

NATIONAL HEALTHCARE CORP
Form 10-Q
November 05, 2013

**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549**

FORM 10-Q

QUARTERLY REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended September 30, 2013

OR

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF
THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from _____ to _____

Commission file number 001-13489

(Exact name of registrant as specified in its Charter)

Delaware

(State or other jurisdiction of
incorporation or organization)

52-2057472

(I.R.S. Employer
Identification No.)

100 E. Vine Street
Murfreesboro, TN

37130

(Address of principal executive offices)
(Zip Code)

(615) 890-2020

Registrant's telephone number, including area code

Indicate by check mark whether the registrant: (1) Has filed all reports required to be filed by Section 13 or 15(d), of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such period that the registrant was required to submit and post such files).

Yes No

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Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company. See the definitions of "large accelerated file," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check one):

Large Accelerated filer []

Accelerated filer [x]

Non-accelerated filer (Do not check if a smaller reporting company) []

Smaller reporting company []

Indicate by check mark whether the registrant is a shell company (as is defined in Rule 12b-2 of the Exchange Act). Yes [] No [x]

14,063,556 shares of common stock of the registrant were outstanding as of November 1, 2013.

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PART I. FINANCIAL INFORMATION**Item 1. Financial Statements.****NATIONAL HEALTHCARE CORPORATION****Interim Condensed Consolidated Statements of Income***(in thousands, except share and per share amounts)**(unaudited)*

| | Three Months Ended | | Nine Months Ended | |
|------------------------------------|--------------------|--------------------------|-------------------|--------------------------|
| | September 30 | | September 30 | |
| | 2013 | 2012 | 2013 | 2012 |
| | | <i>(as adjusted)</i> | | <i>(as adjusted)</i> |
| Revenues: | | | | |
| Net patient revenues | \$ 182,966 | \$ 175,361 | \$ 539,797 | \$ 525,211 |
| Other revenues | 12,806 | 13,946 | 42,364 | 41,814 |
| Net operating revenues | 195,772 | 189,307 | 582,161 | 567,025 |
| Cost and Expenses: | | | | |
| Salaries, wages and benefits | 113,739 | 106,844 | 330,160 | 318,028 |
| Other operating | 45,752 | 48,519 | 148,891 | 149,271 |
| Facility rent | 9,889 | 9,813 | 29,627 | 29,507 |
| Depreciation and amortization | 7,045 | 7,402 | 20,973 | 22,168 |
| Interest | 82 | 119 | 248 | 345 |
| Total costs and expenses | 176,507 | 172,697 | 529,899 | 519,319 |
| Income Before Non-Operating Income | 19,265 | 16,610 | 52,262 | 47,706 |
| Non-Operating Income | 11,171 | 6,771 | 24,421 | 18,546 |
| Income Before Income Taxes | 30,436 | 23,381 | 76,683 | 66,252 |
| Income Tax Provision | (10,559) | (6,185) | (28,659) | (22,847) |
| Net Income | 19,877 | 17,196 | 48,024 | 43,405 |

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| | | | | |
|---|------------|------------|------------|------------|
| Dividends to Preferred Stockholders | (2,167) | (2,167) | (6,503) | (6,503) |
| Net Income Available to Common Stockholders | \$ 17,710 | \$ 15,029 | \$ 41,521 | \$ 36,902 |
| Earnings Per Common Share: | | | | |
| Basic | \$ 1.28 | \$ 1.08 | \$ 3.00 | \$ 2.67 |
| Diluted | \$ 1.19 | \$ 1.04 | \$ 2.88 | \$ 2.62 |
| Weighted Average Common Shares Outstanding: | | | | |
| Basic | 13,820,449 | 13,852,403 | 13,832,706 | 13,846,022 |
| Diluted | 16,686,915 | 16,605,285 | 16,701,491 | 16,578,535 |
| Dividends Declared Per Common Share | \$ 0.32 | \$ 0.30 | \$ 0.94 | \$ 0.90 |

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

NATIONAL HEALTHCARE CORPORATION

Interim Condensed Consolidated Statements of Comprehensive Income

(unaudited – in thousands)

| | Three Months Ended | | Nine Months Ended | |
|--|--------------------|----------------------------------|-------------------|----------------------------------|
| | September 30 | | September 30 | |
| | 2013 | 2012 <i>(as adjusted)</i> | 2013 | 2012 <i>(as adjusted)</i> |
| Net Income | \$ 19,877 | \$ 17,196 | \$ 48,024 | \$ 43,405 |
| Other Comprehensive Income (Loss): | | | | |
| Unrealized gains (losses) on investments in marketable securities | (5,629) | 1,170 | (3,471) | 15,177 |
| Reclassification adjustment for realized (gains) losses on sale of securities | 911 | 53 | 527 | (934) |
| Income tax (expense) benefit related to items of other comprehensive income (loss) | 1,889 | (465) | 993 | (5,524) |
| Other comprehensive income (loss), net of tax | (2,829) | 758 | (1,951) | 8,719 |
| Comprehensive Income | \$ 17,048 | \$ 17,954 | \$ 46,073 | \$ 52,124 |

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

NATIONAL HEALTHCARE CORPORATION**Interim Condensed Consolidated Balance Sheets***(unaudited - in thousands)*

| | September 30, 2013 | December 31, 2012 <i>(as adjusted)</i> |
|---|-----------------------|--|
| Assets | | |
| Current Assets: | | |
| Cash and cash equivalents | \$ 88,410 | \$ 66,701 |
| Restricted cash and cash equivalents | 12,149 | 11,563 |
| Marketable securities | 108,199 | 107,250 |
| Restricted marketable securities | 141,861 | 135,207 |
| Accounts receivable, less allowance for doubtful accounts of \$4,156 and \$3,166, respectively | 79,827 | 76,959 |
| Inventories | 7,078 | 6,660 |
| Prepaid expenses and other assets | 2,016 | 1,132 |
| Notes receivable | 376 | 5,840 |
| Federal income tax receivable | - | 5,933 |
| Total current assets | 439,916 | 417,245 |
| Property and Equipment: | | |
| Property and equipment, at cost | 725,732 | 675,455 |
| Accumulated depreciation and amortization | (270,818) | (254,548) |
| Net property and equipment | 454,914 | 420,907 |
| Other Assets: | | |
| Deposits | 280 | 143 |
| Goodwill | 17,600 | 17,600 |
| Notes receivable | 13,054 | 15,949 |
| Deferred income taxes | 14,083 | 12,817 |
| Investments in limited liability companies | 36,125 | 40,039 |
| Total other assets | 81,142 | 86,548 |
| Total assets | \$ 975,972 | \$ 924,700 |

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

NATIONAL HEALTHCARE CORPORATION

Interim Condensed Consolidated Balance Sheets (continued)

*(in thousands, except share and per share amounts)**(unaudited)*

| | September 30, 2013 | December 31, 2012 <i>(as adjusted)</i> |
|--|-----------------------|--|
| Liabilities and Stockholders' Equity | | |
| Current Liabilities: | | |
| Trade accounts payable | \$ 12,522 | \$ 10,555 |
| Accrued payroll | 56,645 | 37,243 |
| Amounts due to third party payors | 21,009 | 19,267 |
| Accrued risk reserves | 118,714 | 110,331 |
| Deferred income taxes | 22,617 | 24,474 |
| Other current liabilities | 17,689 | 20,411 |
| Dividends payable | 6,726 | 6,480 |
| Total current liabilities | 255,922 | 228,761 |
| Long-term debt | 10,000 | 10,000 |
| Refundable entrance fees | 10,600 | 10,680 |
| Obligation to provide future services | 1,791 | 1,791 |
| Other noncurrent liabilities | 14,026 | 13,890 |
| Deferred revenue | 3,977 | 3,430 |
| Stockholders' Equity: | | |
| Series A Convertible Preferred Stock; \$.01 par value; 25,000,000 shares authorized; 10,837,695 and 10,838,412 shares, respectively, issued and outstanding; stated at liquidation value of \$15.75 per share | 170,510 | 170,514 |
| Common stock, \$.01 par value; 30,000,000 shares authorized; 14,063,449 and 14,158,127 shares, respectively, issued and outstanding | 140 | 141 |
| Capital in excess of par value | 151,854 | 154,692 |
| Retained earnings | 308,295 | 279,993 |
| Accumulated other comprehensive income | 48,857 | 50,808 |
| Total stockholders' equity | 679,656 | 656,148 |
| Total liabilities and stockholders' equity | \$ 975,972 | \$ 924,700 |

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

NATIONAL HEALTHCARE CORPORATION

Interim Condensed Consolidated Statements of Cash Flows

(unaudited – in thousands)

| | Nine Months Ended | |
|---|-------------------|------------------------------|
| | September 30 | |
| | 2013 | 2012 <i>(as adjusted)</i> |
| Cash Flows From Operating Activities: | | |
| Net income | \$ 48,024 | \$ 43,405 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation and amortization | 20,973 | 22,168 |
| Provision for doubtful accounts receivable | 2,331 | 1,773 |
| Equity in earnings of unconsolidated investments | (11,542) | (10,079) |
| Distributions from unconsolidated investments | 15,456 | 6,301 |
| Gain on recovery of notes receivable | (5,454) | - |
| (Gains) losses on sale of marketable securities | 527 | (934) |
| Deferred income taxes | (2,130) | (375) |
| Stock-based compensation | 1,812 | 1,925 |
| Changes in operating assets and liabilities: | | |
| Restricted cash and cash equivalents | (8,721) | (6,270) |
| Accounts receivable | (5,199) | 2,971 |
| Income tax receivable | 5,933 | 3,779 |
| Inventories | (418) | 940 |
| Prepaid expenses and other assets | (884) | (672) |
| Trade accounts payable | 1,967 | (4,288) |
| Accrued payroll | 19,402 | (3,386) |
| Amounts due to third party payors | 1,742 | 2,238 |
| Other current liabilities and accrued risk reserves | 5,662 | 3,635 |
| Other noncurrent liabilities | 136 | (2,668) |
| Deferred revenue | 547 | 866 |
| Net cash provided by operating activities | 90,164 | 61,329 |
| Cash Flows From Investing Activities: | | |
| Additions to property and equipment | (33,981) | (14,888) |
| Acquisition of six skilled nursing facilities | (21,000) | - |
| Acquisition of non-controlling interest in hospice business | - | (7,500) |
| Collections of notes receivable | 13,813 | 336 |
| Change in restricted cash and cash equivalents | 8,135 | 20,940 |
| Purchase of marketable securities | (68,978) | (65,778) |
| Sale of marketable securities | 57,904 | 42,604 |
| Net cash used in investing activities | (44,107) | (24,286) |
| Cash Flows From Financing Activities: | | |
| Tax expense from stock-based compensation | (225) | (271) |
| Dividends paid to preferred stockholders | (6,503) | (6,503) |

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| | | |
|---|------------------|------------------|
| Dividends paid to common stockholders | (12,973) | (12,536) |
| Issuance of common shares | 270 | 5,960 |
| Repurchase of common shares | (4,700) | - |
| Entrance fee refunds | (80) | (1,211) |
| Change in deposits | (137) | 217 |
| Net cash used in financing activities | (24,348) | (14,344) |
| Net Increase in Cash and Cash Equivalents | 21,709 | 22,699 |
| Cash and Cash Equivalents, Beginning of Period | 66,701 | 61,008 |
| Cash and Cash Equivalents, End of Period | \$ 88,410 | \$ 83,707 |

