million spent in total. We spent \$0.6 million and \$0.8 million at owned facilities in Arkansas and Texas, respectively, as well as \$2.2 million at our New Texas facilities. Such expenditures were primarily for facility improvements and equipment, which were financed principally through working capital. For the year ending December 31, 2009, we anticipate that capital expenditures for improvements and equipment for our existing facility operations will be higher as we complete facility renovations and significant projects at certain owned and leased facilities. Investing activities of discontinued operations used no cash in 2007 and used \$49,000 and \$28,000 in 2008 and 2006, respectively.



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

Financing activities of continuing operations used cash of \$4.4 million in 2008 and \$16.4 million in 2006, respectively, and provided cash of \$0.7 million in 2007. Cash used in 2008 primarily resulted from payment of existing debt obligations of \$2.0 million and the repurchase of \$1.7 million of our common stock. The cash provided in 2007 primarily represents the net funds from loan proceeds to acquire the SMSA leasehold interests, offset by the payment of existing debt and the repurchase of \$0.8 million of our common stock. In 2006, proceeds from the sale of discontinued operations were used to repay debt. There were no cash flows from financing activities of discontinued operations in 2008, 2007 or 2006. No interest costs or debt were allocated to discontinued operations.

### *Note Receivable*

We have a note receivable denominated in Canadian dollars from the sale of our Canadian subsidiary in 2004. The balance of the note at December 31, 2008 is approximately \$4.9 million Canadian (\$4.0 million US). During 2009 we entered into negotiations to extend the maturity of this note to May 2010 while the borrower seeks replacement financing. While no formal amendment has been executed, we expect an installment of at least \$600,000 Canadian plus accrued interest would be paid on May 11, 2009. Based on preliminary discussion with the borrower, if the entire principal amount is not paid by May 11, 2009, the interest rate on the note will be based on LIBOR plus 4%, but not less than 5%, and the balance of the note will be due in full on May 11, 2010. All other terms of the note would remain the same.

### *Professional Liability*

We have numerous pending liability claims, disputes and legal actions for professional liability and other related issues. For several years, due to our past claim experience and increasing cost of claims throughout the long-term care industry, the premiums paid by us for professional liability and other liability insurance exceeded the coverage purchased so that it cost more than \$1 to purchase \$1 of insurance coverage. For this reason, effective March 9, 2001, we purchased professional liability insurance coverage for our facilities that, based on historical claims experience, was substantially less than the amount required to satisfy claims that were incurred. As a result, we have been effectively self-insured. We have essentially exhausted all general and professional liability insurance available for claims first asserted prior to March 10, 2007. For claims made during the period from March 10, 2007 through March 9, 2010, we maintain insurance coverage limits of \$100,000 per medical incident and total annual aggregate policy coverage limits of \$500,000. As of December 31, 2008, payments already made by the insurance provider for the period from March 10, 2007 through March 9, 2009 have reduced the remaining aggregate coverage amount in the policy period, but coverage has not been exhausted.

As of December 31, 2008, we have recorded total liabilities for reported and settled professional liability claims and estimates for incurred but unreported claims of \$15.0 million. 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 December 2008, we entered into agreements to settle seven professional liability cases for \$4.3 million including \$0.4 million paid from insurance proceeds. The settlements will be paid in installments from December 2008 through March 2010, with an initial payment of \$1.6 million in December 2008 and quarterly payments of \$0.4 million to \$0.5 million beginning the first quarter of 2009 and continuing through the first quarter of 2010. As of December 31, 2008, we are obligated to pay installments that total \$3.5 million related to the December 2008 and other outstanding case settlements. The remaining obligation for these claims is fully accrued and included in the accrual for professional liability claims. In addition to these settlement payments, we will have throughout the year additional cash expenditures for other settlements and self-insured professional liability costs.

### *Capital Resources*

As of December 31, 2008, we had \$32.4 million of outstanding borrowings, including \$2.2 million in current scheduled payments of long-term debt.

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

In August 2007, we entered into an agreement with a bank for a \$16.5 million term loan to finance the SMSA Acquisition and repay certain existing indebtedness. The term loan has an interest rate of LIBOR plus 2.5%, a maturity of five years, principal payments based on a ten year amortization, with additional payments based on cash flow from operations and amounts realized related to certain collateral. The term loan matures in August 2012 and is secured by receivables and all other unencumbered assets of the company, including land held for sale and notes receivable. In addition to financing the SMSA Acquisition, we used proceeds from this term loan to retire a \$4.0 million term loan that had an interest rate of LIBOR plus 6.25% and a \$2.5 million subordinated note due in September 2007 that had an interest rate of 7%.

The bank loan agreement also includes a \$15 million revolving credit facility that provides revolving credit loans as well as the issuance of letters of credit. The revolver is secured by accounts receivable and there are limits on the maximum amount of loans that may be outstanding under the revolver based on borrowing base restrictions. The revolver has a term of three years, expiring August 2010 and bears interest at our option of LIBOR plus 2.25% or the bank's prime lending rate. Annual fees for letters of credit issued under this revolver are 2.25% of the amount outstanding. We have a letter of credit of approximately \$8.1 million to serve as a security deposit for all of our leases with Omega. Considering the balance of eligible accounts receivable at December 31, 2008, the letter of credit and the current maximum loan of \$15 million, the balance available for future revolving credit loans would be \$6.9 million. As of December 31, 2008, we had no borrowings outstanding under our revolving credit facility.

On August 7, 2006, we entered into an agreement with our commercial mortgage lender to refinance our mortgage debt. Under the terms of the mortgage loan, the lender provided mortgage debt of approximately \$22.5 million with a five year maturity. The proceeds of the mortgage loan were used to retire the existing debt and to fund a \$1.1 million renovation of a nursing center that is part of the collateral for the mortgage loans. The renovation was completed during 2007.

The Company's bank term loan agreement requires additional payments from proceeds received upon certain asset dispositions and excess cash flows, as defined in the term loan agreement. In addition, our term loan agreement allows for voluntary prepayments of principal outstanding, and during 2007, we made voluntary prepayments of \$3.0 million. These prepayments reduce the required amounts that must be paid in future periods from excess cash flows and asset dispositions.

Our debt agreements contain various financial covenants, the most restrictive of which relate to cash flow, debt service coverage ratios, liquidity and limits on the payment of dividends to shareholders. We are in compliance with all such covenants at December 31, 2008. During December 2008 we amended certain provisions of our term loan agreement related to the definition of a Minimum Fixed Charge Coverage Covenant. The amendment changed the measurement of the Minimum Fixed Charge Coverage Covenant by substituting "maintenance capital expenditures," as defined, for substantially all fixed asset expenditures as previously defined in the agreement.

We are subject to a covenant under our mortgage loan that requires us to maintain a combined occupancy for seven owned homes that serve as collateral for the mortgage loan. We were in compliance with the covenant at September 30, 2008, however, the covenant was to become more restrictive as of December 31, 2008, and based on occupancy at September 30, 2008, we would not be in compliance with the more restrictive covenant. We amended this covenant with our mortgage lender in December 2008.

We are in compliance with all covenants, as amended, as of December 31, 2008. There can be no assurances that we will be able to meet all of the covenants set forth in our amended debt agreements. A failure to meet any such covenant could have a material adverse effect on us.

### *Transaction with Omega*

On October 20, 2006, we entered into a Restructuring Stock Issuance and Subscription Agreement ("Restructuring Agreement") to restructure our Series B Redeemable Convertible Preferred Stock held by Omega.

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

Under the Restructuring Agreement we issued Omega 5,000 shares of Series C Preferred Stock in exchange for the 393,658 shares of our Series B Convertible Preferred Stock held by Omega. The new Series C Preferred Stock has a stated value of approximately \$4.9 million and carries an annual dividend rate of 7% of its stated value. Dividends on the Series C Preferred Stock are paid quarterly in cash. The Series C Preferred Stock is not convertible, but is redeemable at its stated value at Omega's option after September 30, 2010, and is redeemable at its stated value at our option after September 30, 2007, subject to certain limitations. In connection with the termination of the conversion feature of the Series B Preferred Stock, we agreed to pay Omega an additional \$687,000 annually under the Lease Amendment.

Advocat and Omega also entered into the Lease Amendment to extend the term and amend the Omega Master Lease covering 28 nursing centers. The initial term of the lease was set to expire in September 2010, with a ten year renewal option. The amended master lease commenced on October 1, 2006, and extends to September 30, 2018. The Lease Amendment also provides for a renewal option of an additional twelve years. Other than the change in rent associated with the restructuring of the preferred stock described above, there was no change in the base rental amounts as a result of the Lease Amendment. Consistent with prior terms, the lease provides for annual increases in lease payments equal to the lesser of two times the increase in the Consumer Price Index or 3 percent. Under generally accepted accounting principles, we are required to report these scheduled rent increases on a straight line basis over the 12 year term of the renewal period. As a result of accruing the scheduled rent increases, our annual rent expense increased by approximately \$2.7 million effective October 1, 2006. This increase has no effect on cash rent payments at the start of the lease term, and will only result in additional cash outlay as the 3 percent annual increases take effect each year.

This Lease Amendment, together with an earlier amendment in 2005, provides financing of up to \$10 million to fund capital improvements made to certain nursing centers leased from Omega. The annual base rent related to these nursing centers will be increased to reflect the amount of capital improvements made to the facilities. The increase in rent is based on a rate of 10.25% per year of the amount financed under this amendment. As of December 31, 2008, we had incurred expenditures of \$10.0 million for these improvements.

### *New Facility Construction*

Texas Facility. In November 2007, we entered into a short-term, single facility lease with Omega for an existing 102 bed skilled nursing center in Paris, Texas and undertook an evaluation of the feasibility of entering into an agreement with Omega for the construction of a replacement facility. On March 14, 2008, we entered into an amendment to our master lease with Omega to provide for the construction and lease of a replacement facility. Upon the completion of the construction of the replacement facility, the existing building will be closed and the single facility lease terminated.

Under the terms of the March 14, 2008 lease amendment and an October 24, 2008 lease amendment, Omega will provide funding and we will supervise the construction of the facility. Construction began during the second quarter of 2008, with completion expected in mid-2009. Rent will commence upon completion of the project, but no later than August 2009. Once construction is completed, annual rent will be equal to 10.25% of the total cost of the replacement facility, including direct costs of construction, carrying costs during the construction period, furnishings and equipment, land cost and the value of the related skilled nursing facility license. The total cost of the replacement facility is expected to be approximately \$7.9 million. Under the terms of the lease amendments, costs incurred in excess of the current estimated cost of \$7.9 million would be borne by us. The lease amendments provide for renewal options with respect to the new facility through 2035.

The replacement facility will be subject to the requirements of our current master lease, with certain exceptions for capital spending requirements. At the fifth anniversary of rent commencement for the replacement facility, we may terminate the lease with respect to this facility. Beginning 18 months after the facility commences operations and continuing until the fifth anniversary of rent commencement, Omega may terminate the lease for this facility if the cash flow of the facility (as defined in the lease amendment) is less than 1.2 times the then existing rent. If we elect to continue the lease, annual rentals for this facility may be increased by an amount equal to one half of the amount of the cash flow of the facility (as defined in the lease amendment) in excess of 1.2 times the then existing rent, effective as of the start of the sixth year after the completion of the building. If at any time beginning 18 months after the completion of the building the average annual cash flow of the facility exceeds 1.3 times the then existing rent, the termination options of both Omega and the Company are eliminated, and the rent reset provisions described above are eliminated.

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

West Virginia Facility. We entered into an option agreement to purchase certain assets of a skilled nursing facility in West Virginia for \$850,000. We made an application to state regulatory authorities to allow us to operate the facility, and this application was approved in February 2008, subject to rights of appeal by contesting parties. The period for appeal terminated during 2008 and we expect to complete the acquisition of these assets and arrange financing for the construction of a new 90 bed replacement facility in 2009. The existing facility closed in February 2009, and will remain closed until the replacement facility is completed. No assurances can be given we will be able to complete the acquisition or arrange construction financing on suitable terms for this project.

### *Share Repurchase*

In November 2007, the Company's Board of Directors authorized the repurchase of up to \$2.5 million of our common stock pursuant to a plan under Rule 10b5-1 and in compliance with Rule 10b-18 of the Securities Exchange Act of 1934, as amended. As of November 1, 2007, there were approximately 5.9 million shares of common stock outstanding.

From the inception of the plan in November 2007 through April 2008, we purchased a total of 231,800 shares for \$2.5 million, the maximum amount authorized by our plan. Repurchases were made through open market or privately negotiated transactions in accordance with all applicable securities laws, rules, and regulations and were funded from available working capital.

### **Amendment to Shareholders' Rights Plan**

On August 1, 2008, the Company's Board amended our current Amended and Restated Rights Agreement (the "Rights Agreement"). The amendment provides for an increase of the exercise price of the rights under the Rights Agreement (the "Rights") to \$50 from \$15 and for the extension of the expiration date of the Rights to August 2, 2018. In addition, the amendment includes a share exchange feature that provides the Company's Board the option of exchanging, in whole or in part, each Right, other than those of the hostile acquiring holder, for one share of our common stock. This provision is intended to avoid requiring Rights holders to pay cash to exercise their Rights and to alleviate the uncertainty as to whether holders will exercise their Rights.

### **Facility Renovations**

During 2005, we began an initiative to complete strategic renovations of certain facilities to improve occupancy, quality of care and profitability. We developed a plan to begin with those facilities with the greatest potential for benefit, and began the renovation program during the third quarter of 2005. As of December 31, 2008, we have completed renovation projects at ten facilities. We expect to complete another renovation in the first quarter of 2009. We are developing plans for additional renovation projects.

A total of \$15.1 million has been spent on these renovation programs to date, with \$10.0 million financed through Omega, \$4.0 million financed with internally generated cash, and \$1.1 million financed with long-term debt. The amounts financed by Omega have resulted in increased rent and are not reflected as capital expenditures. The total renovation funding commitment from Omega was \$10.0 million, which we exhausted during the third quarter of 2008 with the two projects completed in the fourth quarter of 2008. We are funding the cost of the project currently in progress with working capital.

For the eight facilities with renovations completed before the beginning of the fourth quarter 2008 compared to the last twelve months prior to the commencement of renovation, average occupancy increased from 63.2% to 72.0% and Medicare average daily census increased from a total of 81 to 98 in the fourth quarter of 2008. No assurance can be given that these facilities will continue to show such occupancy or Medicare average daily census improvement or that the other renovated facilities will experience similar improvements.

