



Advocat Inc.

ANNUAL REPORT
2009

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 may become the only viable option. We have chosen to focus our business on the skilled nursing centers sector 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 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:

Our Company achieved significant accomplishments in 2009, despite the pressures of a severe recession and the uncertainties of healthcare reform. For the first time in the history of Advocat, we initiated a quarterly cash dividend and during the year we distributed \$1.2 million to our common and preferred shareholders. As a result, our stock can attract a larger investor audience and we rewarded our patient and loyal stockholders. The payment of dividends was approved by the Board because of a strong flow of funds from operations. Funds from operations in 2009 was \$14.9 million which also was one of the best performances in our history and represented a 25% increase over 2008. With these funds we invested \$6.6 million in the maintenance and renovation of our facilities and reduced debt by \$7.6 million.

In 2009 we opened a state of the art facility in Paris, Texas which ushered in a new standard of care for the east Texas community. Our industry is dominated by old and outdated nursing homes and the reception to a modern building was very exciting.

Our goal is to be recognized as the leading high quality provider in every community in which we serve the elderly. To that end, we are committed to updating our facilities, which not only enhances our marketing efforts and attracts high quality staff members, but most of all improves the quality of services for our senior citizens. By the end of 2009 we completed renovations on thirteen facilities, which represent approximately 28% of our total homes. The resulting performances were a major contributor to overall corporate results, as indicated by an average return on invested capital of approximately 37%.

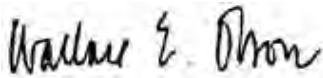
Another important driver of revenue and profitability is favorable patient mix. Medicare patients provide the highest daily average fees, especially the short-term post operative cases for which we deliver special therapeutic services. In 2009 we increased total occupancy and revenue but experienced a slight decline in Medicare average daily census. We believe this was directly related to the recession, which caused people to delay elective procedures and families to postpone placing their elderly in nursing homes. Furthermore, the skilled nursing home profession is facing the same pressures as all medical providers as the nation enters a new era of healthcare reform. However, skilled nursing facilities offer a diverse variety of quality inpatient care at remarkable discounts compared to hospitals and rehabilitation facilities. The demographics indicate that the growth in the senior population segment will continue for a number of years and steadily increase the demand for our services. Therefore, we are optimistic about our profession in general and particularly our business, with its strong financial position and excellent staff of dedicated employees.

Our goals for 2010 are:

- Continue our facility renovation projects.
- Improve our quality census and patient acuity mix.
- Contain costs.
- Review and revise the Company's website.
- Implement strategies intended to achieve a long-term reduction in professional liability exposure.
- Pursue acquisitions and other strategic growth opportunities.

One of our Company's greatest strengths is our strong cash flow, and we are working to maximize shareholder return from that cash flow.

We value your interest and investment in Advocat and look forward to reporting on our progress in 2010.



Wallace E. Olson
Chairman



William R. Council, III
President and CEO

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) and other specialty programming. 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 marketing efforts. Our objective is to increase occupancy in our nursing homes through improved physical plants and our 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 those patients covered by Medicare, Managed Care (including Health Maintenance Organizations (“HMO’s”) and Medicare replacement payors) as well as certain private pay individuals. 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 providing high quality patient 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 33 years as of December 31, 2009. 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. As of December 31, 2009, we have completed renovations at twelve facilities and have two additional projects in progress that we expect to complete in the first half of 2010. In January 2010, we celebrated the grand opening of our thirteenth renovation project, which included a 15 bed expansion to the nursing center. 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. Two of our most recent development projects are discussed below:

- *Texas Facility.* In August 2009, we completed the construction of a 119 bed leased skilled nursing facility, Brentwood Terrace, located in Paris, Texas, replacing an existing 102 bed leased facility. The new facility was financed with funding from our lessor, and is leased under a long term operating lease with renewal options through 2035. The daily census as of December 31, 2009 increased to 95 compared to 67 as of August 25, 2009, the day we moved into the new facility, and Medicare census increased to 10 compared to 7. For the fourth quarter of 2009, average daily census increased to 89 compared to 37 for the second quarter of 2008, when we began construction, and Medicare average daily census increased to over 10 from 3.
- *West Virginia Facility.* On June 17, 2009 we completed the acquisition of certain assets of a skilled nursing facility in West Virginia. We are currently seeking financing for the construction of a new 90 bed replacement facility. The existing facility closed in February 2009. No assurances can be given we will be able to 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, 2009, we operate 50 nursing centers containing 5,784 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, 2009:

	<u>Number of Centers</u>	<u>Licensed Nursing Beds ⁽¹⁾⁽²⁾</u>	<u>Available Nursing Beds ⁽¹⁾⁽²⁾</u>	<u>Assisted Living Units</u>
Operating Locations:				
Alabama	6	711	704	0
Arkansas	12	1,311	1,183	12
Florida ⁽³⁾	5	502	462	0
Kentucky	6	474	470	2
Ohio	1	151	122	0
Tennessee	5	617	586	0
Texas	13	1,868	1,676	0
West Virginia	<u>2</u>	<u>150</u>	<u>150</u>	<u>0</u>
	<u>50</u>	<u>5,784</u>	<u>5,353</u>	<u>14</u>
Classification:				
Owned	9	936	866	0
Leased	<u>41</u>	<u>4,848</u>	<u>4,487</u>	<u>14</u>
Total	<u>50</u>	<u>5,784</u>	<u>5,353</u>	<u>14</u>

⁽¹⁾ The number of "Licensed Nursing Beds" is based on the licensed capacity of the facility. The Company reports its occupancy based on licensed nursing beds. The number of "Available Nursing Beds" represents "Licensed Nursing Beds" less beds removed from service. "Available Nursing 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.

⁽²⁾ An additional 15 licensed beds were placed into service in a leased facility in Kentucky effective January 1, 2010.

⁽³⁾ The number of facilities in Florida decreased to 1 and licensed nursing beds and available nursing beds both decreased to 79 during 2010 upon expiration of the lease term for 4 facilities.

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. Eighteen 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-one 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 42 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, accounts receivable management and administration, all of whom are employed by us. The day-to-day operations of each of our nursing centers is led by an on-site, licensed administrator. The administrator of each nursing center is supported by other professional personnel, including a medical director, who assists in the medical management of the facility, and a director of nursing, who supervises a staff of registered nurses, licensed practical nurses and nurse aides. Other personnel include those providing therapy, dietary, activities and social service, housekeeping, laundry and maintenance and office services. All personnel at our facilities, including the administrators, are our employees.

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

Market Information. Our common stock 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 2008 and 2009:

Period	<u>High</u>	<u>Low</u>
2008 - 1st Quarter	\$ 12.54	\$ 9.67
2008 - 2nd Quarter	12.44	9.96
2008 - 3rd Quarter	10.86	2.86
2008 - 4th Quarter	4.99	1.55
2009 - 1st Quarter	3.78	1.96
2009 - 2nd Quarter	3.90	2.21
2009 - 3rd Quarter	7.27	2.67
2009 - 4th Quarter	8.94	5.33

Our common stock has been traded since May 10, 1994. On February 26, 2010, the closing price for our common stock was \$6.65, as reported by NASDAQ.com.

Holders. On February 26, 2010, there were approximately 252 holders of record of our common stock. Most of our shareholders have their holdings in the street name of their broker/dealer.

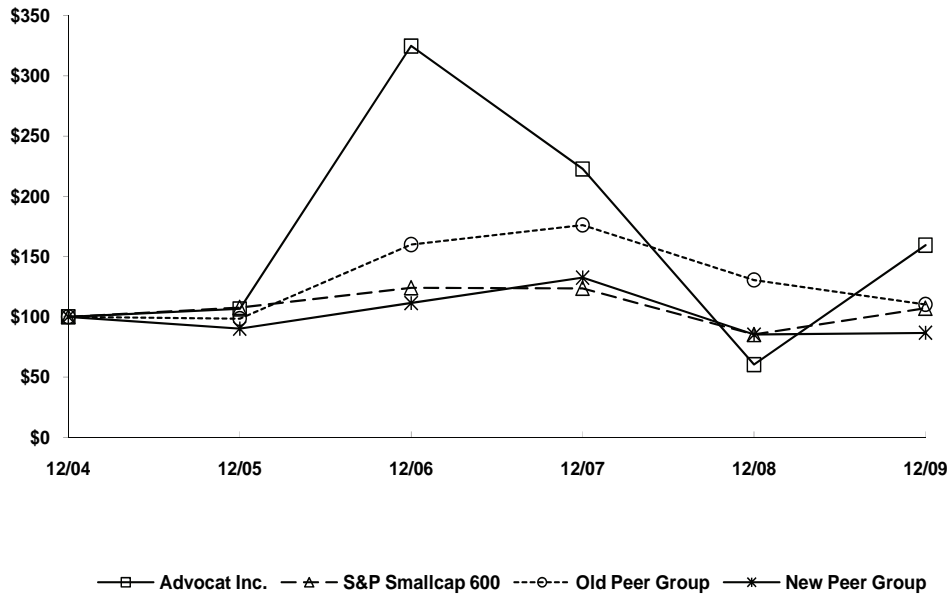
Dividends. We did not pay cash dividends on our Common Stock until 2009. On August 5, 2009, the Board of Directors approved the payment of a \$0.05 per common share quarterly dividend commencing with the quarter ended June 30, 2009. While the Board of Directors intends to pay quarterly dividends, the Board will make the determination of the amount of future cash dividends, if any, to be declared and paid based on, among other things, the Company's financial condition, funds from operations, the level of its capital expenditures and its future business prospects. We are required to pay an annual dividend at a rate of 7% of the stated value on our outstanding Series C Preferred Stock, payable quarterly. As a result, we pay a quarterly dividend of \$86,000 on the outstanding Series C Preferred Stock.

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

The graph below compares the cumulative 5-year total return of holders of Advocat Inc.'s common stock with the cumulative total returns of the S & P Smallcap 600 index, and a customized peer group of four companies that includes Kindred Healthcare Inc., National Healthcare Corp., Skilled Healthcare Group Inc. and Sun Healthcare Group Inc. The old peer group included 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 12/31/2004 to 12/31/2009.

COMPARISON OF 5 YEAR CUMULATIVE TOTAL RETURN*

Among Advocat Inc., The S&P Smallcap 600 Index,
An Old PeerGroup And A New Peer Group



*\$100 invested on 12/31/04 in stock or index, including reinvestment of dividends.
Fiscal year ending December 31.

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

SELECTED 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.

	Year Ended December 31,				
	2009	2008	2007	2006	2005
Statement of Operations Data	(in thousands, except per share amounts)				
REVENUES:					
Patient revenues, net	\$ 302,031	\$ 287,607	\$ 243,907	\$ 213,594	\$ 199,859
EXPENSES:					
Operating	240,095	227,633	186,957	162,747	152,506
Lease	23,422	22,962	20,019	16,082	15,836
Professional liability	9,132	1,658	(1,663)	(5,354)	(4,532)
General and administrative	18,496	18,486	17,552	21,032	13,311
Depreciation and amortization	5,999	5,306	4,093	3,614	3,454
	<u>297,144</u>	<u>276,045</u>	<u>226,958</u>	<u>198,121</u>	<u>180,575</u>
OPERATING INCOME	4,887	11,562	16,949	15,473	19,284
OTHER INCOME (EXPENSE):					
Foreign currency transaction gain (loss)	191	(1,005)	808	21	161
Other income	549	—	—	207	—
Interest income	161	454	1,016	679	534
Interest expense	(1,877)	(2,870)	(3,549)	(3,707)	(3,382)
Debt retirement costs	—	—	(116)	(194)	—
	<u>(976)</u>	<u>(3,421)</u>	<u>(1,841)</u>	<u>(2,994)</u>	<u>(2,687)</u>
INCOME FROM CONTINUING OPERATIONS BEFORE INCOME TAXES	3,911	8,141	15,108	12,479	16,597
(PROVISION) BENEFIT FOR INCOME TAXES	(1,497)	(2,759)	(6,012)	9,510	13,839
NET INCOME FROM CONTINUING OPERATIONS	2,414	5,382	9,096	21,989	30,436
DISCONTINUED OPERATIONS, net of taxes	187	353	291	(45)	(5,134)
NET INCOME	<u>\$ 2,601</u>	<u>\$ 5,735</u>	<u>\$ 9,387</u>	<u>\$ 21,944</u>	<u>\$ 25,302</u>
INCOME (LOSS) PER COMMON SHARE:					
Basic-					
Continuing operations	\$ 0.37	\$ 0.89	\$ 1.49	\$ 3.74	\$ 5.26
Discontinued operations	0.03	0.06	0.05	—	(0.90)
Net per common share	<u>\$ 0.40</u>	<u>\$ 0.95</u>	<u>\$ 1.54</u>	<u>\$ 3.74</u>	<u>\$ 4.36</u>
Diluted-					
Continuing operations	\$ 0.36	\$ 0.86	\$ 1.43	\$ 3.35	\$ 4.67
Discontinued operations	0.03	0.06	0.05	—	(0.79)
Net per common share	<u>\$ 0.39</u>	<u>\$ 0.92</u>	<u>\$ 1.48</u>	<u>\$ 3.35</u>	<u>\$ 3.88</u>
CASH DIVIDENDS DECLARED PER COMMON SHARE	<u>\$ 0.15</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ —</u>
WEIGHTED AVERAGE COMMON SHARES:					
Basic	<u>5,678</u>	<u>5,693</u>	<u>5,870</u>	<u>5,784</u>	<u>5,725</u>
Diluted	<u>5,797</u>	<u>5,887</u>	<u>6,127</u>	<u>6,507</u>	<u>6,498</u>
	December 31,				
	2009	2008	2007	2006	2005
Balance Sheet Data	(in thousands)				
Working capital (deficit)	\$ 12,334	\$ 10,885	\$ 15,677	\$ 8,174	\$ (39,970)
Total assets	\$ 105,266	\$ 107,339	\$ 110,090	\$ 96,901	\$ 93,762
Short-term borrowings and long-term debt including current portion	\$ 24,829	\$ 32,410	\$ 34,455	\$ 31,516	\$ 47,547
Preferred Stock – Series B	—	—	—	—	\$ 4,750
Preferred Stock – Series C (including unamortized premium)	\$ 6,192	\$ 7,891	\$ 9,590	\$ 11,289	—
Shareholders' Equity (deficit)	\$ 19,693	\$ 17,551	\$ 12,744	\$ 3,837	\$ (16,870)

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 United States. Our centers provide a range of health care services to their patients. 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, 2009, our continuing operations consist of 50 nursing centers with 5,784 licensed nursing beds and 14 assisted living units. As of December 31, 2009, our continuing operations included nine owned nursing centers and 41 leased nursing centers.