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

NATIONAL HEALTHCARE CORPORATION

Interim Condensed Consolidated Statements of Stockholders' Equity

(in thousands, except share and per share amounts)

(unaudited)

| | Preferred Stock | | Common Stock | | Capital in | Excess of | <i>(as adjusted)</i> Retained Earnings | Accumulated Other Comprehensive Income | <i>(as adjusted)</i> Total Stockholders' Equity |
|--|-----------------|------------|--------------|--------|---------------|--------------|--|---|--|
| | Shares | Amount | Shares | Amount | Par Value | | | | |
| Balance at January 1, 2012 | 10,838,490 | \$ 170,515 | 13,862,738 | \$ | 138 | \$ 139,183 | \$ 260,331 | \$ 36,702 | \$ 606,869 |
| Net income | — | — | — | — | — | — | 43,405 | — | 43,405 |
| Other comprehensive income | — | — | — | — | — | — | — | 8,719 | 8,719 |
| Stock-based compensation | — | — | — | — | — | 1,925 | — | — | 1,925 |
| Tax expense from exercise of stock options | — | — | — | — | — | (271) | — | — | (271) |
| Shares sold – options exercised | — | — | 130,150 | — | 1 | 5,959 | — | — | 5,960 |
| Shares issued in conversion of preferred stock to common stock | (78) | (1) | 18 | — | — | 1 | — | — | — |
| Dividends declared to preferred stockholders (\$0.60 per | — | — | — | — | — | — | (6,503) | — | (6,503) |

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| | | | | | | | | | | |
|--|------------|------------|------------|-----|---------|------------|------------|----|----------|------------|
| share) | | | | | | | | | | |
| Dividends declared to common stockholders (\$0.90 per share) | – | – | – | – | – | – | (12,587) | – | (12,587) | |
| Balance at September 30, 2012 | 10,838,412 | \$ 170,514 | 13,992,906 | \$ | 139 | \$ 146,797 | \$ 284,646 | \$ | 45,421 | \$ 647,517 |
| Balance at January 1, 2013 | 10,838,412 | \$ 170,514 | 14,158,127 | \$ | 141 | \$ 154,692 | \$ 279,993 | \$ | 50,808 | \$ 656,148 |
| Net income | – | – | – | – | – | – | 48,024 | – | – | 48,024 |
| Other comprehensive loss | – | – | – | – | – | – | – | – | (1,951) | (1,951) |
| Stock-based compensation | – | – | – | – | – | 1,812 | – | – | – | 1,812 |
| Tax expense from exercise of stock options | – | – | – | – | – | (225) | – | – | – | (225) |
| Shares sold – options exercised | – | – | 5,150 | – | – | 270 | – | – | – | 270 |
| Repurchase of common stock | – | – | (100,000) | (1) | (4,699) | – | – | – | – | (4,700) |
| Shares issued in conversion of preferred stock to common stock | (717) | (4) | 172 | – | – | 4 | – | – | – | – |
| Dividends declared to preferred stockholders (\$0.60 per share) | – | – | – | – | – | – | (6,503) | – | – | (6,503) |
| Dividends declared to common stockholders (\$0.94 per share) | – | – | – | – | – | – | (13,219) | – | – | (13,219) |

| | | | | | | | | | | | |
|-------------------------------------|------------|------------|------------|----|-----|------------|------------|----|--------|----|---------|
| Balance at September 30, 2013 | 10,837,695 | \$ 170,510 | 14,063,449 | \$ | 140 | \$ 151,854 | \$ 308,295 | \$ | 48,857 | \$ | 679,656 |
|-------------------------------------|------------|------------|------------|----|-----|------------|------------|----|--------|----|---------|

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

NATIONAL HEALTHCARE CORPORATION

Notes to Interim Condensed Consolidated Financial Statements

September 30, 2013

(unaudited)

Note 1 – Description of Business

National HealthCare Corporation (“NHC” or the “Company”) is a leading provider of senior health care services. We operate or manage, through certain affiliates, 68 skilled nursing centers with 8,803 beds in nine states and provide other senior health care services in one additional state. These operations are provided by separately funded and maintained subsidiaries. We provide health care services to patients in a variety of settings including skilled nursing centers, managed care specialty units, sub–acute care units, Alzheimer's care units, homecare programs, assisted living centers and independent living centers. We also have a non-controlling ownership interest in a hospice care business that services NHC owned health care centers and others. In addition, we provide insurance services, management and accounting services, and lease properties to operators of skilled nursing centers.

Note 2 – Summary of Significant Accounting Policies

The listing below is not intended to be a comprehensive list of all of our significant accounting policies. In many cases, the accounting treatment of a particular transaction is specifically dictated by generally accepted accounting principles, with limited need for management’s judgment in their application. There are also areas in which management’s judgment in selecting any available alternative would not produce a materially different result. See our audited December 31, 2012 consolidated financial statements and notes thereto which contain accounting policies and other disclosures required by generally accepted accounting principles. Our audited December 31, 2012 consolidated financial statements are available at our web site: www.nhccare.com.

Basis of Presentation

The unaudited condensed consolidated financial statements to which these notes are attached include all normal, recurring adjustments which are necessary to fairly present the financial position, results of operations and cash flows of NHC. All significant intercompany transactions and balances have been eliminated in consolidation. We assume that users of these interim financial statements have read or have access to the audited December 31, 2012 consolidated financial statements and Management's Discussion and Analysis of Financial Condition and Results of Operations and that the adequacy of additional disclosure needed for a fair presentation, except in regard to material contingencies, may be determined in that context. Accordingly, footnotes and other disclosures which would substantially duplicate the disclosure contained in our most recent annual report to stockholders have been omitted. This interim financial information is not necessarily indicative of the results that may be expected for a full year for a variety of reasons.

Estimates and Assumptions

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires us 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 and could cause our reported net income to vary significantly from period to period.

Change in Accounting Principle

Effective January 1, 2013, the Company recorded the cumulative effect of a change in accounting principle related to the adoption of ASU No. 2012-01, *Continuing Care Retirement Communities — Refundable Advance Fees*. This standard is intended to clarify the accounting for advance fees ("entrance fees") received by a continuing care retirement community ("CCRC"). The updated guidance states the estimated amount of entrance fees that are expected to be refunded to current CCRC residents under the terms of the resident agreements shall be accounted for and reported as a liability ("refundable entrance fees"). Previously, we accounted for both the 10% non-refundable

and the refundable portions of the entrance fees as deferred revenue, amortizing the deferred revenue over the life expectancy of the resident and the estimated useful life of the building, respectively, in accordance with ASC Topic 954-430, *Health Care Entities-Deferred Revenue*. The Company believes recording the refundable entrance fees as a liability, which includes 90% of the original entry fee paid plus 40% of any estimated appreciation if the apartment exceeds the original resident's entry fee, more clearly aligns how we have historically operated the CCRC. Also, with the adoption of ASU No. 2012-01, our future service obligation calculation for the CCRC was modified. Because the future service obligation calculation includes an offset for unamortized deferred revenue, the reclassification of refundable entrance fee amounts from deferred revenue to a liability has a direct impact on the future revenues input of the calculation. With the loss of deferred revenue, the present value of the CCRC's expenses exceeds the present value of the CCRC's revenues, which creates the recording of a future service obligation.

As described in the guidance for accounting changes, the comparative interim consolidated financial statements of prior periods are adjusted to apply the new accounting method retrospectively. The following tables present the effect on the interim condensed consolidated financial statements of the accounting change that was retrospectively adopted on January 1, 2013:

Consolidated Balance Sheet

(in thousands)

| | | As Previously Reported | December 31, 2012 Effect of Accounting Change | As Adjusted |
|--|----|---------------------------|--|-------------|
| Deferred income taxes | \$ | 10,564 | \$ 2,253 | \$ 12,817 |
| Total assets | | 922,447 | 2,253 | 924,700 |
| Refundable entrance fees | | — | 10,680 | 10,680 |
| Deferred revenue | | 10,124 | (6,694) | 3,430 |
| Obligation to provide future services | | — | 1,791 | 1,791 |
| Retained earnings | | 283,517 | (3,524) | 279,993 |
| Total stockholders' equity | | 659,672 | (3,524) | 656,148 |
| Total liabilities and stockholders' equity | \$ | 922,447 | \$ 2,253 | \$ 924,700 |

Interim Condensed Consolidated Statement of Income

(in thousands, except share and per share amounts)

| | Three Months Ended September 30, 2012 | | | Nine Months Ended September 30, 2012 | | |
|-------------------|---------------------------------------|-----------------------------------|----------------|--------------------------------------|-----------------------------------|----------------|
| | As Previously Reported | Effect of Accounting Change | As Adjusted | As Previously Reported | Effect of Accounting Change | As Adjusted |
| Other revenues \$ | 14,007 | \$ (61) | \$ 13,946 | \$ 42,008 | \$ (194) | \$ 41,814 |
| | 189,368 | (61) | 189,307 | 567,219 | (194) | 567,025 |

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| | | | | | | | |
|---|-----------|-----------|-----------|-----------|-----------|-----------|--|
| Net operating revenues | | | | | | | |
| Income Before Non-Operating Income | 16,671 | (61) | 16,610 | 47,900 | (194) | 47,706 | |
| Income Before Income Taxes | 23,442 | (61) | 23,381 | 66,446 | (194) | 66,252 | |
| Income Tax Provision | (6,209) | 24 | (6,185) | (22,923) | 76 | (22,847) | |
| Net Income | 17,233 | (37) | 17,196 | 43,523 | (118) | 43,405 | |
| Net Income Available to Common Shareholders | \$ 15,066 | \$ (37) | \$ 15,029 | \$ 37,020 | (118) | \$ 36,902 | |
| Basic Earnings Per Share | \$ 1.09 | \$ (0.01) | \$ 1.08 | \$ 2.67 | \$ 0.00 | \$ 2.67 | |
| Diluted Earnings Per Share | \$ 1.04 | \$ 0.00 | \$ 1.04 | \$ 2.63 | \$ (0.01) | \$ 2.62 | |

Interim Condensed Consolidated Statement of Comprehensive Income

(in thousands)

| | Three Months Ended September 30, 2012 | | | Nine Months Ended September 30, 2012 | | |
|----------------------|---------------------------------------|-----------------------------|-------------|--------------------------------------|-----------------------------|-------------|
| | As Previously Reported | Effect of Accounting Change | As Adjusted | As Previously Reported | Effect of Accounting Change | As Adjusted |
| Net Income | \$ 17,233 | \$ (37) | \$ 17,196 | \$ 43,523 | \$ (118) | \$ 43,405 |
| Comprehensive Income | \$ 17,991 | \$ (37) | \$ 17,954 | \$ 52,242 | \$ (118) | \$ 52,124 |

Interim Condensed Consolidated Statement of Cash Flows

(in thousands)

| | Nine Months Ended September 30, 2012 | | |
|--|--------------------------------------|-----------------------------|-------------|
| | As Previously Reported | Effect of Accounting Change | As Adjusted |
| <i>Cash Flows From Operating Activities:</i> | | | |
| Net income | \$ 43,523 | \$ (118) | \$ 43,405 |
| Deferred income taxes | (299) | (76) | (375) |
| Deferred revenue | 959 | (93) | 866 |
| Net cash provided by operating activities | 61,616 | (287) | 61,329 |
| <i>Cash Flows From Financing Activities:</i> | | | |
| Entrance fee deposits | (1,498) | 287 | (1,211) |
| Net cash used in financing activities | \$ (14,631) | \$ 287 | \$ (14,344) |

Interim Condensed Consolidated Statements of Stockholders' Equity

(in thousands)

| | | Nine Months Ended September 30, 2012 | | |
|----------------------------|----|--------------------------------------|-----------------------------------|-------------|
| | | As Previously Reported | Effect of Accounting Change | As Adjusted |
| <i>Retained Earnings</i> | | | | |
| Balance at January 1, 2012 | \$ | 265,198 | \$ (4,867) | \$ 260,331 |

Revenue Recognition – Third Party Payors

Approximately 67% of our net patient revenues are derived from Medicare, Medicaid, and other government programs. Amounts earned under these programs are subject to review by the Medicare and Medicaid intermediaries or their agents. In our opinion, adequate provision has been made for any adjustments that may result from these reviews. Any differences between our original estimates of reimbursements and subsequent revisions are reflected in operations in the period in which the revisions are made often due to final determination or the period of payment no longer being subject to audit or review. We have made provisions of approximately \$21,009,000 and \$19,267,000 as of September 30, 2013 and December 31, 2012, respectively, for various Medicare and Medicaid current and prior year cost reports and claims reviews.