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

### **Receivables**

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

Accounts receivable attributable to patient services of continuing operations totaled \$27.0 million at December 31, 2008, compared to \$27.9 million at December 31, 2007, representing approximately 34 and 37 days revenue in accounts receivable at each period end, respectively. As part of the procedural Medicare and Medicaid change of ownership process, payments from Medicaid and Medicare for the New Texas facilities were temporarily delayed, and \$4.7 million of the balance in receivables at December 31, 2007 was due to these delays. These amounts were collected prior to December 31, 2008. As of December 31, 2008, Texas Medicaid payments have been delayed due to changes in state processing related to a change in Texas Medicaid to a RUG based system, resulting in an increase in receivables of approximately \$1.0 million. Also, as of December 31, 2008, accounts receivable for Tennessee Medicaid increased approximately \$0.4 million as part of a phased in delay in the payment cycle that will take place from November 2008 to September 2009. Once fully implemented, this change will result in an additional increase in accounts receivable from Tennessee Medicaid of approximately \$0.6 million. Excluding effects of these payor delays and changes, our days revenue in accounts receivable are 33 and 32 days as of December 31, 2008 and 2007, respectively.

The allowance for bad debt was \$3.3 million at December 31, 2008, compared to \$2.2 million at December 31, 2007. We did not assume accounts receivables in connection with the New Texas Facilities, and the allowance for doubtful accounts related to these homes increased by approximately \$0.7 million during 2008. 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**

We do not believe that our operations have been materially affected by inflation for the three most recent years; however, in the second half of 2008, the cost of food and utilities at our nursing facilities increased at a higher than expected rate. We are unsure whether this rate of increase will continue in future periods. We expect salary and wage increases for our skilled staff to continue to be higher than average salary and wage increases, as is common in the health care industry.

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

We had letters of credit outstanding of approximately \$8.1 million as of December 31, 2008, which serves as a security deposit for our facility leases with Omega. The letters of credit were issued under our revolving credit facility. Our accounts receivable serve as the collateral for this revolving credit facility. During the year ended December 31, 2008, we incurred approximately \$0.2 million in fees related to these outstanding letters of credit.

### **Recent Accounting Pronouncements**

In May 2008, the FASB issued SFAS No. 162, "The Hierarchy of Generally Accepted Accounting Principles ("GAAP")" ("SFAS No. 162"). The purpose of the new standard is to provide a consistent framework for determining what accounting principles should be used when preparing U.S. GAAP financial statements. Previous guidance did not properly rank the accounting literature. The new standard was effective November 15, 2008. The adoption of SFAS No. 162 did not have a material effect on our financial statements.

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

In December 2007, the FASB issued SFAS No. 141 (revised 2007), "Business Combinations" ("SFAS No. 141R"). SFAS No. 141R establishes principles and requirements for how an acquirer recognizes and measures in its financial statements 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. SFAS No. 141R also establishes disclosure requirements to enable the evaluation of the nature and financial effects of the business combination. The provisions of SFAS No. 141R will be effective for us beginning January 1, 2009. During the fourth quarter of 2008, we expensed \$0.2 million in acquisition costs for the potential West Virginia transaction that was in process but not completed as of December 31, 2008. Under SFAS No. 141, these costs were considered part of the purchase price and as such were capitalized, but under SFAS No. 141R these costs are expensed as incurred.

In April 2008, the FASB issued FASB Staff Position ("FSP") SFAS No. 142-3, "Determination of the Useful Life of Intangible Assets" ("FSP No. 142-3"). FSP No. 142-3 amends the factors that should be considered in developing renewal or extension assumptions used to determine the useful life of a recognized intangible asset under SFAS No. 142, "Goodwill and Other Intangible Assets". The intent of this FSP is to improve the consistency between the useful life of a recognized intangible asset under SFAS No. 142 and the period of expected cash flows used to measure the fair value of the asset under FASB Statement No. 141R, and other GAAP. The FSP is effective for financial statements issued for fiscal years beginning after December 15, 2008, and interim periods within those fiscal years. Early adoption is prohibited. The guidance for determining the useful life of a recognized intangible asset is to be applied prospectively to intangible assets acquired after the effective date. The disclosure requirements are to be applied prospectively to all intangible assets recognized as of, and subsequent to, the effective date. We anticipate following the disclosure guidance in this FSP but adoption will not have an impact on our financial position or results of operation.

In September 2006, the FASB issued SFAS No. 157, "Fair Value Measurements" ("SFAS No. 157"). This new standard provides guidance for using fair value to measure assets and liabilities and establishes a fair value hierarchy that prioritizes the information used to develop the measurements. SFAS No. 157 applies whenever other standards require (or permit) assets or liabilities to be measured at fair value but does not expand the use of fair value in any new circumstances. The provisions of SFAS No. 157 were effective for us beginning January 1, 2008. The adoption of SFAS No. 157 did not have an impact on our financial position, results of operations or cash flows.

In February 2007, the FASB issued SFAS No. 159, "The Fair Value Option for Financial Assets and Financial Liabilities – including an Amendment of FASB Statement No. 115" ("SFAS No. 159"). The new standard permits entities to choose to measure many financial instruments and certain other items at fair value. Most provisions of SFAS No. 159 only impacted those entities that elect the fair value option or have investments accounted for under FASB Statement No. 115. The provisions of SFAS No. 159 were effective for us beginning January 1, 2008. The adoption of this new standard did not have an impact on our financial position.

### **Forward-Looking Statements**

The foregoing discussion and analysis provides information deemed by management to be relevant to an assessment and understanding of our consolidated results of operations and financial condition. This discussion and analysis should be read in conjunction with our consolidated financial statements included herein. Certain statements made by or on behalf of us, including those contained in this "Management's Discussion and Analysis of Financial Condition and Results of Operations" and elsewhere, are forward-looking statements as defined in the Private Securities Litigation Reform Act of 1995. Actual results could differ materially from those contemplated by the forward-looking statements made herein. In addition to any assumptions and other factors referred to specifically in connection with such statements, other factors, many of which are beyond our ability to control or predict, could cause our actual results to differ materially from the results expressed or implied in any forward-looking statements including, but not limited to, our ability to achieve the anticipated cost savings for the New Texas Facilities, our ability to successfully construct and operate the Paris, Texas replacement facility, our ability to increase census at our renovated facilities, changes in governmental reimbursement, government regulation and health care reforms, the increased cost of borrowing under our credit agreements, our ability to comply with covenants contained in those credit agreements, the outcome of professional liability lawsuits and claims, our ability to control ultimate professional liability costs, the accuracy of our estimate of our anticipated professional liability expense, the impact of future licensing surveys, the outcome of regulatory proceedings alleging violations of laws and regulations governing quality of care or violations of other laws and regulations applicable to our business, our ability to control

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

costs, changes to our valuation of deferred tax assets, changes in occupancy rates in our facilities, 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" in the Company's Annual Report on Form 10-K 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, 2008, we had outstanding borrowings of approximately \$32.4 million, all of which is subject to variable interest rates. In the event that interest rates were to change 1%, the impact on future pre-tax cash flows would be approximately \$0.3 million annually, representing the impact of increased or decreased interest expense on variable rate debt.

We have a note receivable denominated in Canadian dollars related to the sale of our Canadian operations. This note is currently recorded on our balance sheet at \$4.0 million US based on the outstanding balance of the note and the exchange rate as of December 31, 2008. The carrying value of the note in our financial statements will be increased or decreased each period based on fluctuations in the exchange rate between US and Canadian currencies, and the effect of such changes will be included as income or loss in our statement of operations in the period of change. In 2008 and 2007, we reported transaction (losses) gains of \$(1,005,000) and \$808,000, respectively, as a result of the effect of changes in the currency exchange rate on this note. A further change of 1% in the exchange rate between US and Canadian currencies would result in a corresponding increase or decrease to earnings of approximately \$40,000.

We are 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). We assessed the effectiveness of our internal control over financial reporting as of December 31, 2008. In making this assessment, our management used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission ("COSO") in Internal Control-Integrated Framework. We have concluded that, as of December 31, 2008, our internal control over financial reporting is effective based on these criteria. Our independent registered public accounting firm, BDO Seidman, LLP, has issued an unqualified audit report on our financial statements included in this annual report as well as an unqualified opinion on the effectiveness of our internal control over financial reporting as of December 31, 2008 which is included herein.

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

### 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, 2008 that has materially affected, or is reasonably likely to materially affect our internal control over financial reporting.

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



## REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

Board of Directors and Shareholders  
Advocat Inc.  
Brentwood, Tennessee

We have audited Advocat Inc.'s (the "Company") internal control over financial reporting as of December 31, 2008, based on criteria established in *Internal Control-Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (the "COSO criteria"). The Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Management's Report on Internal Control over Financial Reporting. Our responsibility is to express an opinion on the Company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audit also included performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, Advocat Inc. maintained, in all material respects, effective internal control over financial reporting as of December 31, 2008 based on the COSO criteria.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of the Company as of December 31, 2008 and 2007 and the related consolidated statements of income, shareholders' equity (deficit), and cash flows for each of the three years in the period ended December 31, 2008 and our report dated March 9, 2009 expressed an unqualified opinion thereon.

*BDO Seidman, LLP*

Nashville, Tennessee  
March 9, 2009

## REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

Board of Directors and Shareholders  
Advocat Inc.  
Brentwood, Tennessee

We have audited the accompanying consolidated balance sheets of Advocat Inc. as of December 31, 2008 and 2007 and the related consolidated statements of income, shareholders' equity (deficit), and cash flows for each of the three years in the period ended December 31, 2008. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the financial statements. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Advocat Inc. at December 31, 2008 and 2007, and the results of its operations and its cash flows for each of the three years in the period ended December 31, 2008, in conformity with accounting principles generally accepted in the United States of America.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), Advocat Inc.'s internal control over financial reporting as of December 31, 2008, based on criteria established in *Internal Control — Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) and our report dated March 9, 2009 expressed an unqualified opinion thereon.

BDO Seidman, LLP

Nashville, Tennessee  
March 9, 2009

**ADVOCAT INC. AND SUBSIDIARIES**  
**CONSOLIDATED BALANCE SHEETS**  
**DECEMBER 31, 2008 AND 2007**

	2008	2007	2008	2007
<b>ASSETS</b>				
<b>CURRENT ASSETS:</b>				
Cash and cash equivalents	\$ 7,598,000	\$ 11,658,000		
Receivables, less allowance for doubtful accounts of \$3,279,000 and \$2,158,000, respectively	23,731,000	26,444,000		
Current portion of note receivable	466,000	629,000		
Prepaid expenses and other current assets	1,748,000	2,130,000		
Insurance refunds receivable	-	1,234,000		
Income tax refundable	1,369,000	-		
Deferred income taxes	3,967,000	2,110,000		
Total current assets	38,879,000	44,205,000		
<b>PROPERTY AND EQUIPMENT, at cost</b>				
Less accumulated depreciation	73,517,000	64,294,000		
Discontinued operations, net	(38,555,000)	(34,091,000)		
Property and equipment, net	1,455,000	1,455,000		
	36,417,000	31,658,000		
<b>OTHER ASSETS:</b>				
Deferred income taxes	13,899,000	16,568,000		
Note receivable, net of current portion	3,486,000	4,983,000		
Deferred financing and other costs, net	1,009,000	1,239,000		
Other assets	2,031,000	1,945,000		
Acquired leasehold interest, net	10,149,000	9,492,000		
Total other assets	30,574,000	34,227,000		
	\$ 105,870,000	\$ 110,090,000		
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>				
<b>CURRENT LIABILITIES:</b>				
Current portion of long-term debt	\$ 2,238,000	\$ 1,942,000		
Trade accounts payable	4,828,000	6,636,000		
Accrued expenses:				
Payroll and employee benefits	9,545,000	11,360,000		
Current portion of self-insurance reserves	6,469,000	4,597,000		
Other current liabilities	4,914,000	3,993,000		
Total current liabilities	27,994,000	28,528,000		
<b>NONCURRENT LIABILITIES:</b>				
Long-term debt, less current portion	30,172,000	32,513,000		
Self-insurance reserves, less current portion	10,212,000	17,578,000		
Other noncurrent liabilities	12,050,000	9,137,000		
Total noncurrent liabilities	52,434,000	59,228,000		
<b>COMMITMENTS AND CONTINGENCIES</b>				
<b>SERIES C REDEEMABLE PREFERRED STOCK, \$ .10 par value, 5,000 shares</b>				
authorized, issued and outstanding, including premium of \$2,973,000 and \$4,672,000 at December 31, 2008 and 2007, respectively	7,891,000	9,590,000		
<b>SHAREHOLDERS' EQUITY:</b>				
Series A preferred stock, authorized 200,000 shares, \$.10 par value, none issued and outstanding	-	-		
Common stock, authorized 20,000,000 shares, \$.01 par value, 5,903,000 and 5,878,000 shares issued, 5,671,000 and 5,804,000 shares outstanding, respectively	59,000	59,000		
Treasury stock at cost, 232,000 and 74,000 shares of common stock at December 31, 2008 and 2007, respectively	(2,500,000)	(817,000)		
Paid-in capital	16,903,000	15,804,000		
Retained earnings (accumulated deficit)	3,089,000	(2,302,000)		
Total shareholders' equity	17,551,000	12,744,000		
	\$ 105,870,000	\$ 110,090,000		