2007 Acquisition and New Lease. Effective August 11, 2007, we purchased the leasehold interests and operations of seven skilled nursing facilities from SMSA for an initial purchase price of approximately \$10.0 million. These facilities include 1,266 licensed nursing beds, with 1,105 beds currently available for use. Effective November 1, 2007, we entered into an agreement to lease a single facility with Omega in Texas. During 2009, we completed the construction of a 119 bed leased skilled nursing facility as a replacement of this single lease facility. These facilities are in our existing geographic and operational footprint and together are referred to as the "New Texas Facilities."

Divestitures

The CMS issued regulations that became effective October 1, 2009 that prohibit us from billing Medicare Part B for certain enteral nutrition, urological, ostomy and tracheostomy supplies. Beginning October 1, these services were provided by third parties. We are still required to provide the labor for the delivery of services but will no longer be a supplier and will not be entitled to any compensation. These regulations will result in reductions of annual revenue and net income of approximately \$1.3 million and \$0.3 million, respectively. The revenue and cost of goods sold for providing these services prior to October 2009 has been reclassified as discontinued operations.

The net assets of discontinued operations presented on the balance sheet represent the real estate related to an assisted living facility in North Carolina closed in April 2006. The Company is continuing its efforts to sell this land. Effective March 31, 2007, we terminated operations at our leased facility in Eureka Springs, Arkansas. The owner of the property, a subsidiary of Omega, sold the property and we cooperated in an orderly transition to the new owner. We have reclassified the operations of this Arkansas facility and the real estate described above as discontinued operations for all periods presented in our consolidated financial statements.

Effective March 31, 2010, we terminated operations of four nursing centers in Florida under a lease that, as amended, was to expire in August 2010. The operating margins of the four facilities subject to this lease did not meet our goals. These four homes contributed revenues of \$25.1 million, \$23.8 million and \$24.0 million and net income of \$0.5 million, \$1.1 million and \$1.6 million in the years ended December 31, 2009, 2008 and 2007 respectively. The facilities are, on average, 50 years old (including three of our ten oldest facilities), and have several structural limitations that significantly impair marketing ability in the very competitive marketplace in Florida. The challenges include multiple three- and four-bed wards (a total of 61 wards representing 223 licensed beds, or approximately 53% of total licensed beds for these facilities) and limited common areas, parking and therapy space. Three of the 4 buildings are substantially "landlocked", without the ability to expand to eliminate the structural challenges. The fourth building is in an economically challenged area of town. We believe these buildings will require replacement or extensive capital investment to remain competitive over the next five to ten years. In the near term, prospects for future reimbursement increases in Florida are limited, as the state of Florida faces multi-billion dollar deficits.

In 2009, the average occupancy of these facilities was 78.5%, compared to 76.7% for us as a whole. Medicare census was 8.7% of total census for these four facilities, compared to 12.7% for us as a whole. As a result of the low Medicare census, operating margins for these facilities are lower than average, and operating expenses were 82.2% of revenue for these four facilities, compared to an average of 79.5% for us as a whole.

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

We initiated discussions with Omega to indicate the terms under which we would be prepared to enter into a long term extension of this lease at a reduced lease rate and participation in the long term project of replacing these facilities with a competitive offering. Omega elected to evaluate the market and requested a short term extension of the existing lease to pursue opportunities. We agreed to extend the lease through August 2010 on a monthly basis until a replacement tenant or buyer could be put into place. Effective March 31, 2010, we terminated operations at these leased facilities as the lessor transferred operations to a new lessee effective April 1, 2010. We cooperated in an orderly transition to the new operator. These facilities are included in continuing operations at December 31, 2009. We will reclassify the operations of these facilities to discontinued operations effective March 31, 2010.

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

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

Selected Financial and Operating Data

The following table summarizes the Advocat statements of continuing operations for the years ended December 31, 2009, 2008 and 2007, and sets forth this data as a percentage of revenues for the same years.

	Year Ended December 31,					
	2009		2008		2007	
	(Dollars in thousands)					
Revenues:						
Patient revenues, net	\$ 302,031	100.0%	\$ 287,607	100.0%	\$ 243,907	100.0%
Expenses:						
Operating	240,095	79.5	227,633	79.1	186,957	76.7
Lease	23,422	7.8	22,962	8.0	20,019	8.2
Professional liability	9,132	3.0	1,658	0.6	(1,663)	(0.7)
General & administrative	18,496	6.1	18,486	6.4	17,552	7.2
Depreciation and amortization	5,999	2.0	5,306	1.9	4,093	1.7
	<u>297,144</u>	<u>98.4</u>	<u>276,045</u>	<u>96.0</u>	<u>226,958</u>	<u>93.1</u>
Operating income	<u>4,887</u>	<u>1.6</u>	<u>11,562</u>	<u>4.0</u>	<u>16,949</u>	<u>6.9</u>
Other income (expense):						
Foreign currency transaction gain (loss)	191	0.1	(1,005)	(0.4)	808	0.3
Other income	549	0.2	—	—	—	—
Interest income	161	—	454	0.2	1,016	0.5
Interest expense	(1,877)	(0.6)	(2,870)	(1.0)	(3,549)	(1.4)
Debt retirement costs	—	—	—	—	(116)	(0.1)
	<u>(976)</u>	<u>(0.3)</u>	<u>(3,421)</u>	<u>(1.2)</u>	<u>(1,841)</u>	<u>(0.7)</u>
Income from continuing operations before income taxes	3,911	1.3	8,141	2.8	15,108	6.2
Provision for income taxes	(1,497)	(0.5)	(2,759)	(1.0)	(6,012)	(2.5)
Net income from continuing operations	<u>\$ 2,414</u>	<u>0.8%</u>	<u>\$ 5,382</u>	<u>1.8%</u>	<u>\$ 9,096</u>	<u>3.7%</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:

	December 31,		
	2009	2008	2007
Licensed Nursing Home Beds:			
Owned	936	942	942
Leased ⁽³⁾	4,848	4,831	4,831
Total	<u>5,784</u>	<u>5,773</u>	<u>5,773</u>
Assisted Living Units:			
Owned	—	—	17
Leased	14	14	49
Total	<u>14</u>	<u>14</u>	<u>66</u>
Total Beds/Units:			
Owned	936	942	959
Leased	4,862	4,845	4,880
Total	<u>5,798</u>	<u>5,787</u>	<u>5,839</u>
Facilities:			
Owned	9	9	9
Leased	41	41	41
Total	<u>50</u>	<u>50</u>	<u>50</u>
Average Occupancy:			
Nursing centers	76.7%	75.3% ⁽¹⁾	77.6% ⁽²⁾
Assisted living units	72.8%	64.3%	63.1
Total	<u>76.7%</u>	<u>75.2%</u>	<u>77.4%</u>

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

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

⁽³⁾ An additional 15 beds were placed into service in a leased facility effective January 1, 2010.

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%, 84.9% and 86.9% for 2009, 2008 and 2007, respectively). Medicare intermediaries make retroactive adjustments based on changes in allowed claims. In addition, certain of the states in which we operate require complicated detailed cost reports which are subject to review and adjustments. In the opinion of management, adequate provision has been made for adjustments that may result from such reviews. Retroactive adjustments, if any, are recorded when objectively determinable, generally within three years of the close of a reimbursement year depending upon the timing of appeals and third-party settlement reviews or audits.

Allowance for Doubtful Accounts

We evaluate the collectability of our accounts receivable by reviewing current aging summaries of accounts receivable, historical collections data and other factors. As a percentage of revenue, our provision for doubtful accounts was approximately 0.7%, 0.8% and 0.5% for 2009, 2008 and 2007, 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 \$18.5 million as of December 31, 2009. 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
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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 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 the Company's accrual for professional liability and other claims for each policy year as of the end of the period:

Policy Year End:	Accrual at	
	December 31, 2009	December 31, 2008
May 31, 2010	\$ 3,763,000	\$ –
March 9, 2009	8,713,000	3,837,000
March 9, 2008	4,377,000	5,769,000
March 9, 2007	1,060,000	3,202,000
March 9, 2006	357,000	1,102,000
March 9, 2005 and earlier	232,000	1,049,000
	\$ 18,502,000	\$ 14,959,000

The Company's cash expenditures for self-insured professional liability costs were \$4.9 million, \$6.8 million and \$2.8 million for the years ended December 31, 2009, 2008 and 2007, respectively.

Although we retain a third-party actuarial firm to assist us, professional and general liability claims are inherently uncertain, and the liability associated with anticipated claims is very difficult to estimate. As a result, our actual liabilities may vary significantly from the accrual, and the amount of the accrual has and may continue to fluctuate by a material amount in any given quarter.

Professional liability costs are material to our financial position, and changes in estimates, as well as differences between estimates and the ultimate amount of loss, may cause a material fluctuation in our reported results of operations. Our professional liability expense was \$9.1 million and \$1.7 million for the years ended December 31, 2009 and 2008, respectively, compared to a negative expense of \$1.7 million for the year ended December 31, 2007, with the negative amount 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 \$2.4 million, \$5.4 million and \$9.1 million, respectively. The total liability recorded at December 31, 2009, was \$18.5 million, compared to current assets of \$41.7 million and total assets of \$105.3 million.

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. 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.

For the period from July 1, 2008 through June 30, 2010, we entered into a series of annual prefunded deductible workers' compensation policies. Under these policies, 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 expected to be incurred, subject to the policy deductibles. 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 \$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 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 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 have no assets recorded at fair value; however, our asset impairment analysis is consistent with the fair value measurements described in the accounting guidance for "*Fair Value Measurements and Disclosures*." We did not record any asset impairments in 2009, 2008 or 2007. 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

Effective January 1, 2009, we adopted the new accounting guidance on "*Business Combinations*" which established 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. The new guidance also establishes disclosure requirements to enable the evaluation of the nature and financial effects of the business combination. During the fourth quarter of 2008, we expensed \$202,000 in acquisition costs related to the transaction discussed in Note 3 of the Consolidated Financial Statements. Under the business combination accounting guidance in effect prior to January 1, 2009, these costs were considered part of the purchase price and as such were capitalized, but effective January 1, 2009 the accounting guidance required these costs be expensed as incurred. The SMSA Acquisition in 2007 has been accounted for as a purchase business combination under the previous guidance. Both the current and previous guidance require that we make certain valuations to determine the fair value of assets acquired and the liabilities assumed. These valuations are subject to retroactive adjustment during the twelve month period subsequent to the acquisition date. Such valuations require us to make significant estimates, judgments and assumptions, including projections of future events and operating performance.

**MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION
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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 the years ended December 31, 2009, 2008 and 2007, we recorded charges of approximately \$0.7 million, \$0.9 million and \$0.6 million in stock-based compensation, respectively. Stock-based compensation expense is a non-cash expense and such amounts are included as a component of general and administrative expense or operating expense based upon the classification of cash compensation paid to the related employees.

Income Taxes

We determine deferred tax assets and liabilities based upon differences between financial reporting and tax bases of assets and liabilities and measure them using the enacted tax laws that will be in effect when the differences are expected to reverse. We maintain a valuation allowance of approximately \$0.9 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. We follow the relevant guidance found in the FASB codification, accounting for uncertainty in income taxes. The guidance provides information and procedures for financial statement recognition and measurement of tax positions taken, or expected to be taken, in tax returns.

Contractual Obligations and Commercial Commitments

We have certain contractual obligations of continuing operations as of December 31, 2009, 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>1 to 3 Years</u>	<u>3 to 5 Years</u>	<u>After 5 Years</u>
Long-term debt obligations (1)	\$ 26,310	\$ 3,186	\$ 23,124	\$ —	\$ —
Settlement Obligations (2)	\$ 735	\$ 735	\$ —	\$ —	\$ —
Series C Preferred Stock (3)	\$ 5,176	\$ 5,176	\$ —	\$ —	\$ —
Elimination of Preferred Stock Conversion feature (4)	\$ 6,009	\$ 687	\$ 1,374	\$ 1,374	\$ 2,574
Operating leases	\$ 599,088	\$ 22,285	\$ 45,577	\$ 47,822	\$ 483,404
Required capital expenditures under mortgage loans and operating leases (5)	\$ 23,631	\$ 671	\$ 983	\$ 840	\$ 21,137
Total	\$ 660,949	\$ 32,740	\$ 71,058	\$ 50,036	\$ 507,115

- (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 that will be paid in 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 to Omega for the elimination of the preferred stock conversion feature in connection with restructuring the preferred stock and master lease agreements. Monthly payments of approximately \$57,000 will be made through the end of the initial lease period that ends in September 2018.
- (5) Includes annual expenditure requirements for capital maintenance under mortgage loan covenants and annual capital expenditure requirements under operating leases.

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

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 \$1.8 million as of December 31, 2009. 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, 2009, the maximum contingent liability for the repurchase of the equity grants is approximately \$0.8 million. No amounts have been accrued for this contingent liability.

Payor Sources

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

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

	<u>Year Ended December 31,</u>					
	<u>2009</u>		<u>2008</u>		<u>2007</u>	
Medicaid	\$165,445	54.8%	\$154,048	53.6%	\$136,694	56.0%
Medicare	90,700	30.0	89,900	31.3	75,252	30.9
Managed care	8,070	2.7	6,902	2.4	3,527	1.5
Private Pay and other	<u>37,816</u>	<u>12.5</u>	<u>36,757</u>	<u>12.7</u>	<u>28,434</u>	<u>11.6</u>
Total	<u>\$302,031</u>	<u>100.0%</u>	<u>\$287,607</u>	<u>100.0%</u>	<u>\$243,907</u>	<u>100.0%</u>

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

**MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION
AND RESULTS OF 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, acquisitions and a new lease agreement. We have reclassified our Consolidated Financial Statements to present certain divestitures as discontinued operations for all periods presented. We have also defined our same center operations in our 2008 and 2007 comparative years in light of these transactions. Same center information excludes the operations of the New Texas Facilities and all discontinued operations.