Revenue Recognition – Private Pay

For private pay patients in skilled nursing or assisted living facilities, we bill room and board in advance with payment being due in the month the services are performed. Charges for ancillary, pharmacy, therapy and other services to private patients are billed in the month following the performance of services; however, all billings are recognized as revenue when the services are performed.

Revenue Recognition – Subordination of Fees and Uncertain Collections

We provide management services to certain long-term care facilities and to others we provide accounting and financial services. We generally charge 6% to 7% of net operating revenues for our management services and a predetermined fixed rate per bed for the accounting and financial services. Our policy is to recognize revenues associated with both management services and accounting and financial services on an accrual basis as the services are provided.

However, under the terms of our management contracts, payments for our management services are subject to subordination to other expenditures of the long-term care center being managed. Furthermore, for certain of the third parties with whom we have contracted to provide services and which we have determined that collection is not reasonably assured, our policy is to recognize income only in the period in which the amounts are realized. We may receive payment for the unpaid and unrecognized management fees in whole or in part in the future only if cash flows from the operating and investing activities of the centers or proceeds from the sale of the centers are sufficient to pay the fees. There can be no assurance that such future cash flows will occur. The realization of such previously unrecognized revenue could cause our reported net income to vary significantly from period to period.

We agree to subordinate our fees to the other expenses of a managed center because we believe we know how to improve the quality of patient services and finances of a long-term care center. We believe subordinating our fees demonstrates to the owner and employees of the managed center how confident we are of the impact we can have in making the center operations successful. We may continue to provide services to certain managed centers despite not being fully paid currently so that we may be able to collect unpaid fees in the future from improved operating results and because the incremental savings from discontinuing services to a center may be small compared to the potential benefit. Also, we may benefit from providing other ancillary services to the managed center.

Accrued Risk Reserves

We are principally self-insured for risks related to employee health insurance, workers' compensation and professional and general liability claims. Our accrued risk reserves primarily represent the accrual for self-insured risks associated with employee health insurance, workers' compensation and professional and general liability claims. The accrued risk reserves include a liability for reported claims and estimates for incurred but unreported claims. Our policy with respect to our workers' compensation and professional and general liability claims is to use an external, independent actuary to estimate our exposure for claims obligations (for both asserted and unasserted claims). Our health insurance reserve is based on our known claims incurred and an estimate of incurred but unreported claims determined by our analysis of historical claims paid. We reassess our accrued risk reserves on a quarterly basis.

Professional liability remains an area of particular concern to us. The entire long term care industry has seen an increase in personal injury/wrongful death claims based on alleged negligence by nursing homes and their employees in providing care to residents. As of September 30, 2013, we and/or our managed centers are defendants in 30 such claims inclusive of years 2005 through September 30, 2013. It remains possible that those pending matters plus potential unasserted claims could exceed our reserves, which could have a material adverse effect on our consolidated

financial position, results of operations and cash flows. It is also possible that future events could cause us to make significant adjustments or revisions to these reserve estimates and cause our reported net income to vary significantly from period to period.

We maintain insurance coverage for incidents occurring in all centers owned or leased by us. The coverages include both primary policies and excess policies. In all years, settlements, if any, in excess of available insurance policy limits and our own reserves would be expensed by us.

Continuing Care Contracts and Refundable Entrance Fees

We have one continuing care retirement center (“CCRC”) within our operations. Residents at this retirement center may enter into continuing care contracts with us. The contract provides that 10% of the resident entry fee becomes non-refundable upon occupancy, and the remaining refundable portion of the entry fee is calculated using the lessor of the price at which the apartment is re-assigned or 90% of the original entry fee, plus 40% of any appreciation if the apartment exceeds the original resident’s entry fee. In each case, we amortize the non-refundable part of these fees into revenue over the actuarially determined remaining life of the resident, which is the expected period of occupancy by the resident. We pay the refundable portion of our entry fees when residents

relocate from our community and the apartment is re-occupied. Refundable entrance fees are classified as non-current liabilities and non-refundable entrance fees are classified as deferred revenue in the Company's consolidated balance sheets. The balances of refundable entrance fees as of September 30, 2013 and December 31, 2012 were \$10,600,000 and \$10,680,000, respectively.

Obligation to Provide Future Services

The CCRC annually calculates the present value of the net cost of future services and the use of facilities to be provided to the current residents and compares that amount with the balance of non-refundable deferred revenue from entrance fees received. If the present value of the net cost of future services exceeds the related anticipated revenues, a liability is recorded (obligation to provide future services) with a corresponding charge to income. With the recent adoption of ASU No. 2012-01, our future service obligation calculation was modified and we now have a liability recorded in the amount of \$1,791,000 as of September 30, 2013 and December 31, 2012.

Deferred Revenue

Deferred revenue includes the deferred gain on the sale of assets to National, the non-refundable portion (10%) of CCRC entrance fees being amortized over the remaining life expectancies of the residents, and premiums received within our workers' compensation and professional liability companies that are not yet earned.

New Accounting Pronouncements

In February 2013, the Financial Accounting Standards Board ("FASB") issued Accounting Standard Update ("ASU") No. 2013-02, which is included in Codification under ASC 220, "Comprehensive Income". The objective of this updated standard is to improve the reporting of reclassifications out of accumulated other comprehensive income. The standard states that disclosure of reclassification amounts required by U.S. GAAP to be reclassified out of accumulated other comprehensive income to net income in their entirety in the same reporting period, should be provided in one location, by component of other comprehensive income. Presentation of such amounts is permitted on either the face of the financial statement where net income is presented or as a separate tabular disclosure in the notes to the financial statements, and should be disclosed by respective line item of net income affected. This accounting standard update became effective beginning in our first quarter of fiscal 2013. The adoption of this accounting standard update resulted in financial statement presentation changes only. The Company has reclassified realized gains on the sale of marketable securities out of accumulated other comprehensive income; as such, these investment gains are classified as "non-operating income" in our consolidated statements of income.

In July 2012, the FASB issued ASU No. 2012-01, which is included in the Codification under ASC subtopic 954-430, "Health Care Entities—Deferred Revenue". This revised standard is intended to clarify the accounting for refundable

advance fees (“refundable entrance fees”) received by a continuing care retirement community. The guidance states that refundable portion of entrance fees should be accounted for as deferred revenue when the refund of the fee is contingent upon the resale of the contract holder’s unit, limited to the proceeds received by the resale, and the legal environment and management’s policy and practice support the withholding of refunds under said conditions. In the event that the refund is contingent upon reoccupancy, but not limited to the proceeds of the resale, then the fees should be accounted for and reported as a liability. This accounting standard update became effective beginning in our first quarter of fiscal 2013. The adoption of this accounting standard resulted in a change of accounting principle which was applied retrospectively, including the cumulative effect of this change recognized through beginning retained earnings. See the beginning of Note 2 under “*Change in Accounting Principle*” for further discussion on the adoption of ASU No. 2012-01.

Reclassifications

Certain prior period amounts have been reclassified to conform to the current financial statement presentation, with no effect on the Company's consolidated financial position or results of operations.

Note 3 – Other Revenues

Other revenues are outlined in the table below. Revenues from management and accounting services include management and accounting fees provided to managed and other health care centers. Revenues from rental income include health care real estate properties owned by us and leased to third party operators. Revenues from insurance services include premiums for workers' compensation, health insurance, and professional liability insurance policies that our wholly-owned limited purpose insurance subsidiaries have written for certain health care centers to which we provide management or accounting services. "Other" revenues include miscellaneous health care related earnings.

Other revenues include the following:

| <i>(in thousands)</i> | Three Months Ended | | Nine Months Ended | |
|---|--------------------|-----------|-------------------|-----------|
| | September 30 | | September 30 | |
| | 2013 | 2012 | 2013 | 2012 |
| Management and accounting services fees | \$ 5,234 | \$ 5,125 | \$ 14,662 | \$ 15,104 |
| Rental income | 4,886 | 4,963 | 14,387 | 14,486 |
| Insurance services | 2,729 | 3,972 | 12,792 | 11,803 |
| Other | (43) | (114) | 523 | 421 |
| | \$ 12,806 | \$ 13,946 | \$ 42,364 | \$ 41,814 |

Management Fees from National

We manage five skilled nursing facilities owned by National Health Corporation ("National"). For the three months and nine months ended September 30, 2013, we recognized management fees and interest on management fees of \$860,000 and \$2,637,000, respectively, from these centers. For the three months and nine months ended September 30, 2012, we recognized management fees and interest on management fees of \$850,000 and \$2,564,000, respectively, from these centers.

Because the amount collectable could not be reasonably determined when the management services were provided, and because we cannot estimate the timing or amount of expected future collections, the unpaid fees from the five centers owned by National will be recognized as revenues only when the collectability of these fees can be reasonably assured. Under the terms of our management agreement with National, the payment of these fees to us may be subordinated to other expenditures of the five long-term care centers. We continue to manage these centers so that we may be able to collect our fees in the future and because the incremental savings from discontinuing services to a center may be small compared to the potential benefit. We may receive payment for the unrecognized management fees in whole or in part in the future only if cash flows from the operating and investing activities of the five centers or

the proceeds from the sale of the centers are sufficient to pay the fees. There can be no assurance that such future improved cash flows will occur.

Management Fees from Other Nursing Centers

For the three months and nine months ended September 30, 2013, we recognized \$787,000 and \$3,131,000, respectively, of management fees from fourteen skilled nursing facilities owned by two non-profit organizations (ElderTrust and SeniorTrust) where a court-appointed receiver was custodian over the assets of the organizations. For the three months and nine months ended September 30, 2012, we recognized management fees of \$1,422,000 and \$4,251,000, respectively, from these centers.

On September 1, 2013 and with court approval, we began operating seven of the health care centers located in the states of Massachusetts and New Hampshire. We previously managed these seven facilities for ElderTrust. The Massachusetts and New Hampshire health care centers were paying approximately \$3,200,000 annually in management fees to NHC. We do not anticipate a material change to our future results of operations and cash flows from the transition of us managing the seven health care centers to us operating the seven health care facilities.

During the first and second quarters of 2013, SeniorTrust sold its seven skilled nursing facilities in Missouri and Kansas and terminated their respective NHC management agreements. At the time of the separation, the Missouri and Kansas health care centers were paying approximately \$2,200,000 annually in management fees to

NHC. We anticipate the loss of management fee revenue from the Missouri and Kansas health care centers to be adverse to our future results of operations and cash flows.