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

**ADVOCAT INC. AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF INCOME**

	Year Ended December 31,		
	2008	2007	2006
<b>REVENUES:</b>			
Patient revenues, net	\$ 288,797,000	\$ 245,061,000	\$ 214,653,000
<b>EXPENSES:</b>			
Operating	228,236,000	187,463,000	163,386,000
Lease	22,962,000	20,019,000	16,082,000
Professional liability	1,658,000	(1,663,000)	(5,354,000)
General and administrative	18,486,000	17,552,000	21,032,000
Depreciation and amortization	5,306,000	4,093,000	3,614,000
	<b>276,648,000</b>	<b>227,464,000</b>	<b>198,760,000</b>
<b>OPERATING INCOME</b>	<b>12,149,000</b>	<b>17,597,000</b>	<b>15,893,000</b>
<b>OTHER INCOME (EXPENSE):</b>			
Foreign currency transaction gain (loss)	(1,005,000)	808,000	21,000
Other income	—	—	207,000
Interest income	454,000	1,016,000	679,000
Interest expense	(2,870,000)	(3,549,000)	(3,707,000)
Debt retirement costs	—	(116,000)	(194,000)
	<b>(3,421,000)</b>	<b>(1,841,000)</b>	<b>(2,994,000)</b>
<b>INCOME FROM CONTINUING OPERATIONS</b>			
BEFORE INCOME TAXES	<b>8,728,000</b>	<b>15,756,000</b>	<b>12,899,000</b>
PROVISION (BENEFIT) FOR INCOME TAXES	<b>2,958,000</b>	<b>6,270,000</b>	<b>(9,496,000)</b>
<b>NET INCOME FROM CONTINUING OPERATIONS</b>	<b>5,770,000</b>	<b>9,486,000</b>	<b>22,395,000</b>
<b>NET INCOME FROM DISCONTINUED OPERATIONS:</b>			
Operating loss, net of tax provision (benefit) of \$(18,000), \$(59,000) and \$0, respectively	(35,000)	(91,000)	(337,000)
Loss on sale, net of tax provision (benefit) of \$0, \$(6,000) and \$0, respectively	0	(8,000)	(114,000)
<b>DISCONTINUED OPERATIONS</b>	<b>(35,000)</b>	<b>(99,000)</b>	<b>(451,000)</b>
<b>NET INCOME</b>	<b>5,735,000</b>	<b>9,387,000</b>	<b>21,944,000</b>
<b>PREFERRED STOCK DIVIDENDS</b>	<b>344,000</b>	<b>344,000</b>	<b>340,000</b>
<b>NET INCOME FOR COMMON STOCK</b>	<b>\$ 5,391,000</b>	<b>\$ 9,043,000</b>	<b>\$ 21,604,000</b>
<b>NET INCOME PER COMMON SHARE:</b>			
<b>Per common share – basic</b>			
Continuing operations	\$ 0.95	\$ 1.56	\$ 3.81
Discontinued operations	—	(0.02)	(0.07)
	<b>\$ 0.95</b>	<b>\$ 1.54</b>	<b>\$ 3.74</b>
<b>Per common share – diluted</b>			
Continuing operations	\$ 0.92	\$ 1.49	\$ 3.42
Discontinued operations	—	(0.01)	(0.07)
	<b>\$ 0.92</b>	<b>\$ 1.48</b>	<b>\$ 3.35</b>
<b>WEIGHTED AVERAGE COMMON SHARES:</b>			
Basic	<b>5,693,000</b>	<b>5,870,000</b>	<b>5,784,000</b>
Diluted	<b>5,887,000</b>	<b>6,127,000</b>	<b>6,507,000</b>

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

**ADVOCAT INC. AND SUBSIDIARIES**

**CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY (DEFICIT)**

	Common Stock		Treasury Stock		Paid-in Capital	Retained Earnings (Accumulated Deficit)	Total
	Shares Issued	Amount	Shares	Amount			
<b>BALANCE, DECEMBER 31, 2005</b>	5,725,000	\$ 57,000	—	\$ —	\$ 16,022,000	\$ (32,949,000)	\$ (16,870,000)
Exercise of stock options	141,000	2,000	—	—	556,000	—	558,000
Net Income	—	—	—	—	—	21,944,000	21,944,000
Preferred stock dividends	—	—	—	—	—	(340,000)	(340,000)
Elimination of preferred stock conversion feature	—	—	—	—	(6,700,000)	—	(6,700,000)
Tax impact of stock options exercised	—	—	—	—	61,000	—	61,000
Stock based compensation	—	—	—	—	5,184,000	—	5,184,000
<b>BALANCE, DECEMBER 31, 2006</b>	<u>5,866,000</u>	<u>59,000</u>	<u>—</u>	<u>—</u>	<u>15,123,000</u>	<u>(11,345,000)</u>	<u>3,837,000</u>
Exercise of stock options	12,000	—	—	—	65,000	—	65,000
Net Income	—	—	—	—	—	9,387,000	9,387,000
Preferred stock dividends	—	—	—	—	—	(344,000)	(344,000)
Repurchase of common stock	—	—	74,000	(817,000)	—	—	(817,000)
Tax impact of stock options exercised	—	—	—	—	(32,000)	—	(32,000)
Stock based compensation	—	—	—	—	648,000	—	648,000
<b>BALANCE, DECEMBER 31, 2007</b>	<u>5,878,000</u>	<u>59,000</u>	<u>74,000</u>	<u>(817,000)</u>	<u>15,804,000</u>	<u>(2,302,000)</u>	<u>12,744,000</u>
Exercise of stock options	25,000	—	—	—	235,000	—	235,000
Net Income	—	—	—	—	—	5,735,000	5,735,000
Preferred stock dividends	—	—	—	—	—	(344,000)	(344,000)
Repurchase of common stock	—	—	158,000	(1,683,000)	—	—	(1,683,000)
Tax impact of stock options exercised	—	—	—	—	(3,000)	—	(3,000)
Stock based compensation	—	—	—	—	867,000	—	867,000
<b>BALANCE, DECEMBER 31, 2008</b>	<u>5,903,000</u>	<u>\$ 59,000</u>	<u>232,000</u>	<u>\$ (2,500,000)</u>	<u>\$ 16,903,000</u>	<u>\$ 3,089,000</u>	<u>\$ 17,551,000</u>

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

**ADVOCAT INC. AND SUBSIDIARIES**

**CONSOLIDATED STATEMENTS OF CASH FLOWS**

	<b>Year Ended December 31,</b>		
	<b>2008</b>	2007	2006
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>			
Net income	\$ 5,735,000	\$ 9,387,000	\$ 21,944,000
Discontinued operations	<b>(35,000)</b>	(99,000)	(451,000)
Net income from continuing operations	<b>5,770,000</b>	9,486,000	22,395,000
Adjustments to reconcile net income from continuing operations to net cash provided by operating activities:			
Depreciation and amortization	<b>5,306,000</b>	4,093,000	3,614,000
Provision for doubtful accounts	<b>2,343,000</b>	1,089,000	1,610,000
Deferred income tax provision (benefit)	<b>830,000</b>	5,137,000	(9,719,000)
Provision for (benefit from) self-insured professional liability, net of cash payments	<b>(5,717,000)</b>	(5,054,000)	(9,323,000)
Stock-based compensation	<b>867,000</b>	648,000	5,184,000
Amortization of deferred balances	<b>426,000</b>	334,000	289,000
Provision for leases in excess of cash payments	<b>1,711,000</b>	2,234,000	606,000
Gain on sale of bed license	—	—	(207,000)
Foreign currency transaction (gain) loss	<b>1,005,000</b>	(808,000)	(21,000)
Debt retirement costs	—	116,000	194,000
Non-cash interest income	<b>(121,000)</b>	(132,000)	(270,000)
Non-cash interest expense	—	—	86,000
Changes in other assets and liabilities affecting operating activities:			
Receivables, net	<b>381,000</b>	(10,633,000)	(393,000)
Prepaid expenses and other assets	<b>210,000</b>	2,781,000	928,000
Trade accounts payable and accrued expenses	<b>(3,498,000)</b>	3,374,000	425,000
Net cash provided by continuing operations	<b>9,513,000</b>	12,665,000	15,398,000
Discontinued operations	<b>(35,000)</b>	22,000	265,000
Net cash provided by operating activities	<b>9,478,000</b>	12,687,000	15,663,000

(Continued)

**ADVOCAT INC. AND SUBSIDIARIES**

**CONSOLIDATED STATEMENTS OF CASH FLOWS**

(Continued)

	<b>Year Ended December 31,</b>		
	<b>2008</b>	<b>2007</b>	<b>2006</b>
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>			
Purchases of property and equipment	\$ (9,703,000)	\$ (6,827,000)	\$ (4,089,000)
Acquisition of leasehold interest	—	(9,096,000)	—
Proceeds from sale of discontinued operations and bed license	—	180,000	10,439,000
Decrease in restricted cash deposits	—	246,000	212,000
Decrease (increase) in cash restricted for capital expenditures	—	864,000	(864,000)
Note receivable issued	—	(1,800,000)	—
Notes receivable collected	765,000	2,500,000	718,000
Deposits and other deferred balances	(138,000)	(120,000)	(422,000)
Net cash provided (used) by continuing operations	(9,076,000)	(14,053,000)	5,994,000
Discontinued operations	(49,000)	—	(28,000)
Net cash provided (used) in investing activities	(9,125,000)	(14,053,000)	5,966,000
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>			
Repayment of debt obligations	(2,045,000)	(13,437,000)	(46,601,000)
Proceeds from issuance of debt	—	16,500,000	30,625,000
Financing costs	(79,000)	(839,000)	(765,000)
Payment of preferred stock dividends	(344,000)	(344,000)	(172,000)
Repurchases of common stock	(1,683,000)	(817,000)	—
Payment for preferred stock restructuring	(497,000)	(448,000)	—
Proceeds from exercise of stock options	235,000	65,000	558,000
Net cash provided (used) in financing activities	(4,413,000)	680,000	(16,355,000)
<b>NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS</b>	<b>(4,060,000)</b>	<b>(686,000)</b>	<b>5,274,000</b>
<b>CASH AND CASH EQUIVALENTS, beginning of period</b>	<b>11,658,000</b>	<b>12,344,000</b>	<b>7,070,000</b>
<b>CASH AND CASH EQUIVALENTS, end of period</b>	<b>\$ 7,598,000</b>	<b>\$ 11,658,000</b>	<b>\$ 12,344,000</b>
<b>SUPPLEMENTAL INFORMATION:</b>			
Cash payments of interest, net of amounts capitalized	\$ 2,506,000	\$ 3,303,000	\$ 3,425,000
Cash payments of income taxes, net of refunds	\$ 3,841,000	\$ 1,658,000	\$ 378,000

**NON-CASH INVESTING AND FINANCING ACTIVITIES:**

During 2006, the Company accrued, but did not pay, preferred stock dividends of \$168,000. Following the preferred stock restructuring in October 2006, the Company began paying preferred stock dividends as shown above.

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

**ADVOCAT INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**DECEMBER 31, 2008, 2007 AND 2006**

**1. COMPANY AND ORGANIZATION**

Advocat Inc. (together with its subsidiaries, "Advocat" or the "Company") provides long-term care services to nursing center patients in eight states, primarily in the Southeast and Southwest. The Company's 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, the Company offers a variety of comprehensive rehabilitation services as well as nutritional support services.

As of December 31, 2008, the Company's continuing operations consist of 50 nursing centers with 5,773 licensed nursing beds and 14 assisted living units. The Company's continuing operations include nine owned nursing centers and 41 leased nursing centers. The Company's continuing operations include centers in Alabama, Arkansas, Florida, Kentucky, Ohio, Tennessee, Texas and West Virginia.

**2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

**Consolidation**

The consolidated financial statements include the operations and accounts of Advocat and its subsidiaries, all wholly-owned. All significant intercompany accounts and transactions have been eliminated in consolidation. The Company's net income on the Consolidated Statements of Income equals Other Comprehensive Income.

The Company is managed as one reporting unit for internal purposes and for decision making. Therefore, management has concluded that the Company is operated as a single reportable segment, as defined in The Financial Accounting Standards Board's ("FASB") Statement of Financial Accounting Standards ("SFAS") No. 131, "Disclosures about Segments of an Enterprise and Related Information."

**Revenues**

***Patient Revenues***

The fees charged by the Company to patients in its nursing centers are recorded on an accrual basis. These rates are contractually adjusted with respect to individuals receiving benefits under federal and state-funded programs and other third-party payors. Rates under federal and state-funded programs are determined prospectively for each facility and may be based on the acuity of the care and services provided. These rates may be based on facility's actual costs subject to program ceilings and other limitations or on established rates based on acuity and services provided as determined by the federal and state-funded programs. Amounts earned under federal and state programs with respect to nursing home patients are subject to review by the third-party payors which may result in retroactive adjustments. In the opinion of management, adequate provision has been made for any adjustments that may result from such reviews. Retroactive adjustments, if any, are recorded when objectively determinable, generally within three years of the close of a reimbursement year depending upon the timing of appeals and third-party settlement reviews or audits. During the years ended December 31, 2008, 2007 and 2006, the Company recorded \$30,000, \$(2,000) and \$(59,000) of net favorable (unfavorable) estimated settlements from federal and state programs for periods prior to the beginning of fiscal 2008, 2007 and 2006, respectively.



**ADVOCAT INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**DECEMBER 31, 2008, 2007 AND 2006**

***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 income in the period identified.

The Company includes the provision for doubtful accounts in operating expenses in its consolidated statements of income. The provisions for doubtful accounts of continuing operations were \$2,343,000, \$1,089,000 and \$1,610,000 for 2008, 2007 and 2006, respectively.

**Lease Expense**

As of December 31, 2008, the Company operates 41 nursing centers under operating leases, including 40 owned or financed by Omega Healthcare Investors, Inc. (together with its subsidiaries, "Omega") and one owned by another party. The Company's operating leases generally require the Company to pay stated rent, subject to increases based on changes in the Consumer Price Index, a minimum percentage increase, or increases in the net revenues of the leased properties. The Company's Omega leases require the Company to pay certain scheduled rent increases. Such scheduled rent increases are recorded as additional lease expense on a straight-line basis recognized over the term of the related leases.

See Notes 3, 7 and 12 for a discussion regarding the amendment of the Company's master lease with Omega in 2007 and 2006, the termination of leases for certain facilities and the addition of certain leased facilities.

**Classification of Expenses**

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

**Property and Equipment**

Property and equipment are recorded at cost with depreciation 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 is capitalized as part of the building cost. Maintenance and repairs are expensed as incurred, and major betterments and improvements are capitalized. Property and equipment obtained through purchase acquisitions are stated at their estimated fair value determined on the respective dates of acquisition.

**ADVOCAT INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**DECEMBER 31, 2008, 2007 AND 2006**

In accordance with SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets," the Company evaluates the recoverability of the carrying values of its properties and other long-lived assets on a property by property basis. On a quarterly basis, the Company reviews its properties for recoverability when events or circumstances, including significant physical changes in the property, significant adverse changes in general economic conditions, and significant deteriorations of the underlying cash flows or fair values of the property, indicate that the carrying amount of the property may not be recoverable. The need to recognize an impairment is based on estimated future undiscounted cash flows from a property compared to the carrying value of that property. If recognition of an impairment is necessary, it is measured as the amount by which the carrying amount of the property exceeds the fair value of the property.

**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.

**Deferred Financing and Other Costs**

The Company records deferred financing and lease costs for 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 income. Deferred lease costs are amortized on a straight-line basis over the term of the related leases. See Note 6 for further discussion.

**Acquired Leasehold Interest**

The Company has recorded an acquired leasehold interest intangible asset related to the acquisition further described in Note 3. The intangible asset is accounted for in accordance with SFAS No. 142, "Goodwill and Other Intangible Assets," and is amortized on a straight-line basis over the remaining life of the acquired lease. The Company evaluates the recoverability of the carrying value of the acquired leasehold intangible on at least an annual basis in accordance with SFAS No. 144, "Accounting for the Impairment or Disposal of Long-lived Assets."