(in thousands)	Year Ended December 31,			
	2009	2008	Change	%
PATIENT REVENUES, net	\$302,031	\$ 287,607	\$ 14,424	5.0%
EXPENSES:				
Operating	240,095	227,633	12,462	5.5%
Lease	23,422	22,962	460	2.0%
Professional liability	9,132	1,658	7,474	450.8%
General and administrative	18,496	18,486	10	0.1%
Depreciation and amortization	5,999	5,306	693	13.1%
Total expenses	297,144	276,045	21,099	7.6%
OPERATING INCOME	4,887	11,562	(6,675)	(57.7)%
OTHER INCOME (EXPENSE):				
Foreign currency transaction gain (loss)	191	(1,005)	1,196	119.0%
Other income	549	—	549	—
Interest income	161	454	(293)	(64.5)%
Interest expense	(1,877)	(2,870)	993	34.6%
	(976)	(3,421)	2,445	71.5%
INCOME FROM CONTINUING OPERATIONS BEFORE INCOME TAXES	3,911	8,141	(4,230)	(52.0)%
PROVISION FOR INCOME TAXES	(1,497)	(2,759)	(1,262)	(45.7)%
NET INCOME FROM CONTINUING OPERATIONS	\$ 2,414	\$ 5,382	\$ (2,968)	(55.1)%

(in thousands)	Year Ended December 31,			
	2008	2007	Change	%
PATIENT REVENUES, net	\$ 287,607	\$ 243,907	\$ 43,700	17.9%
EXPENSES:				
Operating	227,633	186,957	40,676	21.8%
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	276,045	226,958	49,087	21.6%
OPERATING INCOME	11,562	16,949	(5,387)	(31.8)%
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%
	(3,421)	(1,841)	(1,580)	(85.8)%
INCOME FROM CONTINUING OPERATIONS BEFORE INCOME TAXES	8,141	15,108	(6,967)	(46.1)%
PROVISION FOR INCOME TAXES	(2,759)	(6,012)	(3,253)	(54.1)%
NET INCOME FROM CONTINUING OPERATIONS	\$ 5,382	\$ 9,096	\$ (3,714)	(40.8)%

**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. Same center information excludes the operations of the New Texas Facilities and all discontinued operations.

<u>SAME CENTER</u> (in thousands)	<u>Year Ended December 31,</u>			
	<u>2008</u>	<u>2007</u>	<u>Change</u>	<u>%</u>
PATIENT REVENUES, net	\$ 234,941	\$ 224,476	\$ 10,465	4.7%
EXPENSES:				
Operating	180,356	170,007	10,349	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>222,604</u>	<u>207,308</u>	<u>15,296</u>	<u>7.4%</u>
OPERATING INCOME	<u>12,337</u>	<u>17,168</u>	<u>(4,831)</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>\$ 9,474</u>	<u>\$ 15,702</u>	<u>\$ (6,228)</u>	<u>(39.7)%</u>

Year Ended December 31, 2009 Compared With Year Ended December 31, 2008

Patient Revenues

Patient revenues increased to \$302.0 million in 2009 from \$287.6 million in 2008, an increase of \$14.4 million, or 5.0%. This increase is primarily due to increased Medicaid rates in certain states, increased Medicaid, private and Managed Care census, and Medicare rate increases in the first nine months of 2009 compared to 2008, partially offset by the effects of lower Medicare census and a Medicare rate reduction effective October 1, 2009.

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

	<u>Year Ended</u> <u>December 31,</u>	
	<u>2009</u>	<u>2008</u>
Skilled nursing occupancy	76.7%	75.3%
Medicare census as percent of total	12.7%	13.3%
Managed care census as percent of total	1.3%	1.2%
Medicare revenues as percent of total	30.0%	31.3%
Medicaid revenues as percent of total	54.8%	53.6%
Managed care revenues as percent of total	2.7%	2.4%
Medicare average rate per day	\$398.88	\$386.30
Medicaid average rate per day	\$146.05	\$139.45
Managed care average rate per day	\$372.76	\$343.73

The Company's average rate per day for Medicare Part A patients increased 3.3% in 2009 compared to 2008 as a result of the annual inflation adjustment that was effective October 1, 2008 and the acuity levels of Medicare patients in our nursing centers, as indicated by RUG level scores, which were higher in 2009 than in 2008. However, effective October 1, 2009, CMS reduced Medicare rates approximately 1.1%. Our average rate per day for Medicaid patients increased 4.7% in 2009 compared to 2008 as a result of rate increases in certain states, partially funded by increased provider taxes, and increasing patient acuity levels. Taking higher provider taxes into consideration, the net increase in the average Medicaid rate per day was 3.6%.

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

Operating expense

Operating expense increased to \$240.1 million in 2009 from \$227.6 million in 2008, an increase of \$12.5 million, or 5.5%. This increase is primarily attributable to cost increases related to wages and benefits and other costs discussed below. Operating expense increased to 79.5% of revenue in 2009, compared to 79.1% of revenue in 2008.

The largest component of operating expenses is wages, which increased to \$147.2 million in 2009 from \$138.9 million in 2008, an increase of \$8.3 million, or 6.0%. Wages increased primarily as a result of labor costs associated with increases in census and patient acuity levels, competitive labor markets in most of the areas in which we operate and regular merit and inflationary raises for personnel (increase of approximately 2.4% for the period). Wages also increased \$0.4 million in 2009 as a result of increased dietary, laundry and housekeeping employees hired in 2008 following the termination of an outsourcing contract for these services at eight facilities.

Employee health insurance costs were approximately \$1.6 million higher in 2009 compared to 2008, an increase of 23.7%. The Company is self insured for the first \$160,000 in claims per employee each year, and we experienced a higher level of costs during the 2009 period. Employee health insurance costs can vary significantly from year to year, and we evaluate the provisions of these plans annually. Effective January 1, 2010, we implemented changes to our health insurance plans to increase employee-paid premiums and deductibles, which is expected to reduce the level of future cost increases borne by the Company.

Provider taxes increased approximately \$1.8 million in 2009, primarily due to new rate legislation in Florida. Effective April 1, 2009, Florida enacted a provider tax that resulted in increases in the Medicaid rate for facilities in that state.

As part of the transition to the newly constructed Brentwood Terrace replacement facility, we incurred approximately \$0.2 million in increased operating costs. The increased operating costs were a result of additional wages, maintenance, advertising and travel related to the transition of residents and operations to the new building and the increase in census at this new building. For the fourth quarter of 2009, average daily census increased to 89 compared to 37 for the second quarter of 2008, when we began construction and Medicare average daily census increased to over 10 compared to 3.

The above increases were offset by a reduction in workers' compensation insurance expense of approximately \$0.9 million in 2009. We had better claims experience in 2009, resulting in lower expense.

The remaining increases in operating expense are primarily due to the effects of increases in patient acuity levels as indicated by RUG level scores, which were higher in 2009, resulting in greater costs to care for these patients.

Lease expense

Lease expense increased to \$23.4 million in 2009 from \$23.0 million in 2008. The primary reason for the increase in lease expense was rent increases for lessor funded property renovations and the recently completed Brentwood Terrace replacement facility. Initial quarterly rent expense for Brentwood Terrace is approximately \$0.2 million per quarter and accounted for \$0.3 million of the increase in 2009 for the three and a half months the new facility was open.

Professional liability

Professional liability expense increased to \$9.1 million in 2009 from \$1.7 million in 2008, an increase of \$7.4 million. We were engaged in 33 professional liability lawsuits as of December 31, 2009, compared to 28 as of December 31, 2008. Our cash expenditures for professional liability costs were \$4.9 million and \$6.8 million for 2009 and 2008, respectively. Professional liability cash expenditures can fluctuate from year to year.

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

General and administrative expense

General and administrative expense was approximately \$18.5 million in 2009, unchanged from 2008. As a percentage of revenue, general and administrative expense decreased to 6.1% in 2009 from 6.4% in 2008. There was an increase of approximately \$0.3 million increase in wages, as well as higher costs of approximately \$0.2 million incurred in connection with the solicitation of proxies for our annual shareholders' meeting. These increases were offset by decreases in travel costs and stock-based compensation costs. Effective January 1, 2009, we instituted a wage freeze for our corporate and regional management teams, with reduced wage increases for the balance of our employees. These policies have been extended in 2010 and will be reevaluated as business and economic conditions merit.

Depreciation and amortization

Depreciation and amortization expense was approximately \$6.0 million in 2009 and \$5.3 million in 2008. The increase in 2009 is primarily due to depreciation and amortization expenses related to capital expenditures for additions to property and equipment.

Foreign currency transaction gain (loss).

A foreign currency transaction gain of \$191,000 was recorded in 2009 compared to a loss of \$1.0 million in 2008. Such losses result primarily from foreign currency translation of a note receivable from the sale of our Canadian operations in 2004. The balance due on this note was collected in June 2009.

Other income

Other income of \$549,000 is a non-cash gain that is the result of the settlement of pre-acquisition cost report obligations related to one of the homes we acquired in Texas in 2007. We had previously recorded a contingent liability related to cost report assessments and the other income results from the settlement of this liability with CMS for less than the amount accrued.

Interest expense

Interest expense decreased to \$1.9 million in 2009 compared to \$2.9 million in 2008. The reduction in expense is due to principal payments made during 2009 and 2008 and reductions in variable interest rates.

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 \$3.9 million in 2009 compared to income of \$8.1 million in 2008. The provision for income taxes was \$1.5 million in 2009, an effective rate of 38.3%, compared to \$2.8 million in 2008, an effective rate of 33.9%. During 2008, our income taxes were reduced by carryforward credits we generated under the Work Opportunity Tax Credit program in years prior to 2001. The basic and diluted income per common share from continuing operations were \$0.37 and \$0.36, respectively, in 2009, as compared to a basic and diluted income per common share from continuing operations of \$0.89 and \$0.86, respectively, in 2008.

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

As noted in the overview, we completed the SMSA Acquisition and entered into a lease for an additional facility in Texas during 2007. 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
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Patient Revenues. Patient revenues increased to \$287.6 million in 2008 from \$243.9 million in 2007, an increase of \$43.7 million, or 17.9%. Revenues related to the New Texas Facilities were \$52.7 million in 2008 and \$19.4 million in 2007. Same center patient revenues increased to \$234.9 million in 2008 from \$224.5 million in 2007, an increase of \$10.4 million, or 4.7%. 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	77.9%	78.8%
New Texas Facilities	66.8%	67.4%
Total continuing operations	75.3%	77.6%
Medicare census as percent of total:		
Same center	13.7%	13.8%
New Texas Facilities	11.7%	12.9%
Total continuing operations	13.3%	13.7%
Medicare revenues as percent of total:		
Same center	31.1%	30.5%
New Texas Facilities	31.9%	34.7%
Total continuing operations	31.3%	30.9%
Medicaid revenues as percent of total:		
Same center	55.1%	57.0%
New Texas Facilities	46.8%	44.8%
Total continuing operations	53.6%	56.0%
Medicare average rate per day:		
Same center	\$383.15	\$351.80
New Texas Facilities	\$400.05	\$390.54
Total continuing operations	\$386.30	\$355.11
Medicaid average rate per day:		
Same center	\$145.37	\$140.13
New Texas Facilities	\$114.87	\$110.69
Total continuing operations	\$139.45	\$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 \$227.6 million in 2008 from \$187.0 million in 2007, an increase of \$40.6 million, or 21.8%. Operating expense related to the New Texas Facilities was \$47.2 million in 2008 and \$17.0 million in 2007. Same center operating expense increased to \$180.4 million in 2008 from \$170.0 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 76.8% of revenue in 2008, compared to 75.7% 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 areas in which we operate, regular merit

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

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 helped us save approximately \$0.7 million in operating expense in 2009.

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 previous guidance, these costs were considered part of the purchase price and appropriately capitalized, but under current guidance they are expensed as incurred. During 2008, in connection with this 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 helped us save approximately \$0.2 million in general and administrative expense in 2009. 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.

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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 \$8.1 million in 2008 compared to \$15.1 million in 2007. The provision for income taxes was \$2.8 million in 2008, an effective rate of 33.9%, compared to \$6.0 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 \$0.89 and \$0.86, respectively, in 2008, as compared to a basic and diluted income per common share from continuing operations of \$1.49 and \$1.43, respectively, in 2007.

Liquidity and Capital Resources

Liquidity

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

Net cash provided by operating activities of continuing operations totaled \$12.1 million, \$9.1 million and \$12.1 million in 2009, 2008 and 2007, respectively. Operating activities of discontinued operations provided cash of \$0.3 million, \$0.4 million and \$0.6 million in 2009, 2008 and 2007, respectively.

Investing activities of continuing operations used cash of \$9.2 million, \$9.9 million and \$14.1 million in 2009, 2008 and 2007, respectively. These amounts primarily represent cash used for purchases of property, plant and equipment. We have used between \$6.6 million and \$9.7 million for capital expenditures of continuing operations in each of the three calendar years ended December 31, 2009. These uses of cash were partially offset by collections on a note receivable of \$4.2 million, \$0.8 million and \$0.7 million in 2009, 2008 and 2007, respectively. The \$6.9 million and \$0.8 million in "payment for construction in progress – leased facility" in 2009 and 2008, respectively, relate to the replacement facility that was constructed in Texas with lease financing. During the third quarter 2009, the facility was completed and the sale and leaseback of the Brentwood Terrace facility was deemed to have occurred.

Financing activities of continuing operations used cash of \$2.2 million and \$3.6 million in 2009 and 2008 and provided cash of \$0.7 million in 2007. Cash used in 2009, 2008 and 2007 primarily resulted from payment of existing debt obligations of \$7.6 million, \$2.0 million and \$13.4 million, respectively, and the repurchase of \$1.7 million and \$0.8 million of our common stock in 2008 and 2007, respectively. The \$6.9 million and \$0.8 million in "construction allowance receipts – leased facility" in 2009 and 2008, respectively, relate to the replacement facility that was constructed in Texas with lease financing. During the third quarter 2009, the facility was completed and the sale and leaseback of the Brentwood Terrace facility was deemed to have occurred.