Rental Income and Accounting Services Fees

As part of the litigation settlement described in Note 17, we agreed to no longer sublease The Health Center at Standifer Place and Standifer Place Assisted Living facility in Chattanooga, Tennessee to a third party non-profit organization. On October 1, 2013, we terminated the current sublease with the third party non-profit organization and then re-leased the two health care facilities to a third-party for-profit operator. We do not expect the transaction to have a material effect on our future results of operations and cash flows.

Note 4 – Non-Operating Income

Non-operating income is outlined in the table below. Non-operating income includes equity in earnings of unconsolidated investments, dividends and other realized gains and losses on marketable securities, interest income, and the gain on the recovery of notes receivable. Our most significant equity method investment is a 75.1% non-controlling ownership interest in Caris HealthCare L.P. (“Caris”), a business that specializes in hospice care services. The gain on the recovery of notes receivable was due to the collection of certain notes receivable. In accordance with ASC 310, NHC had previously written down these notes due to deteriorated credit qualities.

| <i>(in thousands)</i> | Three Months Ended | | Nine Months Ended | |
|--|----------------------|----------|----------------------|-----------|
| | September 30 2013 | 2012 | September 30 2013 | 2012 |
| Equity in earnings of unconsolidated investments | \$ 3,947 | \$ 4,063 | \$ 11,542 | \$ 10,079 |
| Dividends and other net realized gains and losses on sales of securities | 408 | 1,607 | 3,314 | 5,074 |
| Interest income | 1,362 | 1,101 | 4,111 | 3,393 |
| Gain on the recovery of notes receivable | 5,454 | - | 5,454 | - |
| | \$ 11,171 | \$ 6,771 | \$ 24,421 | \$ 18,546 |

Note 5 – New Lease Commitment with National Health Investors, Inc.

On September 1, 2013, NHC began leasing and operating seven skilled nursing facilities in New Hampshire and Massachusetts from National Health Investors, Inc. ("NHI"). The 15 year lease term consists of base rent of \$3,450,000 annually with rent escalating by 4% of the increase in facility revenue over a 2014 base year. Additionally, NHC has the option to purchase the facilities from NHI in the 13th year of the lease for a purchase price of \$49,000,000.

In addition to the 15 year lease described above for the seven skilled nursing facilities, NHC has a separate master lease agreement with NHI that leases the real property of 32 long-term health care centers, six assisted living centers and three independent living centers.

Total facility rent expense to NHI was \$27,260,000 and \$27,218,000 for the nine months ended September 30, 2013 and 2012, respectively. The approximate future minimum base rent to be paid by us under the NHI non-cancelable operating leases at September 30, 2013 are as follows:

| | Total NHI Lease Commitments |
|------------|--------------------------------|
| 2014 | \$ 34,200,000 |
| 2015 | 34,200,000 |
| 2016 | 34,200,000 |
| 2017 | 34,200,000 |
| 2018 | 34,200,000 |
| Thereafter | 287,900,000 |

Note 6 – Other Operating Expenses

Other operating expenses include the costs of care and services that we provide to the residents of our facilities and the costs of maintaining our facilities. Our primary patient care costs include drugs, medical supplies, purchased professional services, food, and professional liability insurance and licensing fees. The primary facility costs include utilities and property insurance.

Note 7 – Earnings per Share

Basic net income per share is computed based on the weighted average number of common shares outstanding for each period presented. Diluted net income per share reflects the potential dilution that would have occurred if securities to issue common stock were exercised, converted, or resulted in the issuance of common stock that would have then shared in our earnings.

The following table summarizes the earnings and the weighted average number of common shares used in the calculation of basic and diluted earnings per share.

| | Three Months Ended September 30 | | Nine Months Ended September 30 | |
|---|------------------------------------|------------|-----------------------------------|------------|
| <i>(in thousands, except for share and per share amounts)</i> | 2013 | 2012 | 2013 | 2012 |
| Basic: | | | | |
| Weighted average common shares outstanding | 13,820,449 | 13,852,403 | 13,832,706 | 13,846,022 |
| Net income | \$ 19,877 | \$ 17,196 | \$ 48,024 | \$ 43,405 |
| Dividends to preferred stockholders | (2,167) | (2,167) | (6,503) | (6,503) |
| Net income available to common stockholders | 17,710 | 15,029 | 41,521 | 36,902 |
| Earnings per common share, basic | \$ 1.28 | \$ 1.08 | \$ 3.00 | \$ 2.67 |
| Diluted: | | | | |
| Weighted average common shares outstanding | 13,820,449 | 13,852,403 | 13,832,706 | 13,846,022 |
| Dilutive effect of stock options | 7,970 | 7,912 | 8,397 | 8,971 |

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| | | | | |
|--|------------|------------|------------|------------|
| Dilutive effect of restricted stock | 3,840 | 4,641 | 4,640 | 5,417 |
| Dilutive effect of contingent issuable stock | 231,500 | 117,000 | 232,495 | 94,796 |
| Convertible preferred stock | 2,623,156 | 2,623,329 | 2,623,253 | 2,623,329 |
| Assumed average common shares outstanding | 16,686,915 | 16,605,285 | 16,701,491 | 16,578,535 |
| Net income available to common stockholders | \$ 17,710 | \$ 15,029 | \$ 41,521 | \$ 36,902 |
| Add dilutive preferred stock dividends for effect of assumed conversion of preferred stock | 2,167 | 2,167 | 6,503 | 6,503 |
| Net income for diluted earnings per common share | \$ 19,877 | \$ 17,196 | \$ 48,024 | \$ 43,405 |
| Earnings per common share, diluted | \$ 1.19 | \$ 1.04 | \$ 2.88 | \$ 2.62 |

In the above table, options to purchase 989,275 and 1,237,144 shares of our common stock have been excluded for 2013 and 2012, respectively, due to their anti-dilutive impact.

Note 8 – Investments in Marketable Securities

Our investments in marketable securities are classified as available for sale securities. Realized gains and losses from securities sales are recognized in results of operations upon disposition of the securities using the specific identification method on a trade date basis. Refer to Note 9 for a description of the Company's methodology for determining the fair value of marketable securities.

Marketable securities and restricted marketable securities consist of the following:

| | September 30, 2013 | | December 31, 2012 | |
|--|--------------------|------------|-------------------|------------|
| | Amortized | Fair | Amortized | Fair |
| <i>(in thousands)</i> | Cost | Value | Cost | Value |
| Investments available for sale: | | | | |
| Marketable equity securities | \$ 30,176 | \$ 108,199 | \$ 30,176 | \$ 107,250 |
| Restricted investments available for sale: | | | | |
| Corporate debt securities | 62,613 | 62,075 | 61,453 | 62,876 |
| Commercial mortgage-backed securities | 47,830 | 47,293 | 47,194 | 48,063 |
| U.S. Treasury securities | 24,031 | 24,145 | 16,218 | 16,604 |
| State and municipal securities | 8,151 | 8,348 | 7,213 | 7,664 |
| | \$ 172,801 | \$ 250,060 | \$ 162,254 | \$ 242,457 |

Included in the available for sale marketable equity securities are the following *(in thousands, except share amounts)*:

| | September 30, 2013 | | | December 31, 2012 | | |
|------------------|--------------------|-----------|------------|-------------------|-----------|------------|
| | Shares | Cost | Fair Value | Shares | Cost | Fair Value |
| NHI Common Stock | 1,630,642 | \$ 24,734 | \$ 92,767 | 1,630,642 | \$ 24,734 | \$ 92,180 |

The amortized cost and estimated fair value of debt securities classified as available for sale, by contractual maturity, are as follows:

| | September 30, 2013 | | December 31, 2012 | |
|-----------------------|--------------------|------------|-------------------|------------|
| | Cost | Fair Value | Cost | Fair Value |
| <i>(in thousands)</i> | | | | |
| Maturities: | | | | |
| Within 1 year | \$ 10,178 | \$ 10,255 | \$ 8,868 | \$ 8,918 |
| 1 to 5 years | 86,227 | 86,902 | 80,910 | 82,801 |
| 6 to 10 years | 43,658 | 42,180 | 40,670 | 41,856 |
| Over 10 years | 2,562 | 2,524 | 1,630 | 1,632 |
| | \$ 142,625 | \$ 141,861 | \$ 132,078 | \$ 135,207 |

Gross unrealized gains related to available for sale securities are \$79,466,000 and \$80,296,000 as of September 30, 2013 and December 31, 2012, respectively. Gross unrealized losses related to available for sale securities are \$2,207,000 and \$93,000 as of September 30, 2013 and December 31, 2012, respectively. For the marketable securities in gross unrealized loss positions, (a) it is more likely than not that the Company will not be required to sell the investment securities before recovery of the unrealized losses, and (b) the Company expects that the contractual principal and interest will be received on the investment securities. These securities have also been in an unrealized loss position for a period of less than twelve months. As a result, the Company recognized no other-than-temporary impairment during the nine months ended September 30, 2013 or the year ended December 31, 2012.

Proceeds from the sale of investments in restricted marketable securities during the nine months ended September 30, 2013 and 2012 were \$57,904,000 and \$42,604,000, respectively. Investment losses of \$911,000 and \$527,000 were realized on these sales during the three months and nine months ended September 30, 2013, respectively. Investment gains (losses) of \$(53,000) and \$934,000 were realized on these sales during the three months and nine months ended September 30, 2012, respectively.

Note 9 – Fair Value Measurements

The accounting standard for fair value measurements provides a framework for measuring fair value and requires expanded disclosures regarding fair value measurements. Fair value is defined as the price that would be received for an asset or the exit price that would be paid to transfer a liability in the principal or most advantageous market in an orderly transaction between market participants on the measurement date. This accounting standard establishes a fair value hierarchy, which requires an entity to maximize the use of observable inputs, where available. The following summarizes the three levels of inputs that may be used to measure fair value:

Level 1 – The valuation is based on quoted prices in active markets for identical instruments.

Level 2 – The valuation is based on observable inputs such as quoted prices for similar instruments in active markets, quoted prices for identical or similar instruments in markets that are not active, and model-based valuation techniques for which all significant assumptions are observable in the market.

Level 3 – The valuation is based on unobservable inputs that are supported by minimal or no market activity and that are significant to the fair value of the instrument. Level 3 valuations are typically performed using pricing models, discounted cash flow methodologies, or similar techniques that incorporate management's own estimates of assumptions that market participants would use in pricing the instrument, or valuations that require significant management judgment or estimation.

A financial instrument's level within the fair value hierarchy is based on the lowest level of input that is significant to the fair value measurement.

Valuation of Marketable Securities

The Company determines fair value for marketable securities with Level 1 inputs through quoted market prices. The Company determines fair value for marketable securities with Level 2 inputs through broker or dealer quotations or alternative pricing sources with reasonable levels of price transparency. Our Level 2 marketable securities have been initially valued at the transaction price and subsequently valued, at the end of each month, typically utilizing third party pricing services or other market observable data. The pricing services utilize industry standard valuation models, including both income and market based approaches and observable market inputs to determine value. These observable market inputs include reportable trades, benchmark yields, credit spreads, broker/dealer quotes, bids, offers, and other industry and economic events.

We validated the prices provided by our broker by reviewing their pricing methods, obtaining market values from other pricing sources, analyzing pricing data in certain instances and confirming that the relevant markets are active.