**Self Insurance**

Self insurance reserves primarily represent the accrual for self insured risks associated with general and professional liability claims, employee health insurance and workers' compensation. The Company's health insurance reserve 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 reserve relates primarily to periods of self insurance prior to May 1997 and consists of an estimate of the future costs to be incurred for the known claims.

The Company retains the Actuarial Division of Willis of Tennessee, Inc. ("Willis"), a third-party actuarial firm, to estimate the appropriate accrual for incurred general and professional liability claims. The actuary primarily uses historical data regarding the frequency and cost of the Company's claims over a multi-year period and information regarding the Company's number of occupied beds to develop estimates of the Company's ultimate professional liability cost for current periods. The actuary estimates the Company's professional liability accrual for past periods by using currently-known information to adjust the initial reserve that was created for that period. All losses are projected on an undiscounted basis. The self insurance reserves 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.

**ADVOCAT INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**DECEMBER 31, 2008, 2007 AND 2006**

Another key assumption is the limit of claims to a maximum of \$4.5 million. The actuary has selected this limit based on the Company's historical data. While most of the Company's claims have been for amounts less than the \$4.5 million, there have been claims at higher amounts, and there may be claims above this level in the future. 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. To date, the Company has not experienced an uninsured loss in excess of this limit. In the event that the Company believes it has incurred a loss in excess of this limit, an adjustment to the reserves determined by the actuary would be necessary.

Although the Company retains Willis to assist management in estimating the appropriate accrual for these claims, professional liability claims are inherently uncertain, and the liability associated with anticipated claims is very difficult to estimate. 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 quarter. 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. A significant judgment entered against the Company in one or more legal actions could have a material adverse impact on the Company's financial position and cash flows.

#### **Income Taxes**

The Company utilizes SFAS No. 109, "Accounting for Income Taxes," which requires an asset and liability approach for financial accounting and reporting of income taxes. Under this method, deferred tax assets and liabilities are determined based upon differences between financial reporting and tax bases of assets and liabilities and are measured using the enacted tax laws that will be in effect when the differences are expected to reverse. The Company assesses the need for a valuation allowance to reduce the deferred tax assets by the amount that is believed is more likely than not to not be utilized through the turnaround of existing temporary differences, future earnings, or a combination thereof, including certain net operating loss carryforwards we do not expect to realize due to change in ownership limitations. Effective January 1, 2007, the Company adopted the provisions of FASB Interpretation No. 48, "Accounting for Uncertainty in Income Taxes – An Interpretation of FASB Statement No. 109". This interpretation provides guidance on financial statement recognition and measurement of tax positions taken, or expected to be taken, in tax returns. The initial adoption of the interpretation had no impact on the Company's financial statements. See Note 11 for additional information related to the provision for income taxes.

#### **Disclosure of Fair Value of Financial Instruments**

In September 2006, the FASB issued SFAS No. 157, "Fair Value Measurements" ("SFAS No. 157"). This new standard provides guidance for using fair value to measure assets and liabilities and establishes a fair value hierarchy that prioritizes the information used to develop the measurements. SFAS No. 157 applies whenever other standards require (or permit) assets or liabilities to be measured at fair value but does not expand the use of fair value in any new circumstances. The Company adopted the provisions of SFAS No. 157 beginning January 1, 2008. The adoption of SFAS No. 157 did not have an impact on the Company's financial position, results of operations or cash flows as the Company does not record any of its assets or liabilities using fair value accounting as of December 31, 2008.

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 carrying amount of the Company's debt approximates fair value because the interest rates approximate the current rates available to the Company and its individual facilities. The Company's self-insurance reserves are reported on an undiscounted basis as the timing of estimated settlements cannot be determined.

**ADVOCAT INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**DECEMBER 31, 2008, 2007 AND 2006**

**Use of Estimates**

The preparation of 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 financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

**Net Income per Common Share**

The Company utilizes SFAS No. 128, "Earnings Per Share," for the financial reporting of net income per common share. Basic earnings per common share excludes dilution and is computed by dividing income available to common shareholders by the weighted-average number of common 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.

**Stock-Based Compensation**

The Company follows SFAS No. 123 (revised 2004), "Share-Based Payment," using the modified prospective method, in which compensation cost is recognized (a) for all share-based payments granted after the effective date and (b) based on the requirements of SFAS No. 123 for all awards granted to employees prior to the effective date of SFAS No. 123R that remain unvested on the effective date. The Company had no unvested awards granted to employees on the effective date.

The Company recorded non-cash stock-based compensation expense for equity grants issued under the 2005 Plan of \$867,000, \$648,000 and \$5,184,000 during the years ended December 31, 2008, 2007 and 2006, 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. Of these amounts, non-cash stock-based compensation expense of \$61,000, \$22,000 and \$127,000 was recorded as a component of operating expense in 2008, 2007 and 2006, respectively. Non-cash stock-based compensation expense of \$806,000, \$626,000 and \$5,057,000 was recorded as a component of general and administrative expense in 2008, 2007 and 2006, respectively. See Note 9 for additional disclosures about the Company's stock-based compensation plans.

**Recent Accounting Pronouncements**

In May 2008, the FASB issued SFAS No. 162, "The Hierarchy of Generally Accepted Accounting Principles ("GAAP")" ("SFAS No. 162"). The purpose of the new standard is to provide a consistent framework for determining what accounting principles should be used when preparing U.S. GAAP financial statements. Previous guidance did not properly rank the accounting literature. The new standard was effective November 15, 2008. The adoption of SFAS No. 162 did not have a material effect on the Company's financial statements.

In December 2007, the FASB issued SFAS No. 141 (revised 2007), "Business Combinations" ("SFAS No. 141R"). SFAS No. 141R establishes principles and requirements for how an acquirer recognizes and measures in its financial statements 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. SFAS No. 141R also establishes disclosure requirements to enable the evaluation of the nature and financial effects of the business combination. The provisions of SFAS No. 141R will be effective for the Company beginning January 1, 2009. During the fourth quarter of 2008, the Company expensed \$202,000 in acquisition costs for a potential acquisition that is expected to be completed in the first quarter of 2009, as described in Note 3. Under SFAS No. 141, these costs were considered part of the purchase price and as such were capitalized, but under SFAS No. 141R these costs are expensed as incurred.

**ADVOCAT INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**DECEMBER 31, 2008, 2007 AND 2006**

In April 2008, the FASB issued FASB Staff Position (“FSP”) SFAS No. 142-3, “Determination of the Useful Life of Intangible Assets” (“FSP No. 142-3”). FSP No. 142-3 amends the factors that should be considered in developing renewal or extension assumptions used to determine the useful life of a recognized intangible asset under SFAS No. 142, “Goodwill and Other Intangible Assets”. The intent of this FSP is to improve the consistency between the useful life of a recognized intangible asset under SFAS No. 142 and the period of expected cash flows used to measure the fair value of the asset under FASB Statement No. 141R, and other GAAP. The FSP is effective for financial statements issued for fiscal years beginning after December 15, 2008, and interim periods within those fiscal years. Early adoption is prohibited. The guidance for determining the useful life of a recognized intangible asset is to be applied prospectively to intangible assets acquired after the effective date. The disclosure requirements are to be applied prospectively to all intangible assets recognized as of, and subsequent to, the effective date. The Company anticipates following the disclosure guidance in this FSP but adoption will not have an impact on its financial position or results of operation.

In September 2006, the FASB issued SFAS No. 157, “Fair Value Measurements” (“SFAS No. 157”). This new standard provides guidance for using fair value to measure assets and liabilities and establishes a fair value hierarchy that prioritizes the information used to develop the measurements. SFAS No. 157 applies whenever other standards require (or permit) assets or liabilities to be measured at fair value but does not expand the use of fair value in any new circumstances. The provisions of SFAS No. 157 were effective for the Company beginning January 1, 2008. The adoption of SFAS No. 157 did not have an impact on the Company’s financial position, results of operations or cash flows.

In February 2007, the FASB issued SFAS No. 159, “The Fair Value Option for Financial Assets and Financial Liabilities – including an Amendment of FASB Statement No. 115” (“SFAS No. 159”). The new standard permits entities to choose to measure many financial instruments and certain other items at fair value. Most provisions of SFAS No. 159 only impacted those entities that elect the fair value option or have investments accounted for under FASB Statement No. 115. The provisions of SFAS No. 159 were effective for the Company beginning January 1, 2008. The adoption of this new standard did not have an impact on the Company’s financial position.

### **3. ACQUISITIONS**

Effective August 11, 2007, the Company purchased the leasehold interests and operations of seven skilled nursing facilities from SMSA for an initial purchase price of approximately \$9,957,000, including approximately \$8,570,000 in cash, the assumption of approximately \$862,000 in liabilities, and transaction costs of \$525,000. These facilities include 1,266 licensed nursing beds, with 1,105 nursing beds available for use at the date of the acquisition. The SMSA facilities had unaudited revenues of approximately \$52.1 million for the year ended December 31, 2006. The SMSA facilities are in the Company’s existing geographic and operational footprint and are expected to contribute to the Company’s growth strategy and existing base of operations.

The facilities were part of a larger organization that had been in bankruptcy since January 2007. Under the terms of the purchase agreement, the Company acquired the leases and leasehold interests in the facilities, inventory and certain equipment, but did not acquire working capital or assume liabilities, apart from certain obligations for employee paid-time-off benefits, specified lease related obligations and 2007 property taxes.

The facilities are leased from a subsidiary of Omega Healthcare Investors, Inc. (“Omega”). Prior to the SMSA Acquisition, the Company leased 28 facilities from Omega under a master lease agreement (the “Master Lease”). In connection with this acquisition, the Company amended the Master Lease to include the seven SMSA facilities. The substantive terms of the SMSA lease, including payment provisions and lease period including renewal options, were not changed by this amendment. The lease terms for the seven SMSA facilities provide for an initial term and renewal periods at the Company’s option through May 31, 2035. The lease provides for annual increases in lease payments equal to the increase in the consumer price index, not to exceed 2.5%.

**ADVOCAT INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**DECEMBER 31, 2008, 2007 AND 2006**

The SMSA Acquisition is accounted for using the purchase method of accounting. The purchase price of this transaction was allocated to the identifiable assets acquired based upon their respective fair values, and the liabilities assumed are based on the expected or paid settlement amounts. The purchase price allocation was subject to change during the twelve month period subsequent to the acquisition date for items including actual settlement of the assumed liabilities and is now final. The operating results have been included in the Company's consolidated financial statements since the date of the acquisition.

In May 2008, the Company received notification of payments due to the Centers for Medicare and Medicaid Services ("CMS") related to Medicare reimbursement for 1997 and earlier periods for one of the acquired facilities. The total amount of the payments requested by CMS as of December 31, 2008 was approximately \$1,180,000, including accrued interest of approximately \$668,000. The Company intends to seek relief for this assessment from CMS, and is seeking to have the assessment declared to be the responsibility of previous owners of the facility in litigation pending in the United States Bankruptcy Court for the Northern District of Texas, which is the court in which SMSA's bankruptcy case was filed. In the second quarter of 2008, the Company recorded a liability of \$1,022,000 for its estimate of its ultimate liability for this assessment and defense costs, resulting in an increase in the acquired leasehold interest intangible asset. The Company's estimate of the liability takes into consideration the facts and circumstances, including the number of operators of the property in the intervening period since the original assessment and delays by CMS in seeking collection.

The following table summarizes the final purchase price allocation of the net assets acquired, including the adjustment described above:

Current assets	\$ 70,000
Property and equipment	145,000
Deferred tax asset	116,000
Acquired leasehold interest intangible	<u>10,653,000</u>
Total assets acquired	10,984,000
Current liabilities	<u>1,889,000</u>
Total net assets acquired	\$ <u>9,095,000</u>

The purchase price allocation resulted in an acquired leasehold interest intangible asset of approximately \$10,653,000. The intangible asset is subject to full amortization over the remaining life of the lease, including renewal periods, a period of approximately 28 years. Amortization expense of approximately \$367,000 and \$137,000 related to this intangible asset was recorded during the years ended December 31, 2008 and 2007, respectively.

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

2009	\$ 384,000
2010	384,000
2011	384,000
2012	384,000
2013	384,000
thereafter	<u>8,229,000</u>
	\$ <u>10,149,000</u>

In connection with the SMSA Acquisition, the Company incurred expenses of \$347,000 for post acquisition integration costs during 2007, including \$201,000 for travel and other out-of-pocket expenses related to integration activities and \$146,000 in severance and relocation costs resulting from the Texas regional office restructuring necessitated by the acquisition. Such expenses are classified as a component of general and administrative expense in the 2007 consolidated statement of income.

The SMSA Acquisition was financed with proceeds of a new loan, as discussed in Note 6.

**ADVOCAT INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**DECEMBER 31, 2008, 2007 AND 2006**

*West Virginia Facility*

In 2006, the Company entered into an option agreement to purchase certain assets of a skilled nursing facility in West Virginia for \$850,000. The Company made an application to state regulatory authorities to allow it to operate the facility, and this application was approved in February 2008, subject to rights of appeal by contesting parties. The period for appeal terminated during 2008, and the Company expects to complete the acquisition of these assets and arrange financing for the construction of a new 90 bed replacement facility in 2009. The existing facility closed in February 2009, and will remain closed until the replacement facility is completed.

Due to delays in the regulatory approval process as well as declining census in the existing facility, the Company advanced the \$850,000 purchase price and an additional \$196,000 to the owners of the existing facility during 2008 to assist with the working capital needs of the facility. The purchase price of \$850,000 is included in other noncurrent assets in the Company's Consolidated Balance Sheet and amounts advanced in excess of the purchase price have been charged to operating expenses. The Company expects to advance an additional \$231,000 to the owners of the existing facility during 2009.

The Company incurred acquisition costs of \$202,000 during 2008 related to this transaction. Had this transaction closed during 2008, these amounts would have been considered part of the purchase price in accordance with SFAS No. 141. However, such costs are not permitted to be capitalized under SFAS No. 141R, adopted by the Company on January 1, 2009, and, accordingly, were charged to expense in the fourth quarter of 2008.