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Dividends

On August 5, 2009, the Board of Directors approved the payment of a quarterly dividend on common shares of \$0.05 per share commencing with the quarter ended June 30, 2009. While the Board of Directors intends to pay quarterly dividends, the Board will make the determination of the amount of future cash dividends, if any, to be declared and paid based on, among other things, the Company's financial condition, funds from operations, the level of its capital expenditures and its future business prospects.

Preferred Stock

In 2006, we issued Omega 5,000 shares of Series C Preferred Stock with a stated value of approximately \$4.9 million and 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.

Note Receivable

On June 30, 2009, we collected the balance due on a note receivable denominated in Canadian dollars issued in the sale of our Canadian subsidiary in 2004. We received installments totaling approximately \$4.9 million Canadian (\$4.2 million US) during May and June 2009. In accordance with our bank term loan agreement, \$1.8 million of the proceeds we received in collection of this note receivable were paid on the principal balance of our long term debt obligations.

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, 2009. For claims made during the period from March 10, 2009 through May 31, 2010, we maintain insurance coverage limits of \$250,000 per medical incident and total annual aggregate policy coverage limits of \$750,000.

As of December 31, 2009, we have recorded total liabilities for reported and settled professional liability claims and estimates for incurred but unreported claims of \$18.5 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.

Capital Resources

As of December 31, 2009, we had \$24.8 million of outstanding borrowings, including \$2.3 million in current scheduled payments of long-term debt. The \$24.8 million is comprised of \$21.1 million owed on our mortgage loan and \$3.7 million owed on our term loan. The mortgage loan and the term loan carry interest rates of LIBOR plus 3.75% and LIBOR plus 2.5%, respectively. At December 31, 2009, these rates were approximately 3.98% and 2.74%, respectively.

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 is set to mature in August 2012 and is secured by receivables and all other unencumbered assets of the company, including land held for sale and notes receivable. As of December 31, 2009, the remaining outstanding balance of the term loan is \$3.7 million.

**MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION
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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 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 were 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, 2009, the letter of credit and the maximum loan of \$15 million, the balance available for future revolving credit loans is \$6.9 million. Eligible accounts receivable are calculated as defined and consider 80% of certain net receivables while excluding receivables from private pay patients, those pending approval by Medicaid and receivables greater than 90 days. As of December 31, 2009, our borrowing base of eligible accounts receivable is in excess of the \$15 million credit facility.

The revolving credit facility matures in August 2010. We have no borrowings outstanding under the loan but we have outstanding letters of credit in the amount of \$8.1 million as a security deposit for all of our leases with Omega.

Our 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 2009 and 2007, we made voluntary prepayments of \$3.5 million and \$3.0 million, respectively. 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, census and debt service coverage ratios. We are in compliance with all such covenants at December 31, 2009. Our calculated compliance with financial covenants is presented below:

	<u>Requirement</u>	<u>Level at December 31, 2009</u>
Minimum fixed charge coverage ratio	≥ 1.10:1.00	1.28
Minimum adjusted EBITDA (as defined)	≥ \$10.5 million	\$17.0 million
Maximum leverage ratio (leased facilities)	≤ 1.50:1.00	0.29
Debt service coverage ratio (mortgaged facilities)	≥ 1.30:1.00	3.58

New Facility Construction

Texas Facility. In August 2009, we completed the construction of a 119 bed skilled nursing facility, Brentwood Terrace, located in Paris, Texas, replacing an existing 102 bed facility leased from Omega. The new facility was financed with funding from Omega, and is leased from Omega under a long term operating lease with renewal options through 2035. Annual rent is \$789,000 initially, equal to 10.25% of \$7.7 million, the total cost of the replacement facility. The daily census as of December 31, 2009 increased to 95 compared to 67 as of August 25, 2009, the day we moved into the new facility and Medicare census increased to 10 compared to 7. For the fourth quarter of 2009, average daily census increased to 89 compared to 37 for the second quarter of 2008, when we began construction, and Medicare average daily census increased to over 10 from 3. The lease provides for renewal options with respect to the new facility through 2035.

The replacement facility is subject to the requirements of our current master lease, with certain exceptions for capital spending requirements. In August 2014, we may terminate the lease with respect to this facility. Beginning February 2011 and continuing until August 2014, 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 August 25, 2014. If at any time after February 2011 the average annual cash flow of the facility exceeds 1.3 times the then existing rent, both our and Omega's termination options of both Omega and the Company are eliminated, and the rent reset provisions described above are eliminated.

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West Virginia Facility. On June 17, 2009 we completed the acquisition of certain assets of a skilled nursing facility in West Virginia. We had entered into an option agreement to purchase these assets for \$850,000 during 2006. We advanced the \$850,000 purchase price to the owners of the existing facility prior to January 1, 2009. Due to delays in the regulatory approval process as well as declining census in the existing facility, we advanced an additional \$196,000 to the owners of the existing facility during 2008 and \$231,000 during 2009. The amounts advanced in excess of purchase price have been charged to operating expenses. We are currently seeking financing for the construction of a new 90 bed replacement facility. The existing facility closed in February 2009. No assurances can be given we will be able to 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 14, 2009, the Company's Board of Directors amended our current Amended and Restated Rights Agreement (the "Rights Agreement") which was originally adopted in 1995. The amendment changes the definition of "Acquiring Person" to be such person that acquires 20% or more of the shares of Common Stock of the Company, up from the 15% that previously defined an acquiring person. On August 1, 2008, an amendment was approved which provided 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 2008 amendment included 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, 2009, we have completed renovations at twelve facilities and have two additional projects in progress that we expect to complete in the first half of 2010. In January 2010, we celebrated the grand opening of our thirteenth renovation project, which included a 15 bed expansion to the nursing center. We are developing plans for additional renovation projects.

A total of \$19.6 million has been spent on these renovation programs to date, with \$12.5 million financed through Omega, \$6.0 million financed with internally generated cash, and \$1.1 million financed with long-term debt. In May 2009, Omega agreed to provide an additional \$5.0 million to fund renovations to several nursing centers we lease from them under the same terms as prior funding commitments totaling \$10.0 million.

For the eleven facilities with renovations completed before the beginning of the fourth quarter 2009 compared to the last twelve months prior to the commencement of renovation, average occupancy increased from 66.5% to 74.4% and Medicare average daily census increased from a total of 118 to 132 in the fourth quarter of 2009.

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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 \$26.9 million at December 31, 2009, compared to \$27.0 million at December 31, 2008, representing approximately 32 and 34 days revenue in accounts receivable, respectively.

The allowance for bad debt was \$2.9 million and \$3.3 million at December 31, 2009 and 2008, respectively. We continually evaluate the adequacy of our bad debt reserves based on patient mix trends, aging of older balances, payment terms and delays with regard to third-party payors, collateral and deposit resources, as well as other factors. We continue to evaluate and implement additional procedures to strengthen our collection efforts and reduce the incidence of uncollectible accounts.

Inflation

We do not believe that our operations have been materially affected by inflation for the three most recent years; however, beginning in the second half of 2008, the cost of food and utilities at our nursing facilities increased at a higher than expected rate. While these increases have moderated in 2009, we are unsure whether this rate of increase will return in future periods. We expect salary and wage increases for our skilled health care providers to continue to be higher than average salary and wage increases, as is common in the health care industry.

Off-Balance Sheet Arrangements

We had letters of credit outstanding of approximately \$8.1 million as of December 31, 2009, 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 years ended December 31, 2009 and 2008, we incurred approximately \$0.2 million in fees related to these outstanding letters of credit.

Recent Accounting Guidance

In June 2009, the Financial Accounting Standards Board ("FASB") issued its final Statement of Financial Accounting Standards ("SFAS") No. 168, "The 'FASB Accounting Standards Codification' and the Hierarchy of Generally Accepted Accounting Principles, a replacement of FASB Statement No. 162" ("SFAS 168"). SFAS 168 establishes the "FASB Accounting Standards Codification" ("Codification"), which officially launched July 1, 2009, to become the source of authoritative U.S. generally accepted accounting principles ("GAAP") recognized by the FASB to be applied by nongovernmental entities, superseding existing FASB, American Institute of Certified Public Accountants ("AICPA"), Emerging Issues Task Force ("EITF"), and related accounting literature. Rules and interpretive releases of the Securities and Exchange Commission ("SEC") under authority of federal securities laws are also sources of authoritative U.S. GAAP for SEC registrants. SFAS 168 reorganizes the previously issued GAAP pronouncements into accounting topics and displays them using a consistent structure. The subsequent issuances of new standards will be in the form of Accounting Standards Updates that will be included in the Codification. SFAS 168 was effective for us as of the interim period ended September 30, 2009. As the Codification was not intended to change or alter existing GAAP, it did not have an impact on our consolidated financial statements. The only impact was that references to authoritative accounting literature are in accordance with the Codification and the descriptions of accounting guidance references in "italics" are the descriptive titles of the Codification Topics.

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

Accounting guidance adopted in 2009

In June 2008, the FASB issued guidance on “*Earnings Per share*” in determining whether instruments granted in share-based payment transactions are participating Securities. The guidance provides that unvested share-based payment awards that contain nonforfeitable rights to dividends or dividend equivalents (whether paid or unpaid) are participating securities and shall be included in the computation of earnings per share pursuant to the two-class method. We adopted this guidance effective January 1, 2009 and did not require us to retrospectively adjust our earnings per share data based on our analysis of our stock based compensation awards.

In April 2008, the FASB issued guidance on “*Intangibles*” in determining the useful life of intangible assets. This guidance amends the factors that should be considered in developing renewal or extension assumptions used to determine the useful life of recognized intangible assets with the intention of improving the consistency between the useful life of a recognized intangible asset and the period of expected cash flows used to measure the fair value of the asset. We adopted the guidance effective January 1, 2009 with the components used in determining the useful life of a recognized intangible asset being applied prospectively to intangible assets acquired after January 1, 2009, and adoption did not have an impact on our financial position or results of operations. The new required disclosures were adopted as of January 1, 2009 and are included in Note 11 of the Notes to Interim Consolidated Financial Statements.

Effective January 1, 2009, we adopted the new guidance on “*Business Combinations*” which established 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. The new guidance also establishes disclosure requirements to enable the evaluation of the nature and financial effects of the business combination. During the fourth quarter of 2008, we expensed \$202,000 in acquisition costs related to the transaction discussed in Note 3. Under the business combination accounting guidance in effect prior to January 1, 2009, these costs were considered part of the purchase price and as such were capitalized, but effective January 1, 2009 the accounting guidance required these costs be expensed as incurred.

In May 2009, the FASB issued guidance on “*Subsequent Events*” that is intended to establish general standards of accounting and disclosure of events that occur after the balance sheet date but before financial statements are issued or are available to be issued. The guidance requires issuers to reflect in their financial statements and disclosures the effects of subsequent events that provide additional evidence about conditions at the balance sheet date. Disclosures should include the nature of the event and either an estimate of its financial effect or a statement that an estimate cannot be made. The guidance was effective for us beginning with the interim period ended June 30, 2009. As the requirements under the guidance are consistent with our current practice, the implementation did not have an impact on our consolidated financial statements. We have evaluated subsequent events and noted that no subsequent events occurred (that are not already disclosed) that would otherwise make the financial statements misleading if they were not disclosed or recorded.

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 arrange appropriate financing and successfully construct and operate the replacement facility for the recently acquired facility in West Virginia, our ability to increase census at our renovated facilities, changes in governmental reimbursement, government regulation and health care reforms, any increases in the cost of borrowing under our credit agreements, our ability to comply with covenants contained in those credit agreements, the outcome of professional liability lawsuits and claims, our ability to control ultimate professional liability costs, the accuracy of our estimate of our anticipated professional liability expense, the impact of future licensing surveys, the outcome of 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 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, 2009, we had outstanding borrowings of approximately \$24.8 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 \$0.2 million annually, representing the impact of increased or decreased interest expense on variable rate debt. Our existing borrowing arrangements were entered into in 2006 and 2007, and we believe that we have interest rate terms that are less than current market terms. Based on current trends, we expect that our interest rates will increase when we refinance our debt.

MANAGEMENT'S REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING

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, 2009. 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, 2009, 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, 2009 which is included herein.

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, 2009 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, 2009, 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, 2009, 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, 2009 and 2008 and the related consolidated statements of income, shareholders' equity, and cash flows for each of the three years in the period ended December 31, 2009 and our report dated March 9, 2010 expressed an unqualified opinion thereon.

BDO Seidman, LLP

Nashville, Tennessee
March 9, 2010

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, 2009 and 2008 and the related consolidated statements of income, shareholders' equity, and cash flows for each of the three years in the period ended December 31, 2009. 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 and schedule. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Advocat Inc. at December 31, 2009 and 2008, and the results of its operations and its cash flows for each of the three years in the period ended December 31, 2009, 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, 2009, 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, 2010 expressed an unqualified opinion thereon.