After completing our validation procedures, we did not adjust or override any fair value measurements provided by our broker as of September 30, 2013. We did not have any transfers of assets between Level 1 and Level 2 of the fair value measurement hierarchy during the nine months ended September 30, 2013.

Other

The carrying amounts of cash and cash equivalents, restricted cash and cash equivalents, accounts receivable, and accounts payable approximate fair value due to their short-term nature. The estimated fair value of notes receivable approximates the carrying value based principally on their underlying interest rates and terms, maturities, collateral and credit status of the receivables. Our long-term debt approximates fair value due to variable interest rates, but fair value is also determined using Level 2 inputs through alternative pricing sources. At September 30, 2013, there were no material differences between the carrying amounts and fair values of NHC's financial instruments.

The following table summarizes fair value measurements by level at September 30, 2013 and December 31, 2012 for assets and liabilities measured at fair value on a recurring basis (*in thousands*):

| | Fair Value Measurements Using | | | |
|--|-------------------------------|---------------------------------------|---|--|
| | | Quoted Prices in Active Markets | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
| September 30, 2013 | Fair Value | For Identical Assets (Level 1) | | |
| Cash and cash equivalents | \$ 88,410 | \$ 88,410 | \$ — | \$ — |
| Restricted cash and cash equivalents | 12,149 | 12,149 | — | — |
| Marketable equity securities | 108,199 | 108,199 | — | — |
| Corporate debt securities | 62,075 | — | 62,075 | — |
| Commercial mortgage-backed securities | 47,293 | — | 47,293 | — |
| U.S. Treasury securities | 24,145 | 24,145 | — | — |
| State and municipal securities | 8,348 | — | 8,348 | — |
| Total financial assets | \$ 350,619 | \$ 232,903 | \$ 117,716 | \$ — |

| | Fair Value Measurements Using | | | |
|--|-------------------------------|---------------------------------------|---|--|
| | | Quoted Prices in Active Markets | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
| December 31, 2012 | Fair Value | For Identical Assets (Level 1) | | |
| Cash and cash equivalents | \$ 66,701 | \$ 66,701 | \$ — | \$ — |
| Restricted cash and cash equivalents | 11,563 | 11,563 | — | — |
| Marketable equity securities | 107,250 | 107,250 | — | — |
| Corporate debt securities | 62,876 | — | 62,876 | — |
| Commercial mortgage-backed securities | 48,063 | — | 48,063 | — |
| U.S. Treasury securities | 16,604 | 16,604 | — | — |
| State and municipal securities | 7,664 | — | 7,664 | — |
| Total financial assets | \$ 320,721 | \$ 202,118 | \$ 118,603 | \$ — |

Note 10 – Long-Term Debt

Long-term debt consists of the following:

| | Weighted Average Interest Rate | Maturities | 9/30/13 | 12/31/12 |
|---|--------------------------------------|------------|-------------------------------|------------------|
| | | | <i>(dollars in thousands)</i> | |
| Revolving Credit Facility, interest payable monthly | Variable, 0.9% | 2014 | \$ – | \$ – |
| Unsecured term note payable to National, interest payable quarterly, principal payable at maturity | Variable, 2.8% | 2018 | 10,000 10,000 | 10,000 10,000 |
| Less current portion | | | \$ – 10,000 | \$ – 10,000 |

Note 11 – \$75,000,000 Revolving Credit Facility

Effective October 23, 2013, we extended the maturity of our Credit Agreement (the "Credit Agreement") with Bank of America, N.A., as lender (the "Lender"). The Credit Agreement provides for a \$75,000,000 revolving credit facility (the "Credit Facility"), of which up to \$5,000,000 may be utilized for letters of credit.

Borrowings bear interest at either, (i) the Eurodollar rate plus 0.70% or (ii) the prime rate. Letter of credit fees are equal to 0.10% times the maximum amount available to be drawn under outstanding letters of credit.

Commitment fees are payable on the daily unused portion of the Credit Facility at a rate of ten (10) basis points per annum. NHC is permitted to prepay the loans outstanding under the Credit Facility at any time, without penalty.

The Credit Facility matures on October 22, 2014. We currently anticipate renewing the credit agreement at that time and while we have had no indication from the lender there is any question about renewal, there has been no commitment at this time. If the Lender elects to consent to such extension, subject to certain conditions, the maturity date will be extended to the date which is 364 days after the then maturity date.

NHC's obligations under the Credit Agreement are guaranteed by certain NHC subsidiaries and are secured by pledges by NHC and the guarantors of (i) 100% of the equity interests of domestic subsidiaries and (ii) up to 65% of the voting equity interests and 100% of the non-voting equity interests of foreign subsidiaries, in each case, held by NHC or the guarantors.

The Credit Agreement contains customary representations and warranties, and covenants, including covenants that restrict, among other things, asset dispositions, mergers and acquisitions, dividends, restricted payments, debt, liens, investments and affiliate transactions. The Credit Agreement contains customary events of default.

The Credit Facility is available for general corporate purposes, including working capital and acquisitions.

Note 12 - Stock Repurchase Program

On August 1, 2012, the Board of Directors of the Company approved a stock repurchase program authorizing the Company to repurchase up to \$25 million of its outstanding shares of common stock. On February 19, 2013, the Company repurchased 100,000 shares for a total cost of \$4.7 million. These were the only shares repurchased pursuant to the program's authorization. The shares were funded from cash on hand and were cancelled and returned to the status of authorized but unissued. This program expired on July 31, 2013.

On August 1, 2013, the Board of Directors of the Company authorized a new stock repurchase program that will allow the Company to repurchase up to \$25 million of its common stock over a one year period. The program expires on July 31, 2014. Under the stock repurchase program, the Company may repurchase its common stock from time to time, in amounts and at prices the Company deems appropriate, subject to market conditions and other considerations. The Company's repurchases may be executed using open market purchases, privately negotiated agreements or other transactions. The Company intends to fund repurchases under the new stock repurchase program from cash on hand, available borrowings or proceeds from potential debt or other capital market sources. The stock repurchase program may be suspended or discontinued at any time without prior notice. As of September 30, 2013, no repurchases of common stock have been executed under this program.

Note 13 – Stock-Based Compensation

NHC recognizes stock-based compensation expense for all stock options and restricted stock granted over the requisite service period using the fair value for these grants as estimated at the date of grant either using the Black-Scholes pricing model for stock options or the quoted market price for restricted stock.

The 2005 and 2010 Stock-Based Compensation Plans

The Compensation Committee of the Board of Directors (“the Committee”) has the authority to select the participants to be granted options; to designate whether the option granted is an incentive stock option (“ISO”), a non-qualified option, or a stock appreciation right; to establish the number of shares of common stock that may be issued upon exercise of the option; to establish the vesting provision for any award; and to establish the term any award may be outstanding.

The exercise price of any ISO’s granted will not be less than the fair market value of the shares of common stock on the date granted and the term of an ISO may not be any more than ten years. The exercise price of any non-qualified options granted will not be less than the fair market value of the shares of common stock on the date granted unless so determined by the Committee.

In May 2005, our stockholders approved the 2005 Stock Option, Employee Stock Purchase, Physician Stock Purchase and Stock Appreciation Rights Plan (“the 2005 Plan”) pursuant to which 1,200,000 shares of our common stock were available to grant as stock-based payments to key employees, directors, and non-employee consultants. At September 30, 2013, 245,620 shares were available for future grants under the 2005 Plan.

In May 2010, our stockholders approved the 2010 Omnibus Equity Incentive Plan (“the 2010 Plan”) pursuant to which 1,200,000 shares of our common stock were available to grant as stock-based payments to key employees, directors, and non-employee consultants. The shares granted during the nine months ended September 30, 2013 consisted of 45,000 shares to the directors of the Company and 15,275 shares through the Employee Stock Purchase Plan. At September 30, 2013, 410,457 shares were available for future grants under the 2010 Plan.

Compensation expense is recognized only for the awards that ultimately vest. Stock-based compensation totaled \$453,000 and \$1,812,000 for the three months and nine months ended September 30, 2013, respectively. Stock-based compensation totaled \$527,000 and \$1,925,000 for the three months and nine months ended September 30, 2012, respectively. At September 30, 2013, we had \$4,425,000 of unrecognized compensation cost related to unvested stock-based compensation awards, which consisted of \$4,094,000 for stock options and \$331,000 for restricted stock. This expense will be recognized over the remaining weighted average vesting period, which is approximately 2.4 years for stock options and 1.1 years for restricted stock. Stock-based compensation is included in “Salaries, wages and benefits” in the interim condensed consolidated statements of income.

Stock Options

The following table summarizes the significant assumptions used to value the options granted for the nine months ended September 30, 2013 and for the year ended December 31, 2012.

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| | 2013 | 2012 |
|-------------------------|-----------|-----------|
| Risk-free interest rate | 0.25% | 0.28% |
| Expected volatility | 31.1% | 38.8% |
| Expected life, in years | 2.1 years | 2.1 years |
| Expected dividend yield | 2.81% | 2.91% |

The following table summarizes our outstanding stock options for the nine months ended September 30, 2013 and for the year ended December 31, 2012.

| | Number of | Weighted | Aggregate |
|---|-----------|----------------|------------|
| | Shares | Average | Intrinsic |
| | | Exercise Price | Value |
| Options outstanding at January 1, 2012 | 1,482,077 | \$ 46.92 | \$ — |
| Options granted | 63,516 | 44.24 | — |
| Options exercised | (295,371) | 45.41 | — |
| Options cancelled | (115,620) | 50.99 | — |
| Options outstanding at December 31, 2012 | 1,134,602 | 46.75 | — |
| Options granted | 60,375 | 47.97 | — |
| Options exercised | (7,150) | 37.70 | — |
| Options cancelled | (98,000) | 51.11 | — |
| Options outstanding at September 30, 2013 | 1,089,827 | \$ 46.48 | \$ 900,000 |
| Options exercisable at September 30, 2013 | 145,552 | \$ 44.84 | \$ 361,000 |

| Options | Weighted Average | | |
|--------------------|-------------------|----------------|-----------------------|
| Outstanding | Weighted Average | Exercise Price | Remaining Contractual |
| September 30, 2013 | Exercise Prices | Exercise Price | Life in Years |
| 21,750 | \$37.70 | \$ 37.70 | 0.6 |
| 1,052,802 | \$44.80 – \$47.45 | 46.62 | 2.6 |
| 15,275 | \$49.50 | 49.50 | 0.3 |
| 1,089,827 | | \$ 46.49 | 2.5 |

Restricted Stock

The following table summarizes our restricted stock activity for the nine months ended September 30, 2013 and for the year ended December 31, 2012.

| | Number of | Weighted | Aggregate |
|---|-----------|-----------------|-----------|
| | Shares | Average Grant | Intrinsic |
| | | Date Fair Value | Value |
| Non-vested restricted shares at January 1, 2012 | 24,000 | \$ 34.46 | \$ — |

| | | | |
|--|--------|----------|------------|
| Award shares granted | — | — | — |
| Award shares vested | 6,000 | 34.46 | — |
| Non-vested restricted shares at December 31, 2012 | 18,000 | 34.46 | — |
| Award shares granted | — | — | — |
| Award shares vested | 6,000 | 34.46 | — |
| Non-vested restricted shares at September 30, 2013 | 12,000 | \$ 34.46 | \$ 154,000 |

The weighted average remaining contractual life of restricted stock at September 30, 2013 is 1.1 years.