**4. RECEIVABLES**

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

	<b>December 31,</b>	
	<b>2008</b>	2007
Medicare	<b>\$ 10,440,000</b>	\$ 13,891,000
Medicaid and other non-federal government programs	<b>10,187,000</b>	9,594,000
Other patient and resident receivables	<b>6,368,000</b>	4,417,000
Other receivables and advances	<b>15,000</b>	700,000
	<b>\$ 27,010,000</b>	\$ 28,602,000

The SMSA Acquisition resulted in an increase in accounts receivable of approximately \$8,784,000 at December 31, 2007. As part of the procedural Medicare and Medicaid change of ownership process, payments from Medicaid and Medicare for these facilities were temporarily delayed, and \$4,700,000 of the total \$8,784,000 increase in receivables was due to these delays. These payments from Medicare and Medicaid were collected during 2008.

As of December 31, 2008, Texas Medicaid payments have been delayed due to changes in state processing related to a change in Texas Medicaid to a RUG based system, resulting in an increase in receivables of approximately \$1.0 million. Also, as of December 31, 2008, accounts receivable for Tennessee Medicaid increased approximately \$400,000 as part of a phased in delay in the payment cycle that will take place from November 2008 to September 2009.

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 provided as collateral on the Company's debt obligations.

**ADVOCAT INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**DECEMBER 31, 2008, 2007 AND 2006**

**5. PROPERTY AND EQUIPMENT**

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

	December 31,	
	2008	2007
Land	\$ 1,903,000	\$ 1,573,000
Buildings and leasehold improvements	49,098,000	42,835,000
Furniture, fixtures and equipment	22,516,000	19,886,000
	\$ 73,517,000	\$ 64,294,000

Substantially all of the Company's property and equipment are provided as collateral for debt obligations. The Company capitalizes leasehold improvements which will revert back to the lessor of the property at the expiration or termination of the lease, and depreciates these improvements over the shorter of the remaining lease term or the assets' estimated useful lives.

**6. LONG-TERM DEBT**

Long-term debt consists of the following:

	December 31,	
	2008	2007
Mortgage loan payable to a commercial finance company; issued in August 2006; secured by seven nursing centers; payable monthly, interest at 3.75% above LIBOR (4.95% and 8.35% at December 31, 2008 and 2007, respectively).	\$ 21,768,000	\$ 22,163,000
Term loan payable to a bank; issued in August 2007; interest 2.5% above LIBOR (4.0% and 7.1% at December 31, 2008 and 2007, respectively).	10,642,000	12,292,000
	32,410,000	34,455,000
Less current portion	(2,238,000)	(1,942,000)
	\$ 30,172,000	\$32,513,000

As of December 31, 2008, the Company's weighted average interest rate on long-term debt was approximately 4.6%.

In August 2007, the Company entered into an agreement with a bank for a \$16,500,000 term loan to finance the SMSA Acquisition and repay certain existing indebtedness. The term loan has an interest rate of LIBOR plus 2.5%, a maturity of five years, maturing August 2012, and principal payments based on a ten year amortization, with additional payments based upon certain asset dispositions and excess cash flows, as defined in the debt agreements. The term loan is secured by receivables and all other unencumbered assets of the Company, including land held for sale and notes receivable. In addition to financing the acquisition, the Company used proceeds from this term loan to retire a \$4,027,000 term loan with an interest rate of LIBOR plus 6.25%, and a \$2,534,000 subordinated note due in September 2007 with an interest rate of 7%. In connection with the transaction, the Company expensed existing deferred financing costs of \$116,000 during 2007. The deferred financing costs written off relate to the debt that was retired and are reflected as debt retirement costs in the income statement. In connection with the new debt incurred in the 2007 financing, the Company recorded deferred loan costs of \$764,000.



**ADVOCAT INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**DECEMBER 31, 2008, 2007 AND 2006**

The bank loan agreement also includes a \$15,000,000 revolving credit facility that provides revolving credit loans as well as the issuance of letters of credit. The revolver is secured by accounts receivable, and there are limits on the maximum amount of loans that may be outstanding under the revolver based on borrowing base restrictions. The revolver has a term of three years, expiring August 2010 and bears interest at the Company's option of LIBOR plus 2.25% or the bank's prime lending rate. Annual fees for letters of credit issued under this revolver are 2.25% of the amount outstanding. The Company has a letter of credit of approximately \$8,117,000 to serve as a security deposit for all of the Company's leases with Omega. Considering the balance of eligible accounts receivable at December 31, 2008, the letter of credit and the current maximum loan amount of \$15,000,000, the balance available for revolving credit loans as of December 31, 2008 was \$6,883,000. As of December 31, 2008, the Company had no borrowings outstanding under the revolving credit facility.

On August 7, 2006, the Company entered into an agreement with its commercial mortgage lender to refinance its mortgage debt. Under the terms of the new agreement, the lender provided mortgage debt ("Mortgage Loan") of approximately \$22.5 million with a five year maturity. The proceeds of these new loans were used to retire the existing debt and to fund a \$1.1 million renovation of a nursing center that is part of the collateral for the mortgage loans. The renovation was completed in 2007. During 2006, the Company expensed existing deferred financing costs of \$194,000 related to the debt that was retired and recorded new deferred loan costs of \$844,000 as part of the refinancing transaction.

The Mortgage Loan has a term of five years, with principal and interest payable monthly based on a 25 year amortization. Interest is based on 30 day LIBOR plus a margin of 3.75%. The mortgage loan is secured by seven owned nursing centers, related equipment, and a second lien on the accounts receivable of these facilities.

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

2009	\$ 2,238,000
2010	3,901,000
2011	22,216,000
2012	4,055,000
2013	—
Thereafter	—
Total	<u>\$ 32,410,000</u>

The Company's debt agreements require additional payments from proceeds received upon certain asset dispositions and excess cash flows, as defined in the debt agreements. In addition, the Company's debt agreements allow for voluntary prepayments of principal outstanding, and during 2007, the Company made voluntary prepayments of \$3,000,000. These prepayments reduce the required amounts that must be paid in the future from excess cash flows and asset dispositions.

The Company's debt agreements contain various financial covenants, the most restrictive of which relate to cash flow, debt service coverage ratios, liquidity and limits on the payment of dividends to shareholders. The Company is in compliance with all such covenants at December 31, 2008. During December 2008, the Company and the bank amended certain provisions of the term loan agreement related to the definition of a Minimum Fixed Charge Coverage Covenant. The amendment changed the measurement of the Minimum Fixed Charge Coverage Covenant by substituting "maintenance capital expenditures", as defined, for substantially all fixed asset expenditures as previously defined in the agreement. The Company received a waiver of noncompliance with this covenant as of September 30, 2008. The Company paid \$75,000 as an amendment fee and will amortize this deferred cost over the remaining term of the bank debt agreement.

**ADVOCAT INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**DECEMBER 31, 2008, 2007 AND 2006**

The Company is subject to a covenant under its mortgage loan that requires the Company to maintain a combined occupancy for seven owned homes that serve as collateral for the mortgage loan. The Company was in compliance with the covenant at September 30, 2008, however, the covenant was to become more restrictive as of December 31, 2008, and based on occupancy at September 30, 2008, the Company would not be in compliance with the more restrictive covenant. The Company and its mortgage lender amended this covenant in December 2008. The Company is in compliance with all covenants, as amended, as of December 31, 2008.

**7. DISCONTINUED OPERATIONS**

Effective March 31, 2007, the Company terminated operations at its leased facility in Eureka Springs, Arkansas. The owner of the property, a subsidiary of Omega, sold the property and the Company cooperated in an orderly transition to the new owner.

The facility had low occupancy and operated at a loss. The facility had been leased subject to the Omega master lease. Under the terms of that lease, the master lease rental payment was not reduced. This facility contributed revenues of \$575,000 and \$2,110,000 during the periods ended December 31, 2007 and 2006, respectively. In 2003, the Company recorded an impairment charge of \$178,000 to reduce the net book value of this property to its estimated realizable value in accordance with the provisions of SFAS No. 144. No material loss was incurred in connection with the lease termination.

In May 2006, the Company completed the sale of certain assets of eleven assisted living facilities located in North Carolina for a sales price of \$11.0 million. In 2005, the Company recorded an impairment charge of \$4,397,000 to reduce the net book value of these properties to their estimated realizable value, and no material gain or loss was recognized upon the completion of the sale in 2006. The Company owns real estate related to a North Carolina assisted living facility it closed in April 2006. In September 2007, the Company sold the bed license for this North Carolina assisted living facility for a sales price of \$183,000, and recognized a pretax gain on sale of discontinued operations of \$45,000.

Proceeds from these divestiture transactions were used to pay transaction costs and repay debt. In accordance with the provisions of SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets," the Company has classified the operations and the real estate described above as discontinued operations for all periods presented in the Company's consolidated financial statements. The results of discontinued operations do not reflect any allocation of corporate general and administrative expense or any allocation of corporate interest expense.

The net assets of discontinued operations presented on the balance sheet represent the real estate related to the assisted living facility closed in April 2006. The Company is continuing its efforts to sell this land.

**8. NOTE RECEIVABLE**

In May 2004, the Company sold the stock of its Canadian subsidiary, Diversicare Canada Management Services Co., Inc. ("DCMS"), to DCMS Holding, Inc. ("Holding"), a privately-owned Ontario corporation. DCMS operated 14 nursing centers and 24 assisted living facilities in the Canadian provinces of Ontario, British Columbia and Alberta. The sales price was \$16.5 million Canadian which was approximately \$11.8 million US at the May 11, 2004 exchange rate. All U.S. dollar amounts parenthetically referenced are also at the May 11, 2004 exchange rate. Approximately \$8.5 million Canadian (\$6.1 million US) was received at closing, with the balance, \$8.0 million Canadian (\$5.7 million US), originally scheduled to be received in annual installments of \$600,000 Canadian (\$428,000 US) on the anniversary of the closing for the first four years and a final installment of \$5.6 million Canadian (\$4.0 million US) on the fifth anniversary of closing. The future payments may be accelerated upon the occurrences of certain events. The installment portion of the purchase price is evidenced by a promissory note that has been discounted to estimated fair value and was initially recorded in the accompanying balance sheet at \$4.7 million US. The Company received payments of \$765,000, \$700,000 and \$718,000 in 2008, 2007 and 2006, respectively. Foreign currency transaction gain or loss related to this note is recorded as other income or expense in the Consolidated Statements of Income.

**ADVOCAT INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**DECEMBER 31, 2008, 2007 AND 2006**

During 2009 the Company entered into negotiations to extend the maturity of this note to May 2010 while the borrower seeks replacement financing. While no formal amendment has been executed, the Company expects an installment of at least \$600,000 Canadian (\$491,000 US at December 31, 2008 exchange rate) plus accrued interest would be paid on May 11, 2009. Based on preliminary discussion with the borrower, if the entire principal amount is not paid by May 11, 2009, the interest rate on the note will be based on LIBOR plus 4%, but not less than 5%, and the balance of the note will be due in full on May 11, 2010. All other terms of the note would remain the same. The balance of the note receivable was \$3,952,000 at December 31, 2008, with \$466,000 classified as a current asset based on these proposed terms.

**9. SHAREHOLDERS' EQUITY, STOCK PLANS AND PREFERRED STOCK**

**Shareholders' Rights Plan**

On August 1, 2008, the Company's Board of Directors amended its current Amended and Restated Rights Agreement (the "Rights Agreement") which was originally adopted in 1995 and last amended in 2005. The amendment provides for an increase of the exercise price of the rights under the Rights Agreement (the "Rights") to \$50 from \$15 and for the extension of the Expiration Date of the Rights to August 2, 2018.

In addition, the amendment includes a share exchange feature that provides the Company's Board of Directors the option of exchanging, in whole or in part, each Right, other than those of the hostile acquiring holder, for one share of the Company's common stock. This provision is intended to avoid requiring Rights holders to pay cash to exercise their Rights and to alleviate the uncertainty as to whether holders will exercise their Rights. The Plan is designed to protect the Company's shareholders from unfair or coercive takeover tactics. The rights may be exercised only upon the occurrence of certain triggering events, including the acquisition of, or a tender offer for, 15.0% or more of the Company's common stock without the Company's prior approval.

**Stock-Based Compensation Plans**

The Company follows SFAS No. 123 (revised 2004), "Share-Based Payment," using the modified prospective method, in which compensation cost is recognized (a) for all share-based payments granted after the effective date and (b) based on the requirements of SFAS No. 123 for all awards granted to employees prior to the effective date of SFAS No. 123R that remain unvested on the effective date. The Company had no unvested awards granted to employees on the effective date.

In 1994, the Company adopted the 1994 Incentive and Nonqualified Stock Option Plan for Key Personnel (the "Key Personnel Plan") and the 1994 Nonqualified Stock Option Plan for the Directors (the "Director Plan"). Under both plans, the option exercise price equals the stock's closing market price on the day prior to the grant date. The maximum term of any option granted pursuant to either the Key Personnel Plan or to the Director Plan is ten years. In accordance with their terms, the Key Personnel Plan and the Director Plan expired in May 2004 and no further grants can be made under these plans.

In December 2005, the Compensation Committee of the Board of Directors adopted the 2005 Long-Term Incentive Plan ("the 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 options granted thereunder. All options under this plan expire 10 years from the date the shares were authorized by the Board of Directors.

**ADVOCAT INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**DECEMBER 31, 2008, 2007 AND 2006**

At the time of adoption, the Board approved the issuance of options to purchase approximately 332,000 shares of the Company's common stock at a purchase price of \$5.44 per share, the market price of the Company's common stock on the date the options were authorized. This issuance was subject to shareholder approval of the 2005 Plan which occurred in June 2006 at the Company's 2006 Annual Shareholders' Meeting. At the time of shareholder approval, the Company's stock price had increased to \$16.80. Upon shareholder approval, the options for the purchase of approximately 314,000 shares were vested with the remainder vesting one-half each on the next two anniversaries of the date the shares were authorized by the Board of Directors.

During 2008 and 2007, the Compensation Committee of the Board of Directors approved the grant of Stock Only Stock Appreciation Rights ("SOSARs") at the market price of the Company's common stock on the date. The SOSARs vest one-third on the first, second and third anniversaries of the grant date. The SOSARs are valued and recorded in the same manner as stock options under FAS 123R, and will be settled with issuance of new stock for the difference between the market price on the date of exercise and the exercise price.

The Company recorded non-cash stock-based compensation expense for equity grants issued under the 2005 Plan of \$867,000, \$648,000 and \$5,184,000 during the years ended December 31, 2008, 2007 and 2006, 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, 2008, there was \$700,000 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 using the Black-Scholes-Merton equity grant valuation model.