BDO Seidman, LLP

Nashville, Tennessee
March 9, 2010

ADVOCAT INC. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS
DECEMBER 31, 2009 AND 2008

ASSETS	2009	2008	LIABILITIES AND SHAREHOLDERS' EQUITY	2009	2008
CURRENT ASSETS:			CURRENT LIABILITIES:		
Cash and cash equivalents	\$ 8,609,000	\$ 7,598,000	Current portion of long-term debt	\$ 2,278,000	\$ 2,238,000
Receivables, less allowance for doubtful accounts of \$2,863,000 and \$3,279,000, respectively	24,381,000	23,933,000	Trade accounts payable	3,352,000	4,600,000
Receivable for leased facility construction costs	1,406,000	228,000	Accrued construction costs – leased facility	1,406,000	228,000
Current portion of note receivable	–	466,000	Accrued expenses:		
Prepaid expenses and other current assets	2,091,000	1,748,000	Payroll and employee benefits	10,177,000	9,545,000
Income tax refundable	455,000	1,369,000	Current portion of self-insurance reserves	7,860,000	6,469,000
Deferred income taxes	4,792,000	3,967,000	Other current liabilities	4,327,000	5,344,000
Total current assets	<u>41,734,000</u>	<u>39,309,000</u>	Total current liabilities	<u>29,400,000</u>	<u>28,424,000</u>
PROPERTY AND EQUIPMENT, at cost	78,120,000	73,517,000	NONCURRENT LIABILITIES:		
Less accumulated depreciation	(42,213,000)	(38,555,000)	Long-term debt, less current portion	22,551,000	30,172,000
Construction in progress – leased facility	–	1,039,000	Self-insurance reserves, less current portion	12,235,000	10,212,000
Discontinued operations, net	1,455,000	1,455,000	Non-cash obligation for construction in progress – leased facility	–	1,039,000
Property and equipment, net	<u>37,362,000</u>	<u>37,456,000</u>	Other noncurrent liabilities	15,195,000	12,050,000
			Total noncurrent liabilities	<u>49,981,000</u>	<u>53,473,000</u>
			COMMITMENTS AND CONTINGENCIES		
			SERIES C REDEEMABLE PREFERRED STOCK,		
			\$.10 par value, 5,000 shares authorized, issued and outstanding, stated value of \$4,918,000 including premium of \$1,274,000 and \$2,973,000, respectively	6,192,000	7,891,000
			SHAREHOLDERS' EQUITY:		
			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, 5,949,000 and 5,903,000 shares issued, 5,717,000 and 5,671,000 shares outstanding, respectively	59,000	59,000
			Treasury stock at cost, 232,000 shares of common stock	(2,500,000)	(2,500,000)
			Paid-in capital	17,647,000	16,903,000
			Retained earnings	4,487,000	3,089,000
			Total shareholders' equity	<u>19,693,000</u>	<u>17,551,000</u>
				<u>\$ 105,266,000</u>	<u>\$ 107,339,000</u>
OTHER ASSETS:					
Deferred income taxes	13,804,000	13,899,000			
Note receivable, net of current portion	–	3,486,000			
Deferred financing and other costs, net	639,000	1,009,000			
Other assets	1,963,000	2,031,000			
Acquired leasehold interest, net	9,764,000	10,149,000			
Total other assets	<u>26,170,000</u>	<u>30,574,000</u>			
	<u>\$ 105,266,000</u>	<u>\$ 107,339,000</u>			

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

ADVOCAT INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF INCOME

	Year Ended December 31,		
	2009	2008	2007
REVENUES:			
Patient revenues, net	\$ 302,031,000	\$ 287,607,000	\$ 243,907,000
EXPENSES:			
Operating	240,095,000	227,633,000	186,957,000
Lease	23,422,000	22,962,000	20,019,000
Professional liability	9,132,000	1,658,000	(1,663,000)
General and administrative	18,496,000	18,486,000	17,552,000
Depreciation and amortization	5,999,000	5,306,000	4,093,000
	<u>297,144,000</u>	<u>276,045,000</u>	<u>226,958,000</u>
OPERATING INCOME	<u>4,887,000</u>	<u>11,562,000</u>	<u>16,949,000</u>
OTHER INCOME (EXPENSE):			
Foreign currency transaction gain (loss)	191,000	(1,005,000)	808,000
Other income	549,000	—	—
Interest income	161,000	454,000	1,016,000
Interest expense	(1,877,000)	(2,870,000)	(3,549,000)
Debt retirement costs	—	—	(116,000)
	<u>(976,000)</u>	<u>(3,421,000)</u>	<u>(1,841,000)</u>
INCOME FROM CONTINUING OPERATIONS			
BEFORE INCOME TAXES	3,911,000	8,141,000	15,108,000
PROVISION FOR INCOME TAXES	(1,497,000)	(2,759,000)	(6,012,000)
NET INCOME FROM CONTINUING OPERATIONS	<u>2,414,000</u>	<u>5,382,000</u>	<u>9,096,000</u>
NET INCOME FROM DISCONTINUED OPERATIONS:			
Operating income, net of tax provision of \$117,000, \$180,000 and \$199,000, respectively	187,000	353,000	299,000
Loss on sale, net of tax benefit of \$6,000, in 2007	—	—	(8,000)
DISCONTINUED OPERATIONS	<u>187,000</u>	<u>353,000</u>	<u>291,000</u>
NET INCOME	<u>2,601,000</u>	<u>5,735,000</u>	<u>9,387,000</u>
PREFERRED STOCK DIVIDENDS	<u>344,000</u>	<u>344,000</u>	<u>344,000</u>
NET INCOME FOR COMMON STOCK	<u>\$ 2,257,000</u>	<u>\$ 5,391,000</u>	<u>\$ 9,043,000</u>
NET INCOME PER COMMON SHARE:			
Per common share – basic			
Continuing operations	\$ 0.37	\$ 0.89	\$ 1.49
Discontinued operations	0.03	0.06	0.05
	<u>\$ 0.40</u>	<u>\$ 0.95</u>	<u>\$ 1.54</u>
Per common share – diluted			
Continuing operations	\$ 0.36	\$ 0.86	\$ 1.43
Discontinued operations	0.03	0.06	0.05
	<u>\$ 0.39</u>	<u>\$ 0.92</u>	<u>\$ 1.48</u>
COMMON STOCK DIVIDENDS DECLARED			
PER SHARE OF COMMON STOCK	<u>\$ 0.15</u>	<u>\$ —</u>	<u>\$ —</u>
WEIGHTED AVERAGE COMMON SHARES:			
Basic	<u>5,678,000</u>	<u>5,693,000</u>	<u>5,870,000</u>
Diluted	<u>5,797,000</u>	<u>5,887,000</u>	<u>6,127,000</u>

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

ADVOCAT INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY

	Common Stock		Treasury Stock		Paid-in Capital	Retained Earnings (Accumulated Deficit)	Total
	Shares Issued	Amount	Shares	Amount			
BALANCE, DECEMBER 31, 2006	<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
BALANCE, DECEMBER 31, 2007	<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
BALANCE, DECEMBER 31, 2008	<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>
Exercise of stock options	46,000	—	—	—	(76,000)	—	(76,000)
Net Income	—	—	—	—	—	2,601,000	2,601,000
Preferred stock dividends	—	—	—	—	—	(344,000)	(344,000)
Common dividends declared	—	—	—	—	—	(859,000)	(859,000)
Purchase of restricted share units	—	—	—	—	76,000	—	76,000
Tax impact of stock options exercised	—	—	—	—	118,000	—	118,000
Stock based compensation	—	—	—	—	626,000	—	626,000
BALANCE, DECEMBER 31, 2009	<u>5,949,000</u>	<u>\$ 59,000</u>	<u>232,000</u>	<u>\$ (2,500,000)</u>	<u>\$ 17,647,000</u>	<u>\$ 4,487,000</u>	<u>\$ 19,693,000</u>

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

ADVOCAT INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS

	Year Ended December 31,		
	2009	2008	2007
CASH FLOWS FROM OPERATING ACTIVITIES:			
Net income	\$ 2,601,000	\$ 5,735,000	\$ 9,387,000
Discontinued operations	187,000	353,000	291,000
Net income from continuing operations	<u>2,414,000</u>	5,382,000	9,096,000
Adjustments to reconcile net income from continuing operations to net cash provided by operating activities:			
Depreciation and amortization	5,999,000	5,306,000	4,093,000
Provision for doubtful accounts	2,181,000	2,334,000	1,130,000
Deferred income tax provision (benefit)	(678,000)	775,000	4,925,000
Provision for (benefit from) self-insured professional liability, net of cash payments	3,543,000	(5,717,000)	(5,054,000)
Stock-based compensation	689,000	867,000	648,000
Amortization of deferred balances	382,000	426,000	334,000
Provision for leases in excess of cash payments	1,187,000	1,711,000	2,234,000
Payment from lessor for leasehold improvement	771,000	—	—
Non-cash gain on settlement of contingent liability	(549,000)	—	—
Foreign currency transaction (gain) loss	(191,000)	1,005,000	(808,000)
Debt retirement costs	—	—	116,000
Non-cash interest income	(41,000)	(121,000)	(132,000)
Changes in other assets and liabilities affecting operating activities:			
Receivables, net	(4,047,000)	381,000	(10,633,000)
Prepaid expenses and other assets	621,000	210,000	2,781,000
Trade accounts payable and accrued expenses	(157,000)	(3,498,000)	3,374,000
Net cash provided by continuing operations	<u>12,124,000</u>	9,061,000	12,104,000
Discontinued operations	254,000	417,000	583,000
Net cash provided by operating activities	<u>12,378,000</u>	9,478,000	12,687,000

(Continued)

ADVOCAT INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS
(Continued)

	Year Ended December 31,		
	2009	2008	2007
CASH FLOWS FROM INVESTING ACTIVITIES:			
Purchases of property and equipment	\$ (6,559,000)	\$ (9,703,000)	\$ (6,827,000)
Payment for construction in progress – leased facility	(6,891,000)	(811,000)	—
Acquisition of leasehold interest	—	—	(9,096,000)
Proceeds from sale of discontinued operations and bed license	—	—	180,000
Decrease in restricted cash deposits	—	—	1,110,000
Note receivable issued	—	—	(1,800,000)
Notes receivable collected	4,184,000	765,000	2,500,000
Deposits and other deferred balances	59,000	(138,000)	(120,000)
Net cash used in continuing operations	(9,207,000)	(9,887,000)	(14,053,000)
Discontinued operations	—	(49,000)	—
Net cash used in investing activities	(9,207,000)	(9,936,000)	(14,053,000)
CASH FLOWS FROM FINANCING ACTIVITIES:			
Repayment of debt obligations	(7,581,000)	(2,045,000)	(13,437,000)
Proceeds from issuance of debt	—	—	16,500,000
Financing costs	(42,000)	(79,000)	(839,000)
Payment of common stock dividends	(573,000)	—	—
Payment of preferred stock dividends	(344,000)	(344,000)	(344,000)
Repurchases of common stock	—	(1,683,000)	(817,000)
Construction allowance receipts – leased facility	6,891,000	811,000	—
Payment for preferred stock restructuring	(512,000)	(497,000)	(448,000)
Issuance of restricted share units	76,000	—	—
Net settlement of exercised stock options	(78,000)	—	—
Proceeds from exercise of stock options	3,000	235,000	65,000
Net cash provided by (used) in financing activities	(2,160,000)	(3,602,000)	680,000
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	1,011,000	(4,060,000)	(686,000)
CASH AND CASH EQUIVALENTS, beginning of period	7,598,000	11,658,000	12,344,000
CASH AND CASH EQUIVALENTS, end of period	\$ 8,609,000	\$ 7,598,000	\$ 11,658,000
SUPPLEMENTAL INFORMATION:			
Cash payments of interest, net of amounts capitalized	\$ 1,512,000	\$ 2,506,000	\$ 3,303,000
Cash payments of income taxes, net of refunds	\$ 1,413,000	\$ 3,841,000	\$ 1,658,000

NON-CASH TRANSACTIONS:

As discussed in Note 12, the Company was deemed to have control and was considered owner of the Brentwood Terrace replacement facility during the construction period. Upon completion of construction of the replacement facility during the third quarter 2009, a sale and leaseback of the facility was deemed to have occurred and the Company removed both the facility asset and the long term liability from its consolidated balance sheet, resulting in non cash reductions of property and long term liability of \$7.7 million.

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

ADVOCAT INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
DECEMBER 31, 2009, 2008 AND 2007

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 United States. 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, 2009, the Company's continuing operations consist of 50 nursing centers with 5,784 licensed nursing beds and 14 assisted living units. The Company owns 9 and leases 41 of its 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 managing the enterprise. Therefore, management has concluded that the Company is operated as a single reportable segment, as defined in The Financial Accounting Standards Board's ("FASB") guidance on "*Segment Reporting*."

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, 2009, 2008 and 2007, the Company recorded \$109,000, \$30,000 and \$(2,000) of net favorable (unfavorable) estimated settlements from federal and state programs for periods prior to the beginning of fiscal 2009, 2008 and 2007, respectively.

Allowance for Doubtful Accounts

The Company's allowance for doubtful accounts is estimated utilizing current agings of accounts receivable, historical collections data and other factors. Management monitors these factors and determines the estimated provision for doubtful accounts. Historical bad debts have generally resulted from uncollectible private balances, some uncollectible coinsurance and deductibles and other factors. Receivables that are deemed to be uncollectible are written off. The allowance for doubtful accounts balance is assessed on a quarterly basis, with changes in estimated losses being recorded in the Consolidated Statements of 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 \$2,181,000, \$2,334,000 and \$1,130,000 for 2009, 2008 and 2007, respectively.

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Lease Expense

As of December 31, 2009, 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.

In accordance with FASB guidance on “*Property, Plant and Equipment*” specifically the discussion around the 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.

The construction in progress – leased facility asset and non-cash obligation for construction in progress – leased facility liability are discussed in detail in Note 12.

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.

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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 the FASB's guidance on goodwill and other intangible assets, and is amortized on a straight-line basis over the remaining life of the acquired lease, including renewal periods, a period of approximately 28 years from the date of acquisition. 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. As the renewal periods of the acquired leased facilities are solely based on the Company's option, it is expected that costs (if any) to renew the lease through its current amortization period would be nominal and the decision to continue to lease the acquired facilities lies solely within the Company's intent to continue to operate the SMSA facilities. Any renewal costs would be included in deferred lease costs and amortized over the renewal period. Amortization expense of approximately \$384,000, \$367,000 and \$137,000 related to this intangible asset was recorded during the years ended December 31, 2009, 2008 and 2007, respectively. The Company evaluates the recoverability of the carrying value of the acquired leasehold intangible in accordance with the FASB's guidance on accounting for the impairment or disposal of long-lived assets. Included in this evaluation is whether significant adverse changes in general economic conditions, and significant deteriorations of the underlying cash flows or fair values of the intangible asset, indicate that the carrying amount of the intangible asset may not be recoverable. The need to recognize an impairment is based on estimated future undiscounted cash flows from the asset compared to the carrying value of that asset. If recognition of an impairment is necessary, it is measured as the amount by which the carrying amount of the intangible asset exceeds the fair value of the intangible asset.