Note 14 – Accounting for Uncertainty in Income Taxes

Uncertain tax positions may arise where tax laws may allow for alternative interpretations or where the timing of recognition of income is subject to judgment. We believe we have made adequate provision for unrecognized tax benefits related to uncertain tax positions. However, because of uncertainty of interpretation by various tax authorities and the possibility that there are issues that have not been recognized by management, we cannot guarantee we have accurately estimated our tax liabilities. We believe that our liabilities reflect the anticipated outcome of known uncertain tax positions in conformity with ASC Topic 740, *Income Taxes*. Our liabilities for unrecognized tax benefits are presented in the consolidated balance sheets within Other Noncurrent Liabilities.

At September 30, 2013, we had \$12,196,000 of unrecognized tax benefits, composed of \$7,996,000 of deferred tax assets and \$4,200,000 of permanent differences. Accrued interest and penalties of \$1,830,000 relate to unrecognized tax benefits at September 30, 2013. Unrecognized tax benefits of \$4,200,000, net of federal benefit, at September 30, 2013, attributable to permanent differences, would favorably impact our effective tax rate if recognized. Accrued interest and penalties of \$1,594,000 relate to these permanent differences at September 30, 2013. We do not expect to recognize significant increases or decreases in unrecognized tax benefits within the twelve months beginning September 30, 2013, except for the effect of decreases related to the lapse of statute of limitations estimated at \$2,330,000, composed of temporary differences of \$1,390,000, and permanent tax differences of \$940,000. Interest and penalties of \$544,000 relate to these temporary and permanent difference changes within 12 months beginning September 30, 2013.

Interest and penalties expense related to U.S. federal and state income tax returns are included within income tax expense.

The Company is no longer subject to U.S. federal and state examinations by tax authorities for years before 2010 (with certain state exceptions). Currently, there are no U.S. federal or state returns under examination.

Our deferred tax assets have been evaluated for realization based on historical taxable income, tax planning strategies, the expected timing of reversals of existing temporary differences and future taxable income anticipated. Our deferred tax assets are more likely than not to be realized in full due to the existence of sufficient taxable income of the appropriate character under the tax law. As such, there is no need for a valuation allowance.

Note 15 – Guarantees and Contingencies

Accrued Risk Reserves

We are self-insured for risks related to health insurance and have wholly-owned limited purpose insurance companies that insure risks related to workers' compensation and general and professional liability insurance claims both for our owned or leased entities and certain of the entities to which we provide management or accounting services. The liability we have recognized for reported claims and estimates for incurred but unreported claims totals \$118,714,000 and \$110,331,000 at September 30, 2013 and December 31, 2012, respectively. This liability is classified as a current liability based on the uncertainty regarding the timing of potential payments. The liability is included in accrued risk reserves in the interim condensed consolidated balance sheets and is subject to adjustment for actual claims incurred.

It is possible that these claims plus unasserted claims could exceed our insurance coverages and our reserves, which could have a material adverse effect on our consolidated financial position, results of operations and cash flows.

As a result of the terms of our insurance policies and our use of wholly-owned limited purpose insurance companies, we have retained significant insurance risk with respect to workers' compensation and general and professional liability. We use independent actuaries to estimate our exposures for claims obligations (for both asserted and unasserted claims) related to deductibles and exposures in excess of coverage limits, and we maintain reserves for these obligations. Such estimates are based on many variables including historical and statistical information and other factors.

Workers' Compensation

For workers' compensation, we utilize a wholly-owned Tennessee domiciled property/casualty insurance company to write coverage for NHC affiliates and for third-party customers. Policies are written for a duration of twelve months and cover only risks related to workers' compensation losses. All customers are companies which operate in the senior care industry. Business is written on a direct basis. Direct business coverage is written for statutory limits and the insurance company's losses in excess of \$1,000,000 per claim are covered by reinsurance.

For these workers' compensation insurance operations, the premium revenues reflected in the interim condensed consolidated statements of income within "Other Revenues" for the three months and nine months ended September 30, 2013 are \$1,218,000 and \$6,607,000, respectively. During the 2013 year, there was a non-recurring positive insurance settlement reached with one of the states in which we provide workers' compensation insurance.

This event helped increase other revenues in the amount of \$2,769,000 for the nine months ended September 30, 2013. For the three months and nine months ended September 30, 2012, workers' compensation premium revenues reflected within "Other Revenues" were \$1,409,000 and \$4,094,000, respectively. Associated losses and expenses are reflected in the interim condensed consolidated statements of income as "Salaries, wages and benefits."

General and Professional Liability Lawsuits and Insurance

The senior care industry has experienced increases in both the number of personal injury/wrongful death claims and in the severity of awards based upon alleged negligence by nursing facilities and their employees in providing care to residents. As of September 30, 2013, we and/or our managed centers are currently defendants in 30 such claims covering the years 2005 through September 30, 2013.

In 2002, due to the unavailability and/or prohibitive cost of third-party professional liability insurance coverage, we established and capitalized a wholly-owned licensed liability insurance company incorporated in the Cayman Island, for the purpose of managing our losses related to these risks. Thus, since 2002, insurance coverage for incidents occurring at all NHC owned providers, and most providers managed by us, is provided through this wholly-owned insurance company.

Insurance coverage for all years includes both primary policies and excess policies. Beginning in 2003, both primary and excess coverage is provided through our wholly-owned insurance company. The primary coverage is in the amount of \$1.0 million per incident, \$3.0 million per location with an annual primary policy aggregate limit that is adjusted on an annual basis. The excess coverage is \$7.5 million annual excess in the aggregate applicable to years 2005-2007, \$9.0 million annual excess in the aggregate for years 2008-2010 and \$4.0 million excess per occurrence for 2011-2013.

Beginning in 2008 and continuing through September 30, 2013, additional insurance is purchased through third party providers that serve to supplement the coverage provided through our wholly-owned captive insurance company.

For these professional liability insurance operations, the premium revenues reflected in the interim condensed consolidated statements of income as "Other Revenues" for the three months and nine months ended September 30, 2013 are \$654,000 and \$2,539,000, respectively. For the three months and nine months ended September 30, 2012, professional liability premium revenues reflected within "Other Revenues" were \$1,051,000 and \$3,152,000, respectively. Associated losses and expenses including those for self-insurance are included in the interim condensed consolidated statements of income as "Other operating costs and expenses".

Potential Breach of Patient Information

During the third quarter of 2013, officials at one of our owned centers, NHC HealthCare, Mauldin located in Greenville, South Carolina, reported a possible breach of patient information due to a damaged backup tape that was not encrypted. The information on this tape included patient names, social security numbers, birth dates, home addresses and medical information. The facility began an immediate investigation of the incident and security measures have been revised to prevent future incidents of this nature. All affected patients have been notified as well as media outlets in the immediate area.

Also during the third quarter of 2013, officials at one of our managed centers, NHC HealthCare, Oak Ridge in Oak Ridge, Tennessee reported a possible breach of patient information due to a missing backup tape that was not encrypted. The information on this tape included patient names, social security numbers, birth dates, home addresses and medical information. The facility began an immediate investigation and security measures have been revised to prevent future incidents. All affected patients were notified as well as media outlets in the immediate area.

Note 16 – Asset Purchase Acquisition

On September 1, 2013, NHC purchased the real property of six skilled health care centers from National Health Investors, Inc. ("NHI") for \$21 million in cash. The six centers, which are located in Columbia (2), Knoxville and Springfield, Tennessee; Madisonville, Kentucky and Rossville, Georgia, had been leased and

operated by NHC since 1991 and have a total of 650 beds. With the purchase of the six skilled health care centers, NHC's master lease payment with NHI decreases annually by \$2.95 million.

Note 17 – Settlement of SeniorTrust of Florida, Inc. and ElderTrust of Florida, Inc. Litigation

On April 26, 2013, the Company entered into a settlement agreement concerning litigation with two management services clients, ElderTrust of Florida, Inc. (“ElderTrust”), and SeniorTrust of Florida, Inc. (“SeniorTrust”), both Tennessee not-for-profit corporations. NHC's transactions with these entities have been previously disclosed in NHC's Forms 10-Q and Forms 10-K and were the subject of a Civil Investigative Demand by the Office of the Tennessee Attorney General issued in July, 2009. As part of the negotiated settlement, NHC paid \$6,650,000 to resolve the claims, which payment and associated legal fees required the recording of \$5,195,000 of operating expenses in the quarter ending March 31, 2013.

Also as part of the settlement, NHC purchased at a discount the remaining assets and liabilities of the two not-for-profit entities and then in the third quarter of 2013 closed out those assets and obligations, providing for an orderly wind-down and liquidation. As a result of this latter provision in the settlement agreement and related settlement activities, in the quarter ended September 30, 2013 the company recorded a decrease to other operating expenses in the amount of \$5,257,000. As a result and for the nine months ending September 30, 2013, the settlement with ElderTrust and SeniorTrust has had an immaterial impact on NHC's consolidated statement of income. The Company recorded for all periods, including periods prior to 2013, that its net losses related to the settlement activities totaled approximately \$2,505,000.

On September 1, 2013 and with court approval, NHC began leasing and operating ElderTrust's seven skilled nursing facilities in New Hampshire and Massachusetts. At the time of the settlement agreement, ElderTrust was paying approximately \$3,200,000 annually in management fees to NHC. We do not anticipate a material change to our future results of operations and cash flows from the transition of managing the seven health care facilities to leasing and operating the seven health care facilities.

During the first and second quarters of 2013, SeniorTrust sold its seven skilled nursing facilities in Missouri and Kansas and terminated their respective NHC management agreements. At the time of the settlement agreement, SeniorTrust was paying approximately \$2,200,000 annually in management and accounting fees for these seven. We anticipate the loss of management fee revenue from the Missouri and Kansas skilled nursing facilities to be adverse to our future results of operations and cash flows.

In summary and combining all the transactions in the negotiated settlement, we estimate our future results of operations and cash flows will be adversely affected by approximately \$2,200,000 annually, or \$1,350,000 annually net of income taxes. Under the negotiated settlement, we do not admit to any wrongdoing, nor do the opposing parties make any claims as to the validity of their charges.

Item 2.

Management's Discussion and Analysis of Financial Condition and Results of Operations.

Overview

National HealthCare Corporation (“NHC” or the “Company”) is a leading provider of senior health care services. We operate or manage, through certain affiliates, 68 skilled nursing facilities with 8,803 beds in nine states and provide other senior health care services in one additional state. These operations are provided by separately funded and maintained subsidiaries. We provide health care services to patients in a variety of settings including skilled nursing centers, managed care specialty units, sub–acute care units, Alzheimer's care units, homecare programs, assisted living centers and independent living centers. We also have a non-controlling ownership interest in a hospice care business that services NHC owned health care centers and others. In addition, we provide insurance services, management and accounting services, and lease properties to operators of skilled nursing health care centers.

Summary of Goals and Areas of Focus

Earnings

To monitor our earnings, we have developed budgets and management reports to monitor labor, census, and the composition of revenues.

Medicare Reimbursement Rate Changes

In July 2012, CMS released its skilled nursing facility PPS update for the fiscal year 2013, which began October 1, 2012. The notice provided for a 1.8% rate update, which reflects a 2.5% market basket increase that is reduced under the Affordable Care Act by a 0.7% multifactor productivity adjustment. CMS estimates the update will increase overall payments to skilled nursing facilities in fiscal year 2013 by \$670 million compared to fiscal year 2012 levels. The notice also provided an update to certain fiscal year 2012 policy changes involving recalibration of the parity adjustment, reallocation of group therapy time, and changes to the MDS 3.0 patient assessment instrument. The effect of the 2013 PPS rate update on our revenues is dependent upon our census and the mix of our patients at the PPS pay rates.