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

	<b>Year Ended December 31,</b>		
	<b>2008</b>	<b>2007</b>	<b>2006</b>
Expected volatility (range)	<b>113% - 122%</b>	119% - 143%	140% - 153%
Risk free interest rate (range)	<b>2.49% - 3.43%</b>	3.96% - 4.68%	5.07% - 5.10%
Expected dividends	—	—	—
Weighted average expected term (years)	<b>6.0</b>	6.0	5.04

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 an expected dividend yield of zero since it has not paid cash dividends on its common stock.

In computing the fair value of these SOSARs, the Company estimated the SOSAR's expected term based on the average of the vesting term and the original contractual terms of the grants, consistent with the interpretive guidance in Securities and Exchange Commission Staff Accounting Bulletin ("SAB") 107 and SAB 110 (the "Simplified Method"). The Company continues to use the Simplified Method since the Company's exercise history is not representative of the expected term of the SOSARs granted in 2008. The Company's recent exercise history is primarily from options granted in 2005 that were vested at grant date and were significantly in-the-money due to an increase in stock price during the period between grant date and formal approval by shareholders, and from older options granted several years ago that had fully vested.

**ADVOCAT INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**DECEMBER 31, 2008, 2007 AND 2006**

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

	<b>Year Ended December 31,</b>		
	<b>2008</b>	2007	2006
Weighted Average grant date fair value	<b>\$9.39</b>	\$10.55	\$15.90
Total Intrinsic Value of Options Exercised	<b>\$26,000</b>	\$105,000	\$1,640,000

The following table summarizes information regarding stock options and SOSAR grants outstanding as of December 31, 2008:

<b>Range of Exercise Prices</b>	<b>Weighted Average Exercise Prices</b>	<b>Options Outstanding</b>
\$10.38 to \$11.72	\$ 11.22	219,000
\$0.15 to \$5.44	\$ 3.85	329,000
		<u>548,000</u>

As of December 31, 2008, the outstanding equity grants have a weighted average remaining life of 6.56 years and those outstanding equity grants that are exercisable have a weighted average remaining life of 5.83 years. During the year ended December 31, 2008 approximately 25,000 shares were exercised under these plans, resulting in proceeds of \$235,000.

Summarized activity of the equity compensation plans is presented below:

	<b>Shares</b>	<b>Weighted Average Exercise Price</b>
Outstanding, December 31, 2007	472,000	\$ 6.02
Granted	111,000	10.90
Exercised	(25,000)	9.94
Expired or cancelled	(10,000)	8.81
Outstanding, December 31, 2008	<u>548,000</u>	<u>\$ 6.78</u>
Exercisable, December 31, 2008	<u>367,000</u>	<u>\$ 4.63</u>

As of December 31, 2008, there was no aggregate intrinsic value for the Company's equity grants outstanding and equity grants exercisable since the aggregate exercise price exceeded the market value of the underlying shares.

In June 2008, the Company adopted the Advocat Inc. 2008 Stock Purchase Plan for Key Personnel ("Stock Purchase Plan"). The Stock Purchase Plan provides for the granting of rights to purchase shares of the Company's common stock to directors and officers and is administered by the compensation committee of the board of directors. The maximum number of shares of the Company's common stock to be authorized and reserved for issuance under the Stock Purchase Plan is 150,000 shares, subject to equitable adjustment as set forth in the Stock Purchase Plan.

The 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 at a price equal to 85% of the fair market value

**ADVOCAT INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**DECEMBER 31, 2008, 2007 AND 2006**

of a share of the Company's common stock on the date on which such restricted shares or restricted share units are purchased.

The restricted period for restricted shares or restricted share units issued under the Stock Purchase Plan is generally two years from the date of purchase. During the restricted period the shares will have all rights of other shares including voting rights and 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 restricted period. No grants of restricted shares or restricted share units can be made under the Stock Purchase Plan after April 25, 2018. During 2008 no restricted share grants were made under the Stock Purchase plan. Elections were made by participants in 2008 to have a portion of their 2008 bonus paid in restricted shares or restricted share units during 2009.

**Series A Preferred Stock**

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

**Series B and Series C Preferred Stock**

As part of the consideration paid to Omega for restructuring the terms of the Omega Master Lease in November 2000, the Company issued to Omega 393,658 shares of the Company's Series B Redeemable Convertible Preferred Stock ("Series B Preferred Stock"). The Company's Series B Preferred Stock had a stated value of \$3,300,000 and carried an annual dividend rate of 7% of the stated value. The dividends accrued on a daily basis and compounded quarterly.

In October 2006, the Company and Omega entered into a Restructuring Stock Issuance and Subscription Agreement ("Restructuring Agreement") to restructure the Series B Preferred Stock, eliminating the option of Omega to convert the Series B Preferred Stock into shares of Advocat common stock. Advocat and Omega also entered into a Third Amendment to Consolidated Amended and Restated Master Lease ("Lease Amendment") to extend the term of its lease covering 28 nursing centers it leased from Omega.

At the time of the Restructuring Agreement, the Series B Preferred Stock had a recorded value (including accrued dividends) of approximately \$4,918,000 and was convertible into approximately 792,000 shares of common stock. The Company issued 5,000 shares of a new Series C Preferred Stock to Omega in exchange for the 393,658 shares of Series B Preferred Stock held by Omega. The new Series C Preferred Stock has a stated value of approximately \$4,918,000 and an annual dividend rate of 7% of its stated value payable quarterly in cash. The Series C Preferred Stock is not convertible, but is redeemable at its stated value at Omega's option after September 30, 2010, and is redeemable at its stated value at the Company's option after September 30, 2007, subject to certain limitations. In connection with the termination of the conversion feature, the Company agreed to pay Omega an additional \$687,000 per year under the Lease Amendment.

The Company recorded the fair value of the elimination of the conversion feature as a reduction in Paid In Capital with an offsetting increase to record a premium on the Series C Preferred Stock. As a result, the Series C Preferred Stock was initially recorded at a total value of \$11,619,000, equal to the stated value of the Series B Preferred Stock, \$4,918,000, plus the negotiated value of the conversion feature, \$6,701,000. The additional rental payments of \$687,000 annually were discounted over the twelve year term of the renewal so that the net present value of the payments equals the \$6,701,000 preferred stock premium. When payments are made, the preferred stock premium is reduced, interest expense is recorded and cash is reduced.

The Series C Preferred Stock shares have preference in liquidation but do not have voting rights. The total redemption value is equal to the stated value plus any accrued but unpaid dividends. The liquidation preference value is equal to the redemption value.

**ADVOCAT INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**DECEMBER 31, 2008, 2007 AND 2006**

**10. 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:

	<u>2008</u>	<u>2007</u>	<u>2006</u>
<b>Basic net income per common share</b>			
Net income from continuing operations	\$ 5,770,000	\$ 9,486,000	\$ 22,395,000
Preferred stock dividends	(344,000)	(344,000)	(340,000)
Net income from continuing operations for common stock	<u>5,426,000</u>	<u>9,142,000</u>	<u>22,055,000</u>
Discontinued operations:			
Operating loss, net of taxes	(35,000)	(91,000)	(337,000)
Loss on sale, net of taxes	—	(8,000)	(114,000)
Loss from discontinued operations	<u>(35,000)</u>	<u>(99,000)</u>	<u>(451,000)</u>
Net income for common stock	<u>\$ 5,391,000</u>	<u>\$ 9,043,000</u>	<u>\$ 21,604,000</u>
Basic weighted average common shares outstanding	<u>5,693,000</u>	<u>5,870,000</u>	<u>5,784,000</u>
Basic net income (loss) per common share:			
Net income from continuing operations	\$ 0.95	\$ 1.56	\$ 3.81
Loss from discontinued operations	—	(0.02)	(0.05)
Loss on sale of discontinued operations	—	—	(0.02)
Loss from discontinued operations	<u>—</u>	<u>(0.02)</u>	<u>(0.07)</u>
Basic net income per common share	<u>\$ 0.95</u>	<u>\$ 1.54</u>	<u>\$ 3.74</u>

**ADVOCAT INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**DECEMBER 31, 2008, 2007 AND 2006**

	<u>2008</u>	<u>2007</u>	<u>2006</u>
<b>Diluted net income per common share</b>			
Net income from continuing operations for common stock	\$ 5,426,000	\$ 9,142,000	\$ 22,055,000
Add dilutive preferred stock dividends, for effect of assumed conversion of preferred stock	—	—	272,000
Assumed interest on unpaid dividends	—	—	(102,000)
Net income from continuing operations for diluted net income per common share	<u>5,426,000</u>	<u>9,142,000</u>	<u>22,225,000</u>
Discontinued operations:			
Operating loss, net of taxes	(35,000)	(91,000)	(337,000)
Loss on sale	—	(8,000)	(114,000)
Net loss from discontinued operations	<u>(35,000)</u>	<u>(99,000)</u>	<u>(451,000)</u>
Net income for diluted net income per common share	<u>\$ 5,391,000</u>	<u>\$ 9,043,000</u>	<u>\$ 21,774,000</u>
Basic weighted average common shares outstanding	5,693,000	5,870,000	5,784,000
Incremental shares from assumed exercise of stock options	194,000	257,000	215,000
Incremental shares from assumed conversion of preferred stock	—	—	508,000
Diluted average common shares outstanding	<u>5,887,000</u>	<u>6,127,000</u>	<u>6,507,000</u>
Diluted net income per common share			
Net income from continuing operations	\$ 0.92	\$ 1.49	\$ 3.42
Income (loss) from discontinued operations	—	(0.01)	(0.05)
Loss on sale of discontinued operations	—	—	(0.02)
Net loss from discontinued operations	—	(0.01)	(0.07)
Diluted net income per common share	<u>\$ 0.92</u>	<u>\$ 1.48</u>	<u>\$ 3.35</u>

The dilutive effects of the Company's stock options and Series B Preferred Stock are included in the computation of diluted income per common share for the period of time the Series B Preferred Stock was outstanding. See Note 9. Under the applicable provisions of the Internal Revenue Code, Omega, as a Real Estate Investment Trust, is limited in the amount of ownership in the Company it can hold. The terms of the Series B Preferred Stock limit the amount of common stock that Omega may receive on such conversion. The computation of diluted earnings per share in 2006 reflects the effect of these limitations on the number of common shares issued and the effects of interest expense from the assumed issuance of a promissory note for the balance of preferred shares not converted to common stock. The Series C Preferred Stock issued in 2006 in exchange for the Series B Preferred Stock is not convertible.

In 2008 and 2007, the effects of the weighted average outstanding SOSARs were excluded from the computation of diluted earnings per share, as the SOSARs would have been anti-dilutive.



**ADVOCAT INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**DECEMBER 31, 2008, 2007 AND 2006**

**11. INCOME TAXES**

The provision (benefit) for income taxes of continuing operations is composed of the following components:

	<b>Year Ended December 31,</b>		
	<b>2008</b>	2007	2006
Current provision :			
Federal	\$ 1,765,000	\$ 223,000	\$ —
State	363,000	910,000	223,000
	<u>2,128,000</u>	<u>1,133,000</u>	<u>223,000</u>
Deferred provision (benefit):			
Federal	872,000	5,061,000	(8,010,000)
State	(42,000)	76,000	(1,709,000)
	<u>830,000</u>	<u>5,137,000</u>	<u>(9,719,000)</u>
Provision (benefit) for income taxes of continuing operations	<u>\$ 2,958,000</u>	<u>\$ 6,270,000</u>	<u>\$ (9,496,000)</u>

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

	<b>Year Ended December 31,</b>		
	<b>2008</b>	2007	2006
Provision for federal income taxes at statutory rates	\$ 2,968,000	\$ 5,357,000	\$ 4,222,000
Provision for state income taxes at statutory rates, net of federal benefit	349,000	630,000	497,000
Valuation allowance changes affecting the provision (benefit) for income taxes	66,000	42,000	(14,553,000)
Work opportunity tax credits	(654,000)	—	—
Nondeductible expenses	363,000	200,000	248,000
Other	(134,000)	41,000	90,000
Provision (benefit) for income taxes	<u>\$ 2,958,000</u>	<u>\$ 6,270,000</u>	<u>\$ (9,496,000)</u>

The net deferred tax assets and liabilities, at the respective income tax rates, are as follows:

	<b>December 31,</b>	
	<b>2008</b>	2007
Current deferred assets:		
Allowance for doubtful accounts	\$ 1,217,000	\$ 749,000
Accrued liabilities	3,486,000	2,584,000
	<u>4,703,000</u>	<u>3,333,000</u>
Less valuation allowance	(246,000)	(161,000)
	<u>4,457,000</u>	<u>3,172,000</u>
Current deferred liabilities:		
Prepaid expenses	(490,000)	(1,062,000)
	<u>\$ 3,967,000</u>	<u>\$ 2,110,000</u>

**ADVOCAT INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**DECEMBER 31, 2008, 2007 AND 2006**

	<b>December 31,</b>	
	<b>2008</b>	<b>2007</b>
Noncurrent deferred assets:		
Net operating loss and other carryforwards	\$ 2,231,000	\$ 2,527,000
Deferred lease costs	594,000	654,000
Depreciation	524,000	1,805,000
Tax goodwill and intangibles	1,522,000	1,610,000
Stock-based compensation	1,972,000	1,657,000
Accrued rent	3,638,000	2,498,000
Impairment of long-lived assets	355,000	355,000
Noncurrent self-insurance reserves	4,008,000	6,887,000
	<b>14,844,000</b>	17,993,000
Less valuation allowance	(708,000)	(785,000)
	<b>14,136,000</b>	17,208,000
Noncurrent deferred liabilities:		
Note receivable	(237,000)	(640,000)
	<b>\$ 13,899,000</b>	<b>\$ 16,568,000</b>

In 2008, 2007, and 2006, the Company also recorded a deferred tax benefit (provision) to reverse (increase) approximately \$(66,000), \$(42,000) and \$14,553,000, respectively, of the valuation allowance on deferred tax assets. The 2008 and 2007 increases in valuation allowance were based on the Company's assessment of the realization of certain individual tax assets. Prior to 2006, the Company had recorded valuation allowances on a substantial portion of its deferred tax assets. During 2006 the Company assessed the valuation allowance on deferred tax assets based on the Company's belief that it is more likely than not that a larger portion of the Company's net deferred tax assets will be realized due to the Company's achieved earnings trend and improved liquidity and financial position. The Company considered many factors when assessing the likelihood of future realization of its deferred tax assets including its recent cumulative earnings experience by taxing jurisdiction, expectations of future taxable income, the carryforward periods available to the Company, and recent improvements in the Company's overall debt as well as debt classification. Prior to August 2006, the Company had net working capital deficits, short-term debt maturities, and was in default of its debt agreements. As a result of the improvement in financial results and the completion of a refinancing in 2006, management believes it addressed the uncertainties surrounding the realization of the benefits of the Company's deferred tax assets in future periods.