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.

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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.

Income Taxes

The Company follows the FASB's guidance on *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. The Company follows the guidance on financial statement recognition and measurement of tax positions taken, or expected to be taken, in tax returns evaluating the need to recognize or unrecognize uncertain tax positions. See Note 11 for additional information related to the provision for income taxes.

Disclosure of Fair Value of Financial Instruments

Effective January 1, 2008, the Company adopted the FASB's guidance on *Fair Value Measurements and Disclosures*. The new guidance provided rules for using fair value to measure assets and liabilities and established a fair value hierarchy that prioritizes the information used to develop the measurements. It applies whenever other guidance requires (or permits) assets or liabilities to be measured at fair value but did not expand the use of fair value in any new circumstances. The adoption of this guidance did not have an impact on the Company's financial position, results of operations or cash flows as the Company did not elect to modify the carrying value of any of its assets or liabilities under fair value accounting.

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

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

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

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

As noted above, the Company did not elect to expand the use of fair value measurements for assets and liabilities. As such, its long-term debt obligations, receivables and trade accounts payable are still reported at their carrying values. It is noted that the assessment of carrying value compared to fair value for impairment analysis, as discussed in Note 2 "Property and Equipment," follow these fair value principles and hierarchy.

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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 is still reported at its carrying value, though the Company estimates that the fair value of its mortgage loan is an amount less than its carrying value as the Company's current mortgage loan agreement and interest rate were entered into during 2006 and the Company anticipates its rate is lower than what is currently available. At December 31, 2009, the Company's mortgage loan has a carrying value of \$21,177,000 and the estimated fair value is \$20,198,000. The estimate of fair value was calculated by discounting the future cash flows of the mortgage loan at rates the Company expects would be currently offered for similar mortgage loans. The Company's self-insurance reserves are reported on an undiscounted basis as the timing of estimated settlements cannot be determined.

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 the FASB's guidance on *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. See Note 10 for additional disclosures about the Company's Net Income per Common Share.

Stock-Based Compensation

The Company follows the FASB's guidance on *Stock Compensation* to account for share-based payments granted to employees. The Company had no unvested awards granted to employees on the effective date the current guidance took effect.

The Company recorded non-cash stock-based compensation expense for equity grants issued of \$689,000, \$867,000 and \$648,000 during the years ended December 31, 2009, 2008 and 2007, 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 \$38,000, \$61,000 and \$22,000 was recorded as a component of operating expense in 2009, 2008 and 2007, respectively. Non-cash stock-based compensation expense of \$651,000, \$806,000 and \$626,000 was recorded as a component of general and administrative expense in 2009, 2008 and 2007, respectively. See Note 9 for additional disclosures about the Company's stock-based compensation plans.

Recent Accounting Pronouncements

In June 2009, the FASB issued its final Statement of Financial Accounting Standards ("SFAS") No. 168, "The 'FASB Accounting Standards Codification' and the Hierarchy of Generally Accepted Accounting Principles, a replacement of FASB Statement No. 162" ("SFAS 168"). SFAS 168 establishes the "FASB Accounting Standards Codification" ("Codification"), which officially launched July 1, 2009, to become the source of authoritative U.S. generally accepted accounting principles ("GAAP") recognized by the FASB to be applied by nongovernmental entities, superseding existing FASB, American Institute of Certified Public Accountants ("AICPA"), Emerging Issues Task Force ("EITF"), and related accounting literature. Rules and interpretive releases of the Securities and Exchange Commission ("SEC") under authority of federal securities laws are also sources of authoritative U.S. GAAP for SEC registrants. SFAS 168 reorganizes the previously issued GAAP pronouncements into accounting topics and displays them using a consistent structure. The subsequent issuances of new standards will be in the form of Accounting Standards Updates that will be included in the Codification. SFAS 168 was effective for the Company as of the interim period ended

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September 30, 2009. As the Codification was not intended to change or alter existing GAAP, it did not have an impact on the Company's consolidated financial statements. The only impact was that references to authoritative accounting literature are in accordance with the Codification and the descriptions of accounting guidance referenced in "italics" are the descriptive titles of the Codification Topics.

Accounting guidance adopted in 2009

In June 2008, the FASB issued guidance on "*Earnings Per Share*" in determining whether instruments granted in share-based payment transactions are participating securities. The guidance provides that unvested share-based payment awards that contain nonforfeitable rights to dividends or dividend equivalents (whether paid or unpaid) are participating securities and shall be included in the computation of earnings per share pursuant to the two-class method. The Company adopted this guidance effective January 1, 2009, and did not require the Company to retrospectively adjust its earnings per share data based on the Company's analysis of its stock based compensation awards.

In April 2008, the FASB issued guidance on "*Intangibles*" in determining the useful life of intangible assets. This guidance amends the factors that should be considered in developing renewal or extension assumptions used to determine the useful life of recognized intangible assets with the intention of improving the consistency between the useful life of a recognized intangible asset and the period of expected cash flows used to measure the fair value of the asset. The Company adopted the guidance effective January 1, 2009 with the portion of the guidance used in determining the useful life of a recognized intangible asset being applied prospectively to intangible assets acquired after January 1, 2009 and did not have an impact on the Company's financial position or results of operations. The new required disclosures were adopted as of January 1, 2009 and relate to an acquired leasehold interest intangible asset of approximately \$10,653,000 acquired in the SMSA Acquisition. The intangible asset is subject to full amortization over the remaining life of the lease, including renewal periods, a period of approximately 28 years from the date of acquisition. 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. As the renewal periods of the acquired leased facilities are solely based on the Company's option, it is expected that costs (if any) to renew the lease through its current amortization period would be nominal and the decision to continue to lease the acquired facilities lies solely within the Company's intent to continue to operate the SMSA facilities. Any renewal costs would be included in deferred lease costs and amortized over the renewal period. Amortization expense of approximately \$384,000, \$367,000 and \$137,000 related to this intangible asset was recorded during the years ended December 31, 2009, 2008 and 2007, respectively.

Effective January 1, 2009, the Company adopted the new guidance on "*Business Combinations*" which established 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. The new guidance also establishes disclosure requirements to enable the evaluation of the nature and financial effects of the business combination. During the fourth quarter of 2008, the Company expensed \$202,000 in acquisition costs related to the transaction discussed in Note 3. Under the business combination accounting guidance in effect prior to January 1, 2009, these costs were considered part of the purchase price and as such were capitalized, but effective January 1, 2009, the accounting guidance required these costs be expensed as incurred.

In May 2009, the FASB issued guidance on "*Subsequent Events*" that is intended to establish general standards of accounting and disclosure of events that occur after the balance sheet date but before financial statements are issued or are available to be issued. The guidance requires issuers to reflect in their financial statements and disclosures the effects of subsequent events that provide additional evidence about conditions at the balance sheet date. Disclosures should include the nature of the event and either an estimate of its financial effect or a statement that an estimate cannot be made. The guidance was effective for the Company for the interim period ended June 30, 2009. As the requirements under the guidance are consistent with its current practice, the implementation did not have an impact on the Company's consolidated financial statements. The Company has evaluated subsequent events and noted that no subsequent events occurred (that are not already disclosed) that would otherwise make the financial statements misleading if they were not disclosed or recorded.

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Reclassifications

As discussed in Note 7, the consolidated financial statements of the Company have been reclassified to reflect as discontinued operations certain divestitures and lease terminations. Certain amounts in the 2008 and 2007 Consolidated Financial Statements have been reclassified to conform with the presentation of 2009.

3. ACQUISITIONS

On June 17, 2009, the Company completed the acquisition of certain assets of a skilled nursing facility in West Virginia. The Company had entered into an option agreement to purchase these assets for \$850,000 during 2006. The Company advanced the \$850,000 purchase price to the owners of the existing facility prior to January 1, 2009. Due to delays in the regulatory approval process as well as declining census in the existing facility, the Company advanced an additional \$196,000 to the owners of the existing facility during 2008 and \$231,000 during 2009. The purchase price of \$850,000 is included in other noncurrent assets in the Company's Consolidated Balance Sheet and the amounts advanced in excess of the purchase price have been charged to operating expenses. The Company did not assume any liabilities or working capital in connection with the acquisition. The Company is currently seeking financing for the construction of a new 90 bed replacement facility. The existing facility closed in February 2009.

Effective August 11, 2007, the Company 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 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%.

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 2009, the Company reached an agreement with the Centers for Medicare and Medicaid Services ("CMS") to settle cost report obligations related to facilities acquired in 2007. The Company also settled its claims against the seller, Senior Management Services of America North Texas, Inc. ("SMSA"). The settlement payments were made in the second quarter of 2009 and total approximately \$283,000, with related legal and other costs totaling an additional \$175,000. Payment of the settlements and legal fees were less than the amounts previously accrued and resulted in a gain on settlement of \$549,000 that was recorded as other income in the first quarter of 2009. The liability resulted from the August 2007 acquisition of the leasehold interests and operations of seven skilled nursing facilities from SMSA. In May 2008, the Company received notification of payments due to CMS related to Medicare reimbursement for 1997 and earlier periods for one of the acquired facilities. The total amount requested by CMS was approximately \$1,180,000, including accrued

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interest of approximately \$668,000. 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 took 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 \$384,000, \$367,000 and \$137,000 related to this intangible asset was recorded during the years ended December 31, 2009, 2008 and 2007, respectively.

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

2010	\$	384,000
2011		384,000
2012		384,000
2013		384,000
2014		384,000
thereafter		<u>7,844,000</u>
	\$	<u>9,764,000</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.

4. RECEIVABLES

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

	December 31,	
	2009	2008
Medicare	\$ 10,244,000	\$ 10,440,000
Medicaid and other non-federal government programs	11,025,000	10,187,000
Other patient and resident receivables	5,613,000	6,368,000
Other receivables and advances	362,000	217,000
	<u>\$ 27,244,000</u>	<u>\$ 27,212,000</u>
Receivable for leased facility construction costs	\$ 1,406,000	\$ 228,000

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The receivable for leased facility construction is related to renovation projects funded by Omega. See Note 12 for additional discussion of these receivables and leased facility construction projects.

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

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

5. PROPERTY AND EQUIPMENT

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

	December 31,	
	2009	2008
Land	\$ 1,919,000	\$ 1,903,000
Buildings and leasehold improvements	53,459,000	49,098,000
Furniture, fixtures and equipment	22,742,000	22,516,000
	\$ 78,120,000	\$ 73,517,000

Substantially all of the Company's property and equipment are pledged 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,	
	2009	2008
Mortgage loan payable to a commercial finance company; issued in August 2006; secured by seven nursing centers, related equipment, and a second lien on the accounts receivable of these facilities; payable monthly, interest at 3.75% above LIBOR (3.98% and 4.95% at December 31, 2009 and 2008, respectively).	\$ 21,177,000	\$ 21,768,000
Term loan payable to a bank; issued in August 2007; secured by receivables and all other unencumbered assets of the Company, including land held for sale; interest at 2.5% above LIBOR (2.74% and 4.0% at December 31, 2009 and 2008, respectively).	3,652,000	10,642,000
	24,829,000	32,410,000
Less current portion	(2,278,000)	(2,238,000)
	\$ 22,551,000	\$ 30,172,000

As of December 31, 2009, the Company's weighted average interest rate on long-term debt was approximately 3.8%.

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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 carries an interest rate of LIBOR plus 2.5%, a maturity of 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. 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 debt that was retired with proceeds of this loan, and are reflected as debt retirement costs in the 2007 income statement. In connection with the new debt incurred in the 2007 financing, the Company recorded deferred loan costs of \$764,000.

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 can be outstanding under the revolver based on borrowing base restrictions. The revolver has a term of three years, expires in August 2010 with 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, 2009, the letter of credit and the maximum loan amount of \$15,000,000, the balance available for revolving credit loans as of December 31, 2009 is \$6,883,000. As of December 31, 2009, the Company has no borrowings outstanding under the revolving credit facility.

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. The mortgage loan matures in August 2011.

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

2010	\$ 2,278,000
2011	22,198,000
2012	353,000
2013	—
2014	—
Thereafter	—
Total	<u>\$ 24,829,000</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 2009 and 2007, the Company made voluntary prepayments of \$3,500,000 and \$3,000,000, respectively. 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, census and debt service coverage ratios. The Company is in compliance with all such covenants at December 31, 2009.

7. DISCONTINUED OPERATIONS

The Centers for Medicare and Medicaid Services ("CMS") has issued regulations that became effective October 1, 2009 that prohibit the Company from billing Medicare Part B for certain enteral nutrition, urological, ostomy and tracheostomy supplies. Beginning October 1, these services will be provided by third parties. The Company will still be required to provide the labor for the delivery of services but will no longer be a supplier and will not be entitled to any compensation. These services produced revenues of \$974,000, \$1,190,000 and \$1,154,000 and net income of \$204,000, \$388,000 and \$390,000 during the years ended December 31, 2009, 2008 and 2007, respectively. The related revenue and cost of goods sold for providing these services have been reclassified as discontinued operations in the accompanying consolidated financial statements.

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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 during the year ended December 31, 2007.

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

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.

As discussed further in Note 12, the Company leases four nursing centers in Florida under a lease that, as amended, expires in August 2010. The operating margins of the four facilities subject to this lease do not meet the Company's goals. These four homes contributed revenues of \$25,053,000, \$23,772,000, and \$23,996,000 and net income of \$541,000, \$1,076,000 and \$1,602,000 in the years ended December 31, 2009, 2008 and 2007 respectively. The facilities are, on average, 50 years old (including three of the Company's ten oldest facilities), and have several structural limitations that significantly impair marketing ability in the very competitive marketplace in Florida. Limitations include multiple three- and four-bed wards (a total of 61 wards representing 223 licensed beds, or approximately 53% of the total licensed beds for these facilities) and limited common areas, parking and therapy space. Three of the 4 buildings are substantially "landlocked", without the ability to expand to eliminate the structural challenges. The fourth building is in an economically challenged area of town. The Company believes these buildings will require replacement or extensive capital investment to remain competitive over the next five to ten years. In the near term, prospects for future reimbursement increases in Florida are limited, as the state of Florida faces multi-billion dollar deficits.