On April 1, 2013, the automatic 2% cuts (known as "sequestration") began for Medicare providers. We anticipate that, assuming other factors remain constant, the resulting decrease in revenue on our 2013 consolidated statement of income to range from approximately \$1,250,000 to \$1,625,000 for the remaining three months of the 2013 calendar year. We are unable to predict the financial impact of other cuts Congress may implement. However, such impact may be adverse and material to our future results of operations and cash flows.

In July 2013, CMS released its skilled nursing facility PPS update for the fiscal year 2014, which began October 1, 2013. The notice provided for a 1.3% rate update, which reflects a 2.3% market basket increase less a 0.5% multifactor productivity adjustment and a 0.5% adjustment to correct market basket forecasting errors in fiscal year 2012. CMS estimates the update will increase overall payments to skilled nursing facilities in fiscal year 2014 by \$470 million compared to fiscal year 2013 levels. The effect of the 2014 PPS rate update on our revenues will be dependent upon our census and the mix of our patients at the PPS pay rates.

Development and Growth

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We are undertaking to expand our senior care operations while protecting our existing operations and markets. The following table lists our recent construction and purchase activities.

| Type of Operation | Description | Size | Location | Placed in Service |
|-------------------|--------------|---|------------------|--------------------|
| Hospice | Acquisition | Additional 7.5% interest in Caris HealthCare LP | Knoxville, TN | June, 2012 |
| SNF | Acquisition | 106 | Columbia, TN | September, 2013 |
| SNF | Acquisition | 92 | Columbia, TN | September, 2013 |
| SNF | Acquisition | 139 | Knoxville, TN | September, 2013 |
| SNF | Acquisition | 107 | Springfield, TN | September, 2013 |
| SNF | Acquisition | 94 | Madisonville, KY | September, 2013 |
| SNF | Acquisition | 112 | Rossville, GA | September, 2013 |
| SNF | New Facility | 90 Beds | Tullahoma, TN | November, 2013 |
| SNF | Addition | 50 bed | Lexington, SC | Under construction |

In the fourth quarter of 2013, we have opened a 90-bed skilled nursing facility in Tullahoma, Tennessee and will begin construction on a 92-bed skilled nursing facility and 60-unit assisted living community in Sumner County, Tennessee. We will also begin construction of a 52-bed transitional care center in Kingsport, Tennessee. In early 2014, we anticipate starting construction on a 90-bed skilled nursing facility and an 80-unit assisted living community in Nashville, Tennessee.

In addition, we entered into limited liability partnerships with RSF Partners, Inc., and Flournoy Development, Inc. to build and operate an 85-unit assisted living community ("Camellia Walk") in Augusta, Georgia. Camellia Walk is currently under construction and plans to open in the first quarter of 2014.

We also entered into a partnership with Reliant Healthcare, LLC to develop and operate a 14-bed psychiatric hospital focusing on geriatric care in Osage Beach, Missouri. This project is projected to open in 2014.

In the second quarter of 2013, we applied for a CON that would be used to build a replacement center (SNF) that would combine the 92 beds of NHC Hillview with 20 beds from the existing skilled nursing unit at Maury Regional Medical Center. The resulting replacement center would be a partnership between NHC and Maury Regional Medical Center.

During the fourth quarter of 2013 we will apply for Certificates of Need for additional beds in our markets and also evaluate the feasibility of expansion into new markets by building private pay health care centers or by the purchase of existing health care centers. We will also evaluate the feasibility of construction of new assisted living facilities in select markets.

Accrued Risk Reserves

Our accrued professional liability reserves, workers' compensation reserves and health insurance reserves totaled \$118,714,000 at September 30, 2013 and are a primary area of management focus. We have set aside restricted cash and cash equivalents and marketable securities to fund all of our estimated professional liability and workers' compensation liabilities.

As to exposure for professional liability claims, we have developed performance certification criteria to measure and bring focus to the patient care issues most likely to produce professional liability exposure, including in-house acquired pressure ulcers, significant weight loss and numbers of falls. These programs for certification, which we regularly modify and improve, have produced measurable improvements in reducing these incidents. Our experience is that achieving goals in these patient care areas improves both patient and employee satisfaction.

Application of Critical Accounting Policies

Effective January 1, 2013, the Company recorded the cumulative effect of a change in accounting principle related to the adoption of ASU No. 2012-01, *Continuing Care Retirement Communities — Refundable Advance Fees*. This standard is intended to clarify the accounting for advance fees (“entrance fees”) received by a continuing care retirement community (“CCRC”). The updated guidance states the estimated amount of entrance fees that are expected to be refunded to current CCRC residents under the terms of the resident agreements shall be accounted for and reported as a liability (“refundable entrance fees”). Previously, we accounted for both the 10% non-refundable and the refundable portions of the entrance fees as deferred revenue, amortizing the deferred revenue over the life expectancy of the resident and the estimated useful life of the building, respectively, in accordance with ASC Topic 954-430, *Health Care Entities-Deferred Revenue*. The Company believes recording the refundable entrance fees as a liability, which includes 90% of the original entry fee paid plus 40% of any estimated appreciation if the apartment exceeds the original resident’s entry fee, more clearly aligns how we have historically operated the CCRC. Also, with the adoption of ASU No. 2012-01, our future service obligation calculation for the CCRC was modified. Because the future service obligation calculation includes an offset for unamortized deferred revenue, the reclassification of refundable entrance fee amounts from deferred revenue to a liability has a direct impact on the future revenues input of the calculation. With the loss of deferred revenue, the present value of the CCRC’s expenses exceeds the present value of the CCRC’s revenues, which creates the recording of a future service obligation.

There were no other significant changes during the nine month period ended September 30, 2013 to the items we disclosed as our critical accounting policies and estimates in our discussion and analysis of financial condition and results of operations in our December 31, 2012 Annual Report on Form 10-K filed with the SEC.

Government Program Financial Changes

Federal Health Care Reform

In March 2010, President Obama signed into law the Patient Protection and Affordable Care Act ("PPACA" or, commonly, "ACA") and the Health Care and Education Reconciliation Act of 2010 ("HCERA"), which represents significant changes to the current U.S. health care system (collectively the "Acts"). The primary goals of the Acts are to: (1) expand coverage to Americans without health insurance, (2) reform the delivery system to improve quality and drive efficiency, (3) and to lower the overall costs of providing health care. The timeline of the enacted provisions span over several years – some of the provisions were effective immediately in 2010 and others will be phased in through 2020.

The U.S. Supreme Court has since issued its ruling on the constitutionality of a key provision in the ACA, which is the requirement that every American maintain a minimum level of health coverage or pay a penalty beginning in 2014. The Supreme Court upheld the constitutionality of the "individual mandate", holding that the penalty for not doing so could reasonably be interpreted as a tax, which the Constitution permits. The ruling also permits the federal government to pursue a broad expansion of the Medicaid program, but the ruling gives the states the maximum flexibility on whether to do so. In preparation for the Medicaid coverage expansion to occur in 2014, the current Administration is expected to release a host of regulations and an array of new taxes and fees. It is uncertain at this time the effect the Acts, their modifications, or Medicaid expansion will have on our future results of operations or cash flows.

In August 2011 and pursuant to the Budget Control Act of 2011, Congress created a 12-member bipartisan committee called the Joint Select Committee on Deficit Reduction, or the Joint Committee. The Joint Committee was charged with issuing a formal recommendation by November 23, 2011 on how to reduce the federal deficit by at least \$1.5 trillion over the next ten years. The Committee concluded their work in November 2011 and was not able to reach a bipartisan agreement before the Committee's deadline period. This failure by the Committee has triggered automatic reductions in discretionary and mandatory spending that started April 1, 2013, including reductions of not more than 2% to payments to Medicare providers.

The resulting decrease in revenue on our 2013 consolidated statement of income from the 2% Medicare cuts is approximately \$2,500,000 for the nine months of the 2013 calendar year, or \$1,250,000 per quarter. We are unable to predict the financial impact of other cuts Congress may implement. However, such impact may be adverse and material to our future results of operations and cash flows.

Medicare – Skilled Nursing Facilities

In July 2012, CMS released its skilled nursing facility PPS update for the fiscal year 2013, which began October 1, 2012. The notice provided for a 1.8% rate update, which reflects a 2.5% market basket increase that is reduced under the ACA by a 0.7% multifactor productivity adjustment. CMS estimates the update will increase overall payments to skilled nursing facilities in fiscal year 2013 by \$670 million compared to fiscal year 2012 levels. The notice also provides an update to certain fiscal year 2012 policy changes involving recalibration of the parity adjustment, reallocation of group therapy time, and changes to the MDS 3.0 patient assessment instrument. The effect of the 2013 PPS rate update on our revenues is dependent upon our census and the mix of our patients at the PPS pay rates.

On April 1, 2013, the automatic 2% Medicare cuts began for skilled nursing facility providers. The resulting decrease in revenue to our skilled nursing facilities is approximately \$2,000,000 for the nine months of the 2013 calendar year, or \$1,000,000 per quarter.

In July 2013, CMS released its skilled nursing facility PPS update for the fiscal year 2014, which began October 1, 2013. The notice provided for a 1.3% rate update, which reflects a 2.3% market basket increase less a 0.5% multifactor productivity adjustment and a 0.5% adjustment to correct market basket forecasting errors in fiscal year 2012. CMS estimates the update will increase overall payments to skilled nursing facilities in fiscal year 2014 by \$470 million compared to fiscal year 2013 levels. The effect of the 2014 PPS rate update on our revenues will be dependent upon our census and the mix of our patients at the PPS pay rates.

For the first nine months of 2013, our average Medicare per diem rate for skilled nursing facilities decreased 0.3% compared to the same period in 2012.

Medicaid – Skilled Nursing Facilities

Effective July 1, 2012 and for the fiscal year 2013, the state of Tennessee implemented specific individual nursing facility rate increases. The resulting increase in revenue beginning July 1, 2012 was approximately \$3,500,000 annually, or \$875,000 per quarter. During the second quarter of 2013, the state of Tennessee paid a non-recurring acuity based rate adjustment to help account for the higher acuity of patients served as a result of the level of care changes implemented in fiscal year 2013. This one-time rate adjustment also increased revenues \$1,635,000 for fiscal year 2013.

Effective July 1, 2013 and for the fiscal year 2014, the state of Tennessee implemented specific individual nursing facility rate increases. We estimate the resulting increase in revenue beginning July 1, 2013 will be approximately \$1,800,000 annually, or \$450,000 per quarter.

Effective October 1, 2012 and for the fiscal year 2013, South Carolina implemented specific individual nursing facility rate increases. We estimate the resulting increase in revenue beginning October 1, 2012 will be approximately \$1,660,000 annually, or \$415,000 per quarter.

There was no rate increase or decrease implemented as of October 1, 2012 (for the fiscal year 2013) for the Medicaid program in the state of Missouri.

For the first nine months of 2013, our average Medicaid per diem increased 3.5% compared to same period in 2012. We face challenges with respect to states' Medicaid payments, because many currently do not cover the total costs incurred in providing care to those patients. States will continue to control Medicaid expenditures and also look for adequate funding sources, including provider assessments. There are several pieces of legislation that include provisions designed to reduce Medicaid spending. These provisions include, among others, provisions strengthening the Medicaid asset transfer restrictions for persons seeking to qualify for Medicaid long-term care coverage, which could, due to the timing of the penalty period, increase facilities' exposure to uncompensated care. Other provisions could increase state funding for home and community-based services, potentially having an impact on funding for nursing facilities.