The Company continues to maintain a valuation allowance of approximately \$954,000 to reduce the deferred tax assets by the amount management believes is more likely than not to be utilized through the turnaround of existing temporary differences, future earnings, or a combination thereof. In future periods, the Company will continue to assess the need for and adequacy of the remaining valuation allowance.

At December 31, 2008, the Company had \$10,551,000 of net operating losses, which expire at various dates beginning in 2019 and continuing through 2021. The use of these loss carryforwards is limited by change in ownership provisions of the Federal tax code to a maximum of approximately \$5,685,000. In 2005, the Company 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.

In periods prior to 2001, the Company generated tax credits under the Work Opportunity Tax Credit program totaling approximately \$328,000. As the Company was incurring taxable losses in those years the Company did not record tax assets related to these credits. During the three months ending March 31, 2008, the Company recorded these carryforward credits as deferred tax assets, as the Company anticipates using them to reduce its taxes payable in 2008. In addition, we generated and recorded \$326,000 in new Work Opportunity Tax Credits during 2008. The impact of recording these assets reduced the effective tax rate for the year ending December 31, 2008.

**ADVOCAT INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**DECEMBER 31, 2008, 2007 AND 2006**

The Canada Customs and Revenue Agency (“CCRA”) audited the Canadian federal tax return of DCMS, the Company’s Canadian subsidiary sold in 2004 (see Note 8) for the years ended December 31, 2003 and 2002 and proposed certain adjustments to the DCMS tax returns. The adjustments related to the Company’s deductions related to allocation of overhead charges of United States management to DCMS. Under the terms of the sale of DCMS, the Company is liable for any liability that arises from these adjustments. In 2005, the Company recorded a charge for its estimated liability for additional tax, interest and professional fees resulting from these proposed adjustments. During 2008, the Company paid \$234,000 to CCRA for the balance of the assessment.

Effective January 1, 2007, the Company adopted the provisions of Financial Accounting Standards Board (“FASB”) Interpretation No. 48, “Accounting for Uncertainty in Income Taxes – An Interpretation of FASB Statement No. 109” (“FIN 48” or “the interpretation”). This interpretation provides guidance on financial statement recognition and measurement of tax positions taken, or expected to be taken, in tax returns. The initial adoption of the interpretation had no impact on the Company’s financial statements. A reconciliation of the beginning and ending amount of unrecognized tax benefits is as follows:

Balance at January 1, 2008	\$ 307,000
Decreases due to settlement with taxing authorities	(234,000)
Decreases in tax positions for prior years	<u>(3,000)</u>
Balance at December 31, 2008	<u>\$ 70,000</u>

The unrecognized tax benefits are accrued in “other current liabilities.” The net decrease in the amount of unrecognized tax benefits during the year ended December 31, 2008 was related to the adjustment of the estimated liability, to the fluctuation of the exchange rate between US and Canadian currencies and payments made to taxing authorities. None of the current unrecognized tax benefits are expected to impact the Company’s effective tax rates.

The Company has chosen to classify interest and penalties as a component separate from income tax expense in its consolidated statements of income. The tax years 2005 through 2007 remain open to examination by major taxing jurisdictions in which the Company operates.

**12. 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, 2009, are as follows:

2009	\$	22,154,000
2010		21,720,000
2011		21,950,000
2012		22,472,000
2013		23,023,000
Thereafter		<u>494,614,000</u>
		<u>\$ 605,933,000</u>

Under lease agreements with Omega and others, the Company’s lease payments are subject to periodic annual escalations as described below and in Note 2. Total lease expense for continuing operations was \$22,962,000, \$20,019,000 and \$16,082,000 for 2008, 2007 and 2006, respectively. The accrued liability related to straight line rent was \$9,267,000 and \$7,556,000 at December 31, 2008 and 2007, respectively, and is included in “Other noncurrent liabilities” on the accompanying consolidated balance sheets.

**ADVOCAT INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**DECEMBER 31, 2008, 2007 AND 2006**

**Omega Leases**

The Company leases 35 facilities from Omega under the Master Lease. On October 20, 2006, the company and Omega entered into a Third Amendment to Consolidated Amended and Restated Master Lease (“Lease Amendment”) to extend the term of its facilities leased from Omega. All of the equipment, inventory and other related assets of the facilities leased pursuant to the Master Lease have been pledged as security under the Master Lease and remain so under the Lease Amendment.

The initial term of the Master Lease was ten years, expiring September 30, 2010, with a ten-year renewal term at the option of the Company. The amended master lease commenced on October 1, 2006, and extends to September 30, 2018. The Lease Amendment also provides for a renewal option of an additional twelve years. Other than the change in rent associated with the restructuring of the preferred stock described in Note 9, there was no change in the base rental amounts as a result of the Lease Amendment. Consistent with prior terms, the lease provides for annual increases in lease payments equal to the lesser of two times the increase in the consumer price index or 3 percent. Under generally accepted accounting principles, the Company is required to report these scheduled rent increases on a straight line basis over the 12 year term of the renewal period. As a result of accruing the scheduled rent increases, the Company’s annual rent expense increased by approximately \$2.7 million effective October 1, 2006. This increase had no effect on cash rent payments at the start of the lease term and will only result in additional cash outlay as the 3 percent annual increases take effect each year.

Effective August 11, 2007, as described in Note 3, the Company completed the SMSA Acquisition in which it acquired the leases and leasehold interests in the SMSA facilities which are leased from a subsidiary of Omega. In connection with this acquisition, the Company amended the Master Lease to include the seven SMSA facilities (“SMSA Amendment”). The substantive terms of the SMSA lease, including payment provisions and lease period including renewal options were not changed by the amendment. The lease terms for the seven SMSA facilities provide for an initial term and renewal periods at the Company’s option through May 31, 2035. The lease provides for annual increases in lease payments equal to the increase in the consumer price index, not to exceed 2.5%.

The Master Lease requires the Company to fund annual capital expenditures related to the leased facilities at an amount currently equal to \$399 per licensed bed. The Florida Lease (discussed below) currently requires that we spend \$373 per bed, per year on capital expenditures. 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 \$29,295,000. These capital expenditures are being depreciated on a straight-line basis over the initial lease term.

Upon expiration of the Master Lease or in the event of a default under the Master Lease, the Company is required to transfer all of the leasehold improvements, equipment, furniture and fixtures of the leased facilities to Omega. The assets to be transferred to Omega are being depreciated 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.

As described in Note 6, the Company has issued a letter of credit of approximately \$8,117,000 as a security deposit for all of the Company’s leases with Omega.

The 2006 Lease Amendment together with an earlier amendment in 2005 provided financing of up to \$10,000,000 to be used to fund renovations to several nursing centers leased from Omega. The annual base rent related to these facilities was increased to reflect the amount of capital improvements made to the respective facilities as the related expenditures were made. The increase is based on a rate of 10.25% per year of the amount financed under this amendment. The remainder of the \$10,000,000 was used in 2008 to fund renovation projects. The amendments also included provisions to amend certain professional liability insurance requirements of the master lease agreement in order to cure certain defaults under the Master Lease agreement.

**ADVOCAT INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**DECEMBER 31, 2008, 2007 AND 2006**

In November 2007, the Company entered into a short-term, single facility lease with Omega for an existing 102 bed skilled nursing center in Paris, Texas, and undertook an evaluation of the feasibility of entering into an agreement with Omega for the construction of a replacement facility. On March 14, 2008, the Company entered into an amendment to its master lease with Omega to provide for the construction and lease of a replacement facility. Upon the completion of the construction of the replacement facility, the existing building will be closed and the single facility lease terminated.

Under the terms of the lease amendment, Omega will provide funding and the Company will supervise the construction of the facility. Construction began during the second quarter of 2008, with completion expected in mid-2009. Rent will commence upon completion of the project, but no later than August 2009. Once construction is completed, annual rent will be equal to 10.25% of the total cost of the replacement facility, including direct costs of construction, carrying costs during the construction period, furnishings and equipment, land cost and the value of the related skilled nursing facility license. The total cost of the replacement facility is expected to be approximately \$7.9 million. Under the terms of the March 14, 2008 lease amendment and an October 24, 2008 lease amendment, costs incurred in excess of the current estimated cost of \$7.9 million would be borne by the Company. As of December 31, 2008, the Company had incurred approximately \$1,039,000 in capitalized reimbursable construction costs for this replacement facility, of which approximately \$811,000 had been reimbursed by Omega. The lease amendment provides for renewal options with respect to the new facility through 2035.

The replacement facility will be subject to the requirements of the Company's current master lease, with certain exceptions for capital spending requirements. At the fifth anniversary of rent commencement for the replacement facility, the Company may terminate the lease with respect to this facility. Beginning 18 months after the facility commences operations and continuing until the fifth anniversary of rent commencement, Omega may terminate the lease for this facility if the cash flow of the facility (as defined in the lease amendment) is less than 1.2 times the then existing rent. If the Company elects to continue the lease, annual rentals for this facility may be increased by an amount equal to one half of the amount of the cash flow of the facility (as defined in the lease amendment) in excess of 1.2 times the then existing rent, effective as of the start of the sixth year after the completion of the building. If at any time beginning 18 months after the completion of the building the average annual cash flow of the facility exceeds 1.3 times the then existing rent, the termination options of both Omega and the Company are eliminated, and the rent reset provisions described above are eliminated.

#### **Florida Leases**

Effective April 1, 2003, the Company entered into a lease for four nursing centers in Florida that had previously been managed by the Company under management contracts. Omega holds mortgages on these properties and the Company makes the lease payments directly to Omega.

In December 2005, the term of the lease was extended through February 2010. The lease provides for annual increases equal to the lesser of two times the consumer price index or 3.0% in subsequent years. Effective January 1, 2006, the amendment eliminated the previously required additional rents that were based on the profitability of the facilities. The Company is recording all scheduled rent increases as additional lease expense on a straight-line basis over the remaining lease term.

#### **Insurance Matters**

##### ***Professional Liability and Other Liability Insurance***

Due to the Company's past claims experience and increasing cost of claims throughout the long-term care industry, the premiums paid by the Company for professional liability and other liability insurance to cover future periods exceeds the coverage purchased so that it costs more than \$1 to purchase \$1 of insurance coverage. For this reason, effective March 9, 2001, the Company has purchased professional liability insurance coverage for its facilities that, based on historical claims experience, is likely to be substantially less than the claims that are expected to be incurred. As a result, the Company is effectively self-insured and expects to remain so for the foreseeable future.

**ADVOCAT INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**DECEMBER 31, 2008, 2007 AND 2006**

The Company has essentially exhausted all general and professional liability insurance available for claims asserted prior to March 10, 2007. For claims made during the period from March 10, 2007 through March 9, 2010, the Company maintains insurance with coverage limits of \$100,000 per medical incident and total annual aggregate policy coverage limits of \$500,000. As of December 31, 2008, payments already made by the insurance provider for the period from March 10, 2007 through March 9, 2009 have reduced the remaining aggregate coverage amount in the policy period, but coverage has not been exhausted.

***Reserve for Estimated Self-Insured Professional Liability Claims***

Because the Company anticipates that its actual liability for existing and anticipated claims will exceed the Company's limited professional liability insurance coverage, the Company has recorded total liabilities for professional liability and other claims of \$14,959,000 as of December 31, 2008. 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.

The Company records its estimated liability for these professional liability claims based on the results of a third-party actuarial analysis prepared by the Actuarial Division of Willis of Tennessee, Inc. ("Willis"). Each quarter, amounts are added to the accrual for estimates of anticipated liability for claims incurred during that period. These estimates are assessed and adjusted quarterly as claims are actually reported, as lawsuits are filed, and as those actions are actually resolved. As indicated by the chart of reserves by policy year set forth below, final determination of the Company's actual liability for claims incurred in any given period is a process that takes years. At each quarter end, the Company records any revisions in estimates and differences between actual settlements and reserves, with changes in estimated losses being recorded in the consolidated statements of income in the period identified. Any increase in the accrual decreases income in the period, and any reduction in the accrual increases income during the period.

Although the Company retains Willis to assist management in estimating the appropriate accrual for these claims, professional liability claims are inherently uncertain, and the liability associated with anticipated claims is very difficult to estimate. 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 quarter. 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. A significant judgment entered against the Company in one or more legal actions could have a material adverse impact on the Company's financial position and cash flows.

The following summarizes the Company's accrual for professional liability and other claims for each policy year as of the end of the period:

	<b>Accrual at</b>	
	<b>December 31,</b>	
	<b>2008</b>	<b>2007</b>
Policy Year End March 9,		
2009	<b>\$ 3,837,000</b>	\$ —
2008	<b>5,769,000</b>	5,134,000
2007	<b>3,202,000</b>	7,625,000
2006	<b>1,102,000</b>	4,757,000
2005	<b>774,000</b>	2,339,000
2004 and earlier	<b>275,000</b>	820,000
	<b>\$ 14,959,000</b>	<b>\$ 20,675,000</b>

**ADVOCAT INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**DECEMBER 31, 2008, 2007 AND 2006**

The Company's cash expenditures for self-insured professional liability costs were \$6,754,000 and \$2,776,000 for the years ending December 31, 2008 and 2007, respectively. In December 2008, the Company entered into agreements to settle seven professional liability cases for \$4,300,000 including \$400,000 paid from insurance proceeds. The settlements will be paid in installments from December 2008 through March 2010, with an initial payment of \$1,630,000 in December 2008 and quarterly payments of \$440,000 to \$460,000 beginning the first quarter of 2009 and continuing through the first quarter of 2010. As of December 31, 2008, we are obligated to pay installments that total \$3,495,000 related to the December 2008 and other outstanding case settlements. The remaining obligation for these claims is fully accrued and included in the accrual for professional liability claims. In addition to these settlement payments, the Company will have throughout the year additional cash expenditures for other settlements and self-insured professional liability costs.

***Other Insurance***

With respect to workers' compensation insurance, substantially all of the Company's employees became covered under either an indemnity insurance plan or state-sponsored programs in May 1997. The Company is completely self-insured for workers' compensation exposures prior to May 1997. The Company has been and remains a non-subscriber to the Texas workers' compensation system and is, therefore, completely self-insured for employee injuries with respect to its Texas operations. The Company has provided reserves for the settlement of outstanding self-insured claims at amounts believed to be adequate. The liability recorded by the Company for the self-insured obligations under these plans is \$492,000 as of December 31, 2008.