In 2009, the average occupancy of these facilities was 78.5%, compared to 76.7% for the Company as a whole. Medicare census was 8.7% of total census for these four facilities, compared to 12.7% for the Company as a whole. As a result of the low Medicare census, operating margins for these facilities are lower than average, and operating expenses were 82.2% of revenue for these four facilities, compared to an average of 79.5% for the Company as a whole.

The Company initiated discussions with Omega to indicate the terms under which it would be prepared to enter into a long term extension of this lease at a reduced lease rate and participation in the long term project of replacing these facilities with a competitive offering. Omega elected to evaluate the market and requested a short term extension of the existing lease to pursue opportunities. The Company agreed to extend the lease through August 2010 on a monthly basis until a replacement tenant or buyer can be put into place. When a new operator is in place the lease will terminate and the Company will cooperate in an orderly transition to the new operator. These facilities are included in continuing operations at December 31, 2009. The Company will reclassify the operations of these facilities to discontinued operations once the transfer is completed.

8. NOTE RECEIVABLE

On June 30, 2009, the Company collected the balance due on a note receivable denominated in Canadian dollars issued in the sale of its Canadian subsidiary in 2004. The Company received installments totaling approximately \$4.9 million Canadian (\$4,184,000 US) during May and June 2009. In accordance with the Company's bank term loan agreement, \$1.8 million (US) of the proceeds received in collection on this note receivable were paid on the principal balance of the Company's long-term debt obligations. The note receivable resulted from the May 2004 sale of the Company's Canadian subsidiary, Diversicare Canada Management Services Co., Inc. ("DCMS"), to DCMS Holding, Inc. ("Holding"), a privately-owned Ontario corporation. 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

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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 installment portion of the purchase price was evidenced by a promissory note that was discounted to estimated fair value and was initially recorded in the accompanying balance sheet at \$4.7 million US. The Company received payments of \$4,184,000, \$765,000 and \$700,000 in 2009, 2008 and 2007, respectively. Foreign currency transaction gain or loss related to this note was recorded as other income or expense in the Consolidated Statements of Income.

9. SHAREHOLDERS' EQUITY, STOCK PLANS AND PREFERRED STOCK

Shareholders' Rights Plan

On August 14, 2009, the Company's Board of Directors amended its current Amended and Restated Rights Agreement (the "Rights Agreement") which was originally adopted in 1995. The amendment changes the definition of "Acquiring Person" to be such person that acquires 20% or more of the shares of Common Stock of the Company up from the 15% that previously defined an acquiring person. On August 1, 2008, another amendment was approved which provided 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, 20.0% or more of the Company's common stock without the Company's prior approval.

Stock-Based Compensation Plans

The Company follows the FASB's guidance on *Stock Compensation* to account for share-based payments granted to employees.

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 equity awards granted thereunder. All options under this plan expire 10 years from the date the shares were authorized by the Board of Directors.

During 2009, 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, 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.

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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 Stock Purchase Plan allows participants to elect to utilize a specified portion of base salary, annual cash bonus, or director compensation to purchase restricted shares or restricted share units (“RSU’s”) at a price equal to 85% of the fair market value of a share of the Company’s common stock on the date on which such restricted shares or restricted share units are purchased.

The restriction 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 restriction 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 restriction period. No grants of restricted shares or restricted share units can be made under the Stock Purchase Plan after April 25, 2018.

During 2009 and 2008, several of the Company’s officers elected to use a percentage of their annual bonus to purchase RSU’s under the Stock Purchase Plan. In March 2009, the Company issued a total of 36,896 RSU’s to twenty employees in lieu of paying a total of \$76,000 in cash to such employees. Unrestricted shares of common stock will be issued in exchange for the RSU’s in March 2011, subject to the conditions of the Stock Purchase Plan. RSU expense is recorded as annual bonus amounts are recorded during the year earned. The discount on RSU’s issued is 15% of the share price on the date the RSU’s are issued and is amortized to expense over the restriction period.

The Company recorded non-cash stock-based compensation expense for equity grants and RSU’s issued under the Plans of \$689,000, \$867,000 and \$648,000 during the years ended December 31, 2009, 2008 and 2007, 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, 2009, there was \$317,000 (including \$9,000 related to non-vested RSU’s) 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.

	Year Ended December 31,		
	<u>2009</u>	<u>2008</u>	<u>2007</u>
Expected volatility (range)	95% - 111%	113% - 122%	119% - 143%
Risk free interest rate (range)	2.02% - 2.40%	2.49% - 3.43%	3.96% - 4.68%
Expected dividends	—	—	—
Weighted average expected term (years)	6.0	6.0	6.0

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 prior to these grants being issued, it had not paid cash dividends on its common stock.

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In computing the fair value of these SOSARs, the Company estimated the SOSARs expected term based on the average of the vesting term and the original contractual terms of the grants, consistent with the Securities and Exchange Commissions interpretive guidance often referred to as the "Simplified Method." The Company continues to use the Simplified Method since the Company's exercise history is not representative of the expected term of the SOSARs granted in 2009. The Company's recent exercise history is primarily from options granted in 2005 that were vested at grant date and were significantly in-the-money due to an increase in stock price during the period between grant date and formal approval by shareholders, and from older options granted several years ago that had fully vested.

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

	Year Ended December 31,		
	2009	2008	2007
Weighted Average grant date fair value	\$1.91	\$9.39	\$10.55
Total Intrinsic Value of Options Exercised	\$320,000	\$26,000	\$105,000

The following table summarizes information regarding stock options and SOSAR grants outstanding as of December 31, 2009:

Range of Exercise Prices	Weighted Average Exercise Prices	Options Outstanding
\$10.38 to \$11.59	\$ 11.19	228,000
\$0.35 to \$5.44	\$ 3.99	375,000
		<u>603,000</u>

As of December 31, 2009, the outstanding equity grants have a weighted average remaining life of 6.92 years and those outstanding equity grants that are exercisable have a weighted average remaining life of 5.98 years. During the year ended December 31, 2009 approximately 63,000 option grants were exercised under these plans, resulting in proceeds of \$3,000.

Summarized activity of the equity compensation plans is presented below:

	Shares	Weighted Average Exercise Price
Outstanding, December 31, 2008	548,000	\$ 6.78
Granted	125,000	3.38
Exercised	(63,000)	0.40
Expired or cancelled	(7,000)	9.51
Outstanding, December 31, 2009	<u>603,000</u>	<u>\$ 6.72</u>
Exercisable, December 31, 2009	<u>383,000</u>	<u>\$ 6.69</u>

As of December 31, 2009, the aggregate intrinsic value for the Company's equity grants outstanding and equity grants exercisable were \$591,000 and \$386,000, respectively.

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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") with a stated value of \$3,300,000 and an annual dividend rate of 7% of the stated value. In October 2006, the Company and Omega entered into a Restructuring Stock Issuance and Subscription Agreement ("Restructuring Agreement") to restructure the Series B Preferred Stock, eliminating the option of Omega to convert the Series B Preferred Stock into shares of 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.

Series C Redeemable Preferred Stock

	2009	2008	2007
Balance at the beginning of the period	\$ 7,891,000	\$ 9,590,000	\$ 11,289,000
Amortization of preferred stock premium	(1,699,000)	(1,699,000)	(1,699,000)
Balance at the end of the period	<u>\$ 6,192,000</u>	<u>\$ 7,891,000</u>	<u>\$ 9,590,000</u>

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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>2009</u>	<u>2008</u>	<u>2007</u>
Basic net income per common share			
Net income from continuing operations	\$ 2,414,000	\$ 5,382,000	\$ 9,096,000
Preferred stock dividends	(344,000)	(344,000)	(344,000)
Net income from continuing operations for common stock	<u>2,070,000</u>	<u>5,038,000</u>	<u>8,752,000</u>
Discontinued operations:			
Operating income, net of taxes	187,000	353,000	299,000
Loss on sale, net of taxes	—	—	(8,000)
Income from discontinued operations	<u>187,000</u>	<u>353,000</u>	<u>291,000</u>
Net income for common stock	<u>\$ 2,257,000</u>	<u>\$ 5,391,000</u>	<u>\$ 9,043,000</u>
Basic weighted average common shares outstanding	<u>5,678,000</u>	<u>5,693,000</u>	<u>5,870,000</u>
Basic net income per common share:			
Net income from continuing operations	\$ 0.37	\$ 0.89	\$ 1.49
Income from discontinued operations	0.03	0.06	0.05
Basic net income per common share	<u>\$ 0.40</u>	<u>\$ 0.95</u>	<u>\$ 1.54</u>
	<u>2009</u>	<u>2008</u>	<u>2007</u>
Diluted net income per common share			
Net income from continuing operations for diluted net income per common share	\$ 2,070,000	\$ 5,038,000	\$ 8,752,000
Discontinued operations:			
Operating loss, net of taxes	187,000	353,000	299,000
Loss on sale	—	—	(8,000)
Net loss from discontinued operations	<u>187,000</u>	<u>353,000</u>	<u>291,000</u>
Net income for diluted net income per common share	<u>\$ 2,257,000</u>	<u>\$ 5,391,000</u>	<u>\$ 9,043,000</u>
Basic weighted average common shares outstanding	5,678,000	5,693,000	5,870,000
Incremental shares from assumed exercise of options, SoSARs and Restricted Stock Units	<u>119,000</u>	<u>194,000</u>	<u>257,000</u>
Diluted weighted average common shares outstanding	<u>5,797,000</u>	<u>5,887,000</u>	<u>6,127,000</u>
Diluted net income per common share			
Net income from continuing operations	\$ 0.36	\$ 0.86	\$ 1.43
Net income from discontinued operations	0.03	0.06	0.05
Diluted net income per common share	<u>\$ 0.39</u>	<u>\$ 0.92</u>	<u>\$ 1.48</u>

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

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In 2009, 2008 and 2007, the effects of a 228,000, 216,000 and 111,000 weighted average outstanding SOSARs and Options, respectively, were excluded from the computation of diluted earnings per share, as they would have been anti-dilutive.

11. INCOME TAXES

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

	Year Ended December 31,		
	2009	2008	2007
Current provision :			
Federal	\$ 1,837,000	\$ 1,645,000	\$ 214,000
State	338,000	339,000	873,000
	<u>2,175,000</u>	<u>1,984,000</u>	<u>1,087,000</u>
Deferred provision (benefit):			
Federal	(694,000)	814,000	4,854,000
State	16,000	(39,000)	71,000
	<u>(678,000)</u>	<u>775,000</u>	<u>4,925,000</u>
Provision for income taxes of continuing operations	<u>\$ 1,497,000</u>	<u>\$ 2,759,000</u>	<u>\$ 6,012,000</u>

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

	Year Ended December 31,		
	2009	2008	2007
Provision for federal income taxes at statutory rates	\$ 1,330,000	\$ 2,768,000	\$ 5,137,000
Provision for state income taxes, net of federal benefit	283,000	198,000	604,000
Valuation allowance changes affecting the provision (benefit) for income taxes	(76,000)	66,000	42,000
Work opportunity tax credits	(600,000)	(654,000)	—
Nondeductible expenses	516,000	361,000	201,000
Other	44,000	20,000	28,000
Provision (benefit) for income taxes	<u>\$ 1,497,000</u>	<u>\$ 2,759,000</u>	<u>\$ 6,012,000</u>

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

	December 31,	
	2009	2008
Current deferred assets:		
Allowance for doubtful accounts	\$ 1,044,000	\$ 1,217,000
Accrued liabilities	4,579,000	3,486,000
	<u>5,623,000</u>	<u>4,703,000</u>
Less valuation allowance	(243,000)	(246,000)
	<u>5,380,000</u>	<u>4,457,000</u>
Current deferred liabilities:		
Prepaid expenses	(588,000)	(490,000)
	<u>\$ 4,792,000</u>	<u>\$ 3,967,000</u>

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	December 31,	
	2009	2008
Noncurrent deferred assets:		
Net operating loss and other carryforwards	\$ 2,032,000	\$ 2,231,000
Deferred lease costs	527,000	594,000
Depreciation	182,000	524,000
Tax goodwill and intangibles	391,000	1,522,000
Stock-based compensation	2,144,000	1,972,000
Accrued rent	4,059,000	3,638,000
Impairment of long-lived assets	355,000	355,000
Noncurrent self-insurance reserves	4,749,000	4,008,000
	14,439,000	14,844,000
Less valuation allowance	(635,000)	(708,000)
	13,804,000	14,136,000
Noncurrent deferred liabilities:		
Note receivable	—	(237,000)
	\$ 13,804,000	\$ 13,899,000

In 2009, 2008, and 2007, the Company recorded a deferred tax benefit (provision) to reverse (increase) approximately \$76,000, \$(66,000) and \$(42,000), respectively, of the valuation allowance on deferred tax assets. The (increases) decreases in valuation allowance were based on the Company's assessment of the realization of certain individual tax assets. The Company continues to maintain a valuation allowance of approximately \$878,000 to reduce the deferred tax assets by the amount management believes 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, the Company will continue to assess the need for and adequacy of the remaining valuation allowance.

At December 31, 2009, the Company had \$10,099,000 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 \$5,233,000. 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 used them to reduce its taxes payable in 2008. The impact of recording these assets reduced the effective tax rate for the year ending December 31, 2008. In addition, the Company generated and recorded \$600,000 and \$326,000 in new Work Opportunity Tax Credits during 2009 and 2008, respectively.

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.

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Effective January 1, 2007, the Company adopted FASB's guidance on financial statement recognition and measurement of tax positions taken, or expected to be taken, in tax returns evaluating the need to recognize or unrecognized uncertain tax positions. The initial adoption of the guidance had no impact on the Company's financial statements. A reconciliation of the beginning and ending amount of unrecognized tax benefits is as follows:

	<u>2009</u>	<u>2008</u>
Balance at the beginning of the period	\$ 70,000	\$ 307,000
Decreases due to settlement with taxing authorities	—	(234,000)
Changes in tax positions for prior years	<u>6,000</u>	<u>(3,000)</u>
Balance at the end of the period	<u>\$ 76,000</u>	<u>\$ 70,000</u>

The unrecognized tax benefits are accrued in "other current liabilities." The net increase in the amount of unrecognized tax benefits during the year ended December 31, 2009 was related primarily to the adjustment of the estimated liability. The net decrease in the amount of unrecognized tax benefits during the year ended December 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 2006 through 2008 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, 2010, are as follows:

2010	\$ 22,285,000
2011	22,520,000
2012	23,057,000
2013	23,624,000
2014	24,198,000
Thereafter	<u>483,404,000</u>
	<u>\$ 599,088,000</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 \$23,422,000, \$22,962,000 and \$20,019,000 for 2009, 2008 and 2007, respectively. The accrued liability related to straight line rent was \$10,454,000 and \$9,267,000 at December 31, 2009 and 2008, respectively, and is included in "Other noncurrent liabilities" on the accompanying consolidated balance sheets.