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. The Company accounts for premium expense under these policies based on its estimate of the level of claims expected to be incurred, and had recorded insurance refunds receivable of \$1,234,000 as of December 31, 2007. During the year ending December 31, 2008, the Company received the proceeds of these insurance refunds. Any adjustments of future premiums for workers' compensation policies and differences between actual settlements and reserves for self-insured obligations are included in expense in the period finalized.

From July 1, 2007 through June 30, 2008, the Company had a guaranteed cost policy for workers' compensation insurance, under which expense was equal to the premiums paid. As a result, there will be no premium refunds for this policy period.

For the period from July 1, 2008 through June 30, 2009, the Company entered into a prefunded deductible workers' compensation 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. Any differences in estimated claims costs and actual amounts are included in expense in the period finalized.

Through December 31, 2008, the Company is self-insured for health insurance benefits for certain employees and dependents for amounts up to \$150,000 per individual annually. Effective January 1, 2009, the self insured level rose to \$160,000 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 \$1,230,000 at December 31, 2008. The differences between actual settlements and reserves are included in expense in the period finalized.

**ADVOCAT INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**DECEMBER 31, 2008, 2007 AND 2006**

**Employment Agreements**

The Company has employment agreements with certain members of management that provide for the payment to these members of amounts up to 2.5 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 approximately \$2,013,000 as of December 31, 2008. The terms of such agreements are from one to three years and automatically renew for one 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 the Company's common stock on December 31, 2008, the maximum contingent liability for the repurchase of the equity grants is approximately \$198,000. No amounts have been accrued for this contingent liability.

**Health Care Industry and Legal Proceedings**

The health care industry is subject to numerous laws and regulations of federal, state and local governments. These laws and regulations include, but are not necessarily limited to, matters such as licensure, accreditation, government health care program participation requirements, reimbursement for patient services, quality of resident care and Medicare and Medicaid fraud and abuse. Over the last several years, government activity has increased with respect to investigations and allegations concerning possible violations by health care providers of fraud and abuse statutes and regulations as well as laws and regulations governing quality of care issues in the skilled nursing profession in general. Violations of these laws and regulations could result in exclusion from government health care programs together with the imposition of significant fines and penalties, as well as significant repayments for patient services previously billed. Compliance with such laws and regulations is subject to ongoing government review and interpretation, as well as regulatory actions which may be unknown or unasserted at this time. The Company is involved in regulatory actions of this type from time to time. Additionally, changes in these laws and regulations, such as reimbursement policies of Medicare and Medicaid programs as a result of budget cuts by federal and state governments or other legislative and regulatory actions, could have a material adverse effect on the industry and the Company's financial position, results of operations, and cash flows.

All of the Company's nursing centers must be licensed by the state in which they are located in order to accept patients, regardless of payor source. In most states, nursing homes are subject to certificate of need laws, which require the Company to obtain government approval for the construction of new nursing homes or the addition of new licensed beds to existing homes. The Company's nursing centers must comply with detailed statutory and regulatory requirements on an ongoing basis in order to qualify for licensure, as well as for certification as a provider eligible to receive payments from the Medicare and Medicaid programs. Generally, the requirements for licensure and Medicare/Medicaid certification are similar and relate to quality and adequacy of personnel, quality of medical care, record keeping, dietary services, resident rights, and the physical condition of the facility and the adequacy of the equipment used therein. Each facility is subject to periodic inspections, known as "surveys" by health care regulators, to determine compliance with all applicable licensure and certification standards. Such requirements are both subjective and subject to change. If the survey concludes that there are deficiencies in compliance, the facility is subject to various sanctions, including but not limited to monetary fines and penalties, suspension of new admissions, non-payment for new admissions and loss of licensure or certification. Generally, however, once a facility receives written notice of any compliance deficiencies, it may submit a written plan of correction and is given a reasonable opportunity to correct the deficiencies. There can be no assurance that, in the future, the Company will be able to maintain such licenses and certifications for its facilities or that the Company will not be required to expend significant sums in order to comply with regulatory requirements.

As of December 31, 2008, the Company is engaged in 28 professional liability lawsuits. Eleven lawsuits are currently scheduled for trial, and it is expected that additional cases will be set for trial. The ultimate results of any of the Company's professional liability claims and disputes cannot be predicted. The Company has limited, and sometimes no, professional liability insurance with regard to most of these claims. A significant judgment entered against the Company in one or more of these legal actions could have a material adverse impact on the Company's financial position and cash flows.



**ADVOCAT INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**DECEMBER 31, 2008, 2007 AND 2006**

The Company has initiated litigation filed in the United States Bankruptcy Court for the Northern District of Texas against SMSA, Lyric Health Care Holdings, Inc., IHS Acquisition No. 128, Inc. and Lyric Health Care LLC adversary proceeding number 08-03393, seeking a declaratory judgment that the defendants are responsible for the overpayments claimed by CMS as described in Note 3. The claimed overpayments at issue occurred several years prior to the Company's purchase of the facility and the defendants are prior owners of the facility. In February 2009, the case was dismissed against SMSA, and dismissed without prejudice against Lyric Health Care Holdings, Inc., and Lyric Health Care LLC, (Together, "Lyric"). The Company intends to file a motion asking the court to alter, amend or reconsider its ruling against SMSA and depending on the outcome of that ruling, the Company may appeal the court's decision. The Company may also pursue its claims against Lyric in a new action in another appropriate court and will defend itself against this claimed overpayment. The outcome of this matter cannot be predicted, and the Company has recorded a liability equal to its estimate of its potential ultimate exposure for this CMS assessment and defense costs.

In January 2009, a purported class action complaint was filed in the Circuit Court of Garland County, Arkansas against the Company and certain of its subsidiaries and Garland Nursing & Rehabilitation Center (the "Facility"). The complaint alleges that the defendants breached their statutory and contractual obligations to the residents of the Facility over the past five years. The Company removed this lawsuit to the United States District Court for the Western District of Arkansas, case number 09-6008. The lawsuit is in its very early stages and has not yet been certified by the court as a class action. The Company cannot predict whether the action will remain in federal court, but it believes that the complaint is without merit and intends to defend the lawsuit vigorously.

The Company cannot currently predict with certainty the ultimate impact of any of the above cases on the Company's financial condition, cash flows or results of operations. In the course of the Company's business, it is periodically involved in governmental investigations, regulatory and administrative proceedings and lawsuits relating to its compliance with regulations and laws governing its operations, including reimbursement laws, fraud and abuse laws, elderly abuse laws, and state and federal false claims acts and laws governing quality of care issues. A finding of non-compliance with any of these governing laws or regulations in any such lawsuit, regulatory proceeding or investigation could have a material adverse impact on the Company's financial condition, cash flows or results of operations and could also subject it to fines, penalties and damages. Moreover, the Company could be excluded from the Medicare, Medicaid or other state or federally-funded health care programs, which would also have a material adverse impact on its financial condition, cash flows or results of operations.

### **Reimbursement**

Certain per person annual Medicare Part B reimbursement limits on therapy services became effective January 1, 2006. Subject to certain exceptions, the current limits impose a \$1,810 per patient annual ceiling on physical and speech therapy services, and a separate \$1,810 per patient annual ceiling on occupational therapy services. CMS established an exception process to permit therapy services in certain situations, and the majority of services provided by the Company are reimbursed under the exceptions. In July 2008, Congress passed the Medicare Improvements for Patients and Providers Act of 2008, which extends the exceptions process through December 31, 2009. If the exception process is discontinued after December 31, 2009, it is expected that the reimbursement limitations will reduce therapy revenues and negatively impact the Company's operating results and cash flows.

In December 2006, Congress passed the Tax Relief and Health Care Act of 2006 (TRHCA). The TRHCA reduces the maximum federal matching under Medicare provider assessments to 5.5% of aggregate Medicaid outlays. This reduction in funding became effective for fiscal years beginning after January 1, 2008. This change has not had a material impact on the Company's results of operations.

**ADVOCAT INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**DECEMBER 31, 2008, 2007 AND 2006**

Reduction in health care spending has become a national priority in the United States, and the field of health care regulation and reimbursement is a rapidly evolving one. CMS, after initially issuing a draft regulation that would have reduced Medicare payments to skilled nursing facilities by approximately 0.3% effective October 1, 2008, ultimately issued a final rule, providing for a 3.4% market basket increase. The 3.4% market basket increase was effective October 1, 2008. The actual amount of the market basket increase is based on several factors and varies for each individual center. It is estimated that the market basket adjustment will result in an average increase of approximately 3.5% for the Company's facilities as a group, increasing the Company's revenue by approximately \$200,000 per month based on current occupancy levels.

As a result of current economic conditions, several states in which the Company operates face budget shortfalls, which could result in reductions in Medicaid funding for nursing facilities. The federal government has recently made an effort to address the financial challenges state Medicaid programs are facing by increasing the amount of Medicaid funding available to states. On February 17, 2009, the "American Recovery and Reinvestment Act of 2009," ("ARRA") was enacted. Among other provisions, the ARRA provides \$87 billion for a temporary, 27 month, period to assist states in maintaining and expanding Medicaid enrollment. Under ARRA, each state will receive an increase in federal Medicaid match funding, which may be used by the states to mitigate rate freezes or rate cuts. At this point it is unclear how much of an impact ARRA will have on Medicaid payments in the states in which the Company operates as the decisions on the allocation of funding in these states have not been finalized, and the potential impact to the Company is unknown.

The Company is unable to predict what, if any, reform proposals or reimbursement limitations will be implemented in the future, or the effect such changes would have on its operations. For the year ended December 31, 2008, the Company derived 31.5% and 53.3% of its total patient and resident revenues related to continuing operations from the Medicare and Medicaid programs, respectively. Any health care reforms that significantly limit rates of reimbursement under these programs could, therefore, have a material adverse effect on its profitability.

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

**ADVOCAT INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**DECEMBER 31, 2008, 2007 AND 2006**

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

Selected quarterly financial information for each of the quarters in the years ended December 31, 2008 and 2007 is as follows:

<b>2008</b>	<b>Quarter</b>			
	<b>First</b>	<b>Second</b>	<b>Third</b>	<b>Fourth</b>
Net revenues	<u>\$ 71,466,000</u>	<u>\$ 70,845,000</u>	<u>\$ 72,206,000</u>	<u>\$ 74,280,000</u>
Professional liability expense (benefit) <sup>(1)</sup>	<u>(1,043,000)</u>	<u>1,401,000</u>	<u>278,000</u>	<u>1,022,000</u>
Net income from continuing operations	<u>3,101,000</u>	<u>709,000</u>	<u>674,000</u>	<u>1,286,000</u>
Income (loss) from discontinued operations	<u>(12,000)</u>	<u>(19,000)</u>	<u>(4,000)</u>	<u>—</u>
Net income for common stock	<u>\$ 3,003,000</u>	<u>\$ 604,000</u>	<u>\$ 584,000</u>	<u>\$ 1,200,000</u>
Basic net income per common share:				
Net income from continuing operations	<u>\$ 0.52</u>	<u>\$ 0.11</u>	<u>\$ 0.10</u>	<u>\$ 0.21</u>
Income (loss) from discontinued operations	<u>—</u>	<u>—</u>	<u>—</u>	<u>—</u>
Net income per common share	<u>\$ 0.52</u>	<u>\$ 0.11</u>	<u>\$ 0.10</u>	<u>\$ 0.21</u>
Diluted net income per common share:				
Net income from continuing operations	<u>\$ 0.50</u>	<u>\$ 0.11</u>	<u>\$ 0.10</u>	<u>\$ 0.21</u>
Income (loss) from discontinued operations	<u>—</u>	<u>(0.01)</u>	<u>—</u>	<u>—</u>
Net income per common share	<u>\$ 0.50</u>	<u>\$ 0.10</u>	<u>\$ 0.10</u>	<u>\$ 0.21</u>

<sup>(1)</sup> The Company's quarterly results are significantly affected by the amounts recorded for professional liability expense, as discussed further in Note 12. The amount of expense (benefit) recorded for professional liability in each quarter of 2008 is set forth in the table above.

**ADVOCAT INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**DECEMBER 31, 2008, 2007 AND 2006**

2007	Quarter			
	First	Second	Third	Fourth
Net revenues	\$ 54,592,000	\$ 55,381,000	\$ 63,884,000	\$ 71,204,000
Professional liability expense (benefit) <sup>(1)</sup>	423,000	(3,378,000)	(6,000)	1,298,000
Net income from continuing operations	1,380,000	4,261,000	2,021,000	1,824,000
Income (loss) from discontinued operations	(19,000)	(17,000)	(72,000)	9,000
Net income for common stock	\$ 1,275,000	\$ 4,158,000	\$ 1,863,000	\$ 1,747,000
Basic net income per common share:				
Net income from continuing operations	\$ 0.22	\$ 0.71	\$ 0.33	\$ 0.30
Loss from discontinued operations	—	—	(0.01)	—
Net income per common share	\$ 0.22	\$ 0.71	\$ 0.32	\$ 0.30
Diluted net income per common share:				
Net income from continuing operations	\$ 0.21	\$ 0.68	\$ 0.32	\$ 0.28
Income (loss) from discontinued operations	—	—	(0.02)	0.01
Net income per common share	\$ 0.21	\$ 0.68	\$ 0.30	\$ 0.29

<sup>(1)</sup> The Company's quarterly results are significantly affected by the amounts recorded for professional liability expense, as discussed further in Note 12. The amount of expense (benefit) recorded for professional liability in each quarter of 2007 is set forth in the table above.

## CORPORATE DATA/OFFICERS AND DIRECTORS

### *Corporate Offices*

Advocat Inc.  
1621 Galleria Boulevard  
Brentwood, Tennessee 37027  
615.771.7575  
615.771.7409 (fax)

### *Registrar and Transfer Agent*

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

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

### *Independent Registered Public Accounting Firm*

BDO Seidman, 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, 2008. A copy of the report is available to stockholders free of charge from the following:

Corporate Secretary  
Advocat 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.irinfo.com/avc>

### *Executive Officers*

William R. Council, III  
President and Chief Executive Officer

L. Glynn Riddle, Jr.  
Executive Vice President and Chief Financial Officer

Raymond L. Tyler, Jr.  
Senior Vice President of Nursing Home Operations

### *Directors*

Wallace E. Olson  
Chairman of the Board  
Advocat Inc.

Richard M. Brame  
Chief Financial Officer  
Covington Senior Living, LLC

William R. Council, III  
President and Chief Executive Officer  
Advocat Inc.

Robert Z. Hensley  
Business Consultant

Chad A. McCurdy  
Managing Partner  
Marlin Capital Partners, LLC

William C. O'Neil, Jr.  
Private Investor