Omega Leases

The Company leases 36 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.

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The Lease amendment extended the term to September 30, 2018 and provided 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. These scheduled increases had no effect on cash rent payments at the start of the lease term and only result in additional cash outlay as the 3 percent annual increases take effect each year.

In August 2009, the Company completed the construction of a 119 bed skilled nursing facility, Brentwood Terrace, located in Paris, Texas, replacing an existing 102 bed facility leased from Omega. The new facility was financed with funding from Omega and is leased from Omega under a long term operating lease with renewal options through 2035. Annual rent is \$789,000 initially, equal to 10.25% of \$7,702,000, the total cost of the replacement facility.

Since the Company supervised construction of the facility and would have been responsible for costs incurred in excess of \$7.9 million, the Company was deemed to have control of the construction project and was considered the owner during the construction period. In accordance with the accounting guidance surrounding lessee involvement in asset construction, the Company recorded the amounts incurred for facility construction as "Construction in progress – leased facility," a component of property and equipment, and amounts reimbursed by Omega were recorded as "Non-cash obligations for construction in progress – leased facility," a long term liability. Upon completion of construction of the replacement facility during the third quarter 2009, a sale and leaseback of the facility was deemed to have occurred and the Company removed both the facility asset and the long term liability from its consolidated balance sheet resulting in a zero balance at December 31, 2009 compared to \$1,039,000 at December 31, 2008. There was no resulting gain or loss on the deemed sale and leaseback transaction and the Company will have no continuing involvement with the property except for its operating lease described above. The Company had \$228,000 in unreimbursed construction costs due from Omega recorded as "receivable for leased facility construction costs" in the consolidated balance sheet at December 31, 2008 as these amounts were collected for this project in 2009.

The replacement facility is subject to the requirements of the Company's Master Lease, with certain exceptions for capital spending requirements. In August 2014, the Company may terminate the lease with respect to this facility. Beginning February 2011 and continuing until August 2014, 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 August 25, 2014. If at any time after February 2011 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.

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 \$394 per licensed bed. These amounts are subject to adjustment for increases in the Consumer Price Index. The Company is in compliance with the capital expenditure requirements. Total required capital expenditures during the remaining lease term and renewal options are \$23,237,000. These capital expenditures are being depreciated on a straight-line basis over the initial lease term.

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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.

In May 2009, the Company entered into an amendment to the Master lease with Omega under which Omega agreed to provide \$5,000,000 to fund renovations to several nursing centers leased from Omega. The annual base rent related to these facilities will be increased to reflect the amount of capital improvements to the respective facilities as the related expenditures are made. The increase is based on a rate of 10.25% per year of the amount financed under this amendment. This arrangement is similar to amendments entered into in 2006 and 2005 that provided financing totaling \$10,000,000 that was used to fund renovations to several nursing centers leased from Omega.

As of December 31, 2009, renovation projects have been completed at nine leased facilities with these funds, and work continues on two additional projects. In January 2010, we celebrated the grand opening of our tenth lessor funded renovation project, which included a 15 bed expansion. Plans are being developed for additional renovation projects. The Company had \$1,406,000 in unreimbursed construction costs due from Omega recorded as "receivable for leased facility construction costs" in the consolidated balance sheet at December 31, 2009 for three projects being funded by Omega.

The Company recently completed an expansion to one of its facilities by making use of fifteen licensed beds it acquired in 2005. This expansion project was funded by Omega, and similar to the Company's other projects, costs reimbursed by Omega will result in increased rent over the life of the lease. This project increased capacity and footprint compared to the Company's previous lessor funded facility projects which included renovations of existing facilities, but did not increase capacity. Accordingly, the costs incurred to expand the facility are recorded as a leasehold improvement asset of \$771,000 at December 31, 2009. The amounts reimbursed by Omega for this project are included as a long term liability. The capitalized leasehold improvements and lessor reimbursed costs will be amortized over the initial lease term ending in September 2018.

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. The lease provides for annual increases equal to the lesser of two times the Consumer Price Index or 3.0% in subsequent years. The Company is recording all scheduled rent increases as additional lease expense on a straight-line basis over the remaining lease term. On March 2, 2010, the Company entered into a Second Amendment to Master Lease with OHI Asset (FL), LLC, an affiliate of Omega, with respect to these properties. The Master Lease was scheduled to expire by its terms on February 28, 2010. The purpose of the amendment is to extend the term for a transition period which will end no later than August 31, 2010. As discussed in Note 7, the Company does not anticipate renewing this lease and has extended the lease on a monthly basis until a replacement tenant can be put into place. When a new operator is in place the lease will terminate and the Company will cooperate in an orderly transition to the new operator.

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.

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The Company has essentially exhausted all general and professional liability insurance available for claims asserted prior to March 10, 2009. For claims made during the period from March 10, 2009 through May 31, 2010, the Company maintains insurance with coverage limits of \$250,000 per medical incident and total annual aggregate policy coverage limits of \$750,000.

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 \$18,502,000 as of December 31, 2009. 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.

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

	Accrual at December 31,	
	2009	2008
Policy Year End:		
May 31, 2010	\$ 3,763,000	\$ —
March 9, 2009	8,713,000	3,837,000
March 9, 2008	4,377,000	5,769,000
March 9, 2007	1,060,000	3,202,000
March 9, 2006	357,000	1,102,000
2005 and earlier	232,000	1,049,000
	\$ 18,502,000	\$ 14,959,000

The Company's cash expenditures for self-insured professional liability costs were \$4,886,000, \$6,754,000 and \$2,776,000 for the years ending December 31, 2009, 2008 and 2007, respectively.

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Other Insurance-

With respect to workers' compensation insurance, substantially all of the Company's employees became covered under either an indemnity insurance plan or state-sponsored programs in May 1997. The Company is completely self-insured for workers' compensation exposures prior to May 1997. The Company has been and remains a non-subscriber to the Texas workers' compensation system and is, therefore, completely self-insured for employee injuries with respect to its Texas operations. 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 \$256,000 as of December 31, 2009.

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 for these policies based on its estimate of the level of claims expected to be incurred. 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. The Company has recorded a liability of \$176,000 for expected adjustments that relate to these workers' compensation insurance programs as of December 31, 2009.

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.

For the period from July 1, 2008 through June 30, 2010, the Company entered into a series of prefunded deductible workers' compensation policies. Under these policies, 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 these policies based on its estimate of the level of claims subject to the policy deductibles expected to be incurred. The Company has recorded a liability of \$40,000 for the estimated self-insured obligations under these policies as of December 31, 2009. Any differences in estimated claims costs and actual amounts are included in expense in the period finalized.

As of December 31, 2009, the Company is self-insured for health insurance benefits for certain employees and dependents for amounts up 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 \$1,121,000 at December 31, 2009. The differences between actual settlements and reserves are included in expense in the period finalized.

Employment Agreements

The Company has employment agreements with certain members of management that provide for the payment to these members of amounts up to 2.5 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 \$1,792,000 as of December 31, 2009. 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, 2009, the maximum contingent liability for the repurchase of the equity grants is approximately \$803,000. No amounts have been accrued for this contingent liability.

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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.

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, increased staffing requirements, 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 make mutually agreeable measures 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. Recently, the Company has experienced an increase in the severity of survey citations and the size of monetary penalties, consistent with industry trends.

As of December 31, 2009, the Company is engaged in 33 professional liability lawsuits. Seven lawsuits are currently scheduled for trial during the next seven months, 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.

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

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 subject it to fines, penalties and damages being excluded from the Medicare or Medicaid programs and could also have a material adverse impact on its financial condition, cash flows or results of operations.

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Reimbursement

Subject to certain exceptions, the limits effective January 1, 2010 impose a \$1,860 per patient annual ceiling on physical and speech therapy services, and a separate \$1,860 per patient annual ceiling on occupational therapy services. The Centers for Medicare and Medicaid 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. The exceptions process expired as of December 31, 2009 but in March 2010, Congress passed temporary legislation which retroactively extended the exceptions process to the period beginning January 1, 2010 through March 31, 2010. Both health care reform bills passed by Congress included language to extend the exception process, though no final legislative action to extend the exception process past March 31, 2010 has occurred. If the exception process is discontinued, it is expected that the reimbursement limitations will reduce therapy revenues and negatively impact the Company’s operating results and cash flows.

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. In July 2009, the Centers for Medicare and Medicaid Services (“CMS”) issued a final regulation that reduced Medicare payments to skilled nursing facilities by approximately 1.1% compared to the fiscal year ending September 30, 2009. The rate reduction was effective October 1, 2009. The decrease is the net effect of a 3.3% decrease intended to correct CMS forecasting errors that resulted when the current Resource Utilization Group (RUG) system went into effect in 2006, partially offset by a 2.2% inflation increase as measured by the SNF “market basket.”

As discussed in Note 7, CMS has issued regulations that became effective October 1, 2009 that prohibit the Company from billing Medicare Part B for certain enteral nutrition, urological, ostomy and tracheostomy supplies. Beginning October 1, these services were provided by third parties. The Company will still be required to provide the labor for the delivery of services but will no longer be a supplier and will not be entitled to any compensation. These services produced revenues of \$974,000, \$1,190,000 and \$1,154,000 and net income of \$204,000, \$388,000 and \$390,000 during the years ended December 31, 2009, 2008 and 2007, respectively.

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 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 provided \$87 billion for a temporary period to assist states in maintaining and expanding Medicaid enrollment. Pressures on state budgets are expected to continue in the future and are expected to result in Medicaid rate reductions once the ARRA provisions that assist states in maintaining and expanding Medicaid end on December 31, 2010. The Company received annual Medicaid rate increases during the third quarter of 2009. These rate changes increased its average rate per day for Medicaid patients by 1.7%, but were accompanied by provider tax increases in certain states, which reduced the net effective Medicaid rate increase to approximately 1.0%.

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, 2009, the Company derived 30.0% and 54.8% of its total patient and resident revenues related to continuing operations from the Medicare and Medicaid programs, respectively.

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

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13. QUARTERLY FINANCIAL INFORMATION (Unaudited)

Selected quarterly financial information for each of the quarters in the years ended December 31, 2009 and 2008 is as follows:

2009	Quarter			
	First	Second	Third	Fourth
Net revenues	<u>\$ 73,455,000</u>	<u>\$ 75,712,000</u>	<u>\$ 76,737,000</u>	<u>\$ 76,127,000</u>
Professional liability expense ⁽¹⁾	<u>3,242,000</u>	<u>2,955,000</u>	<u>902,000</u>	<u>2,033,000</u>
Other income ⁽²⁾	<u>549,000</u>	<u>—</u>	<u>—</u>	<u>—</u>
Net income from continuing operations	<u>292,000</u>	<u>873,000</u>	<u>1,075,000</u>	<u>174,000</u>
Income from discontinued operations	<u>71,000</u>	<u>57,000</u>	<u>57,000</u>	<u>2,000</u>
Net income for common stock	<u>\$ 277,000</u>	<u>\$ 844,000</u>	<u>\$ 1,046,000</u>	<u>\$ 90,000</u>
Basic net income per common share:				
Net income from continuing operations	\$ 0.04	\$ 0.14	\$ 0.17	\$ 0.02
Income from discontinued operations	0.01	0.01	0.01	—
Net income per common share	<u>\$ 0.05</u>	<u>\$ 0.15</u>	<u>\$ 0.18</u>	<u>\$ 0.02</u>
Diluted net income per common share:				
Net income from continuing operations	\$ 0.04	\$ 0.14	\$ 0.17	\$ 0.02
Income from discontinued operations	0.01	0.01	0.01	—
Net income per common share	<u>\$ 0.05</u>	<u>\$ 0.15</u>	<u>\$ 0.18</u>	<u>\$ 0.02</u>

⁽¹⁾ 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 recorded for professional liability in each quarter of 2009 is set forth in the table above.

⁽²⁾ During the first quarter of 2009, as discussed further in Note 3, the Company reached an agreement with CMS to settle for an amount less than the amounts previously accrued, resulting in a gain on settlement of \$549,000 that was recorded as other income.

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2008	Quarter			
	First	Second	Third	Fourth
Net revenues	\$ 71,157,000	\$ 70,562,000	\$ 71,931,000	\$ 73,957,000
Professional liability expense (benefit) ⁽¹⁾	(1,043,000)	1,401,000	278,000	1,022,000
Net income from continuing operations	3,006,000	608,000	594,000	1,174,000
Income from discontinued operations	83,000	82,000	76,000	112,000
Net income for common stock	\$ 3,003,000	\$ 604,000	\$ 584,000	\$ 1,200,000
Basic net income per common share:				
Net income from continuing operations	\$ 0.51	\$ 0.09	\$ 0.09	\$ 0.19
Income from discontinued operations	0.01	0.02	0.01	0.02
Net income per common share	\$ 0.52	\$ 0.11	\$ 0.10	\$ 0.21
Diluted net income per common share:				
Net income from continuing operations	\$ 0.49	\$ 0.09	\$ 0.09	\$ 0.19
Income from discontinued operations	0.01	0.01	0.01	0.02
Net income per common share	\$ 0.50	\$ 0.10	\$ 0.10	\$ 0.21

⁽¹⁾ 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.

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, 2009. 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

Kelly J. Gill
Executive Vice President and Chief Operating 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.

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

Richard M. Brame
Private Investor

Robert Z. Hensley
Business Consultant

Chad A. McCurdy
Managing Partner
Marlin Capital Partners, LLC

William C. O'Neil, Jr.
Private Investor