Medicare – Homecare Programs

In November 2012, CMS issued a final rule to update and revise reimbursement rates for the calendar year 2013. The final rule includes a 2.3% market basket increase, a 1% reduction mandated by the ACA, and a negative 1.32% case-mix adjustment. The net effect of these changes is a 0.04% decrease in the base rate. Additionally, the wage index was updated which impacts providers differently depending on their geographic location. In total, CMS estimates the effect of these changes will result in a 0.01% reduction in reimbursement to home health providers.

On April 1, 2013, the automatic 2% Medicare cuts began for homecare providers. The resulting decrease in revenue to our homecare programs is approximately \$500,000 for the nine months of the 2013 calendar year, or \$250,000 per quarter.

Litigation Settlement

See Note 17 to the Interim Condensed Consolidated Financial Statements regarding the details of the SeniorTrust and ElderTrust litigation settlement.

Results of Operations

Three Months Ended September 30, 2013 Compared to Three Months Ended September 30, 2012

Results for the three month period ended September 30, 2013 include a 3.4% increase in net operating revenues and a 30.2% increase in income before income taxes compared to the same period in 2012.

The total census at owned and leased skilled nursing facilities for the quarter averaged 89.5% compared to an average of 89.7% for the same quarter a year ago.

Medicare and managed care per diem rates at our owned and leased skilled nursing facilities decreased 0.1% and 1.2%, respectively, compared to the quarter a year ago. Medicaid and private pay per diem rates at our owned and leased skilled nursing facilities increased 2.6% and 8.3%, respectively, compared to the quarter a year ago.

Net patient revenues increased \$7,605,000 or 4.3% compared to the same period last year. In combination with our overall average skilled nursing facility per diem increasing 3.1%, we also had a favorable skilled patient mix change compared to the quarter a year ago that helped increase net patient revenues. On September 1, 2013, we began leasing and operating seven skilled nursing facilities in Massachusetts and New Hampshire. These newly leased facilities helped increase net patient revenues \$5,182,000.

Other revenues decreased \$1,140,000 or 8.2% in the three month 2013 period to \$12,806,000 from \$13,946,000 in the 2012 three-month period. The decrease in other revenues is primarily due to the decreased collection of management fees and insurance service revenue (\$1,215,000) from the discontinuation of our relationship with the SeniorTrust non-profit organization. We discontinued providing management and insurance services in February 2013 for two of SeniorTrusts' skilled healthcare facilities and April 2013 for the remaining five skilled healthcare facilities.

Other revenues are further detailed in Note 3 of our interim condensed consolidated financial statements. As discussed in Note 3 and Note 17 of this Form 10-Q, we are discontinuing our relationship with certain non-profit organizations and we estimate our future results of operations and cash flows to be adversely affected by approximately \$2,200,000 annually, or \$1,350,000 net of income taxes annually.

Total costs and expenses for the 2013 third quarter compared to the 2012 third quarter increased \$3,810,000 or 2.2% to \$176,507,000 from \$172,697,000. Salaries, wages and benefits, the largest operating costs of our company, increased \$6,895,000 to \$113,739,000 from \$106,844,000. Other operating expenses decreased \$2,767,000 or 5.7% to \$45,752,000 for the 2013 period compared to \$48,519,000 for the 2012 period. Facility rent expense increased \$76,000 or 0.8% to \$9,889,000. Depreciation and amortization decreased 4.8% to \$7,045,000.

The increase in salaries, wages and benefits is primarily due to the new operations of the seven leased skilled nursing facilities in Massachusetts and New Hampshire (\$3,719,000). We also had increased costs for therapist services of \$1,176,000 and inflationary wage increases for our partners.

As discussed in Note 17 of our consolidated financial statements, a decrease to other operating expenses was recorded in the amount of \$5,257,000 due to NHC completing the settlement related activities with SeniorTrust and ElderTrust. For the three months ending March 31, 2013, NHC paid \$6,650,000 to resolve the litigation claims, which payment and associated legal fees required recording other operating expenses in the amount of \$5,195,000. With the settlement related activities now being completed and for the nine months ending September 30, 2013, the settlement had an immaterial impact on NHC's consolidated statement of income. The new operations of the seven leased skilled nursing facilities in Massachusetts and New Hampshire increased other operating expenses in the amount of \$1,592,000, which offset the decrease mentioned above.

Non-operating income increased by \$4,400,000 to \$11,171,000 in the three month 2013 period in comparison to \$6,771,000 for the three month 2012 period, as further detailed in Note 4 to our interim condensed consolidated financial statements. The increase is primarily due to the gain on the recovery of notes receivable (\$5,454,000) from the collection of certain notes receivable NHC had previously written down.

The income tax provision for the three months ended September 30, 2013 is \$10,559,000 (an effective income tax rate of 34.7%). The income tax provision and effective tax rate for the three months ended September 30, 2013 were favorably impacted by adjustments to unrecognized tax benefits of \$54,000, excluding statute of limitation expirations and unfavorably impacted by permanent differences including nondeductible expenses of \$410,000 resulting in an increase in the provision. The income tax provision and effective tax rate for 2013 were favorably impacted by statute of limitation expirations resulting in a benefit to the provision of \$1,605,000 or 5.3% of income before taxes in 2013. The income tax provision for the three months ended September 30, 2012 was

\$6,185,000 (an effective income tax rate of 26.5%). The income tax provision and effective tax rate for the three months ended September 30, 2012 were unfavorably impacted by adjustments to unrecognized tax benefits of \$193,000 and permanent differences including nondeductible expenses of \$208,000 resulting in an increase in the provision. The income tax provision and effective tax rate for 2012 were favorably impacted by statute of limitation expirations resulting in a benefit to the provision of \$3,187,000 or 13.6% of income before taxes in 2012.

Nine Months Ended September 30, 2013 Compared to Nine Months Ended September 30, 2012

Results for the nine month period ended September 30, 2013 include a 2.7% increase in net operating revenues and a 15.7% increase in income before income taxes compared to the same period in 2012.

The total census at owned and leased skilled nursing facilities for the nine months averaged 89.5% compared to an average of 90.3% for the same period a year ago.

Medicare and managed care per diem rates at our owned and leased skilled nursing facilities decreased 0.3% and 0.5%, respectively, compared to the nine months a year ago. Medicaid and private pay per diem rates at our owned and leased skilled nursing facilities increased 3.5% and 5.2%, respectively, compared to the nine month period a year ago.

Net patient revenues increased \$14,586,000 or 2.8% compared to the same period last year. In combination with our overall average skilled nursing facility per diem increasing 3.3%, we also had a favorable skilled patient mix change compared to the nine month period a year ago that helped increase net patient revenues. On September 1, 2013, we began leasing and operating seven skilled nursing facilities in Massachusetts and New Hampshire. These newly leased facilities helped increase net patient revenues \$5,182,000. Also in our skilled nursing facilities, the Tennessee Medicaid program paid a non-recurring acuity based rate adjustment to help account for the higher acuity of patients served as a result of the level of care changes implemented in fiscal year 2013 (\$1,635,000). Homecare operations also increased net patient revenues in the amount of \$4,160,000 compared to the nine month period a year ago.

Other revenues increased \$550,000 or 1.3% in the nine month 2013 period to \$42,364,000 from \$41,814,000 in the 2012 nine month period. The increase in other revenues is primarily due to the increased workers compensation insurance revenue recorded as a result of a positive settlement reached with one of the states in which we insure third party operators of healthcare facilities. The insurance settlement revenue of \$2,769,000 is a nonrecurring item. Offsetting the increase in revenue from the insurance settlement, management fees and insurance service revenue decreased \$2,303,000 from the discontinuation of our relationship with the SeniorTrust non-profit organization. We discontinued providing management and insurance services in February 2013 for two of SeniorTrusts' healthcare facilities and April 2013 for the remaining five healthcare facilities.

Other revenues are further detailed in Note 3 of our interim condensed consolidated financial statements. As discussed in Note 3 and Note 17 of this Form 10-Q, we are discontinuing our relationship with certain non-profit organizations and we estimate our future results of operations and cash flows to be adversely affected by approximately \$2,200,000 annually, or \$1,350,000 net of income taxes annually, due to the loss of management fees and insurance services from the discontinuation of these relationships.

Total costs and expenses for the 2013 nine months compared to the 2012 nine months increased \$10,580,000 or 2.0% to \$529,899,000 from \$519,319,000. Salaries, wages and benefits, the largest operating costs of our company, increased \$12,132,000 to \$330,160,000 from \$318,028,000. Other operating expenses decreased \$380,000 or 0.3% to \$148,891,000 for the 2013 period compared to \$149,271,000 for the 2012 period. Facility rent expense increased \$120,000 or 0.4% to \$29,627,000. Depreciation and amortization decreased 5.4% to \$20,973,000.

The increase in salaries, wages and benefits is primarily due to the new operations of the seven leased skilled nursing facilities in Massachusetts and New Hampshire (\$3,719,000). We also had increased costs for therapist services of \$3,007,000, increased costs for our homecare operations of \$2,350,000, and inflationary wage increases for our partners.

The decrease in other operating expenses is primarily due to the continued cost saving measures implemented in our skilled nursing facilities (\$3,302,000). The new operations of the seven leased skilled nursing

facilities in Massachusetts and New Hampshire increased other operating expenses by \$1,592,000. Homecare operations also increased other operating expenses by \$2,141,000.

Non-operating income increased by \$5,875,000 to \$24,421,000 in the nine month 2013 period in comparison to \$18,546,000 for the nine month 2012 period, as further detailed in Note 4 to our interim condensed consolidated financial statements. The increase is primarily due to the gain on the recovery of notes receivable (\$5,454,000) from the collection of certain notes receivable NHC had previously written down. We also acquired an additional 7.5% non-controlling ownership interest in Caris effective June 1, 2012; therefore, we have nine months of equity in earnings for the 2013 period compared to four months for the 2012 period. This ownership percentage change increased non-operating income by \$1,491,000. Offsetting the non-operating income items above, our restricted marketable securities had investment income in the 2013 nine month period that was lower than the 2012 nine month period by \$1,037,000.

The income tax provision for the nine months ended September 30, 2013 is \$28,659,000 (an effective income tax rate of 37.4%). The income tax provision and effective tax rate for the nine months ended September 30, 2013 were unfavorably impacted by adjustments to unrecognized tax benefits of \$260,000 and permanent differences including nondeductible expenses of \$490,000 resulting in an increase in the provision. The income tax provision and effective tax rate for 2013 were favorably impacted by statute of limitation expirations resulting in a benefit to the provision of \$1,605,000 or 2.1% of income before taxes in 2013. The income tax provision for the nine months ended September 30, 2012 was \$22,847,000 (an effective income tax rate of 34.5%). The income tax provision and effective tax rate for the nine months ended September 30, 2012 were unfavorably impacted by adjustments to unrecognized tax benefits of \$218,000 and permanent differences including nondeductible expenses of \$348,000 resulting in an increase in the provision. The income tax provision and effective tax rate for 2012 were favorably impacted by statute of limitation expirations resulting in a benefit to the provision of \$3,187,000 or 4.8% of income before taxes in 2012.

Liquidity, Capital Resources, and Financial Condition

Our primary sources of cash include revenues from the operations of our healthcare and senior living facilities, insurance services, management services and accounting services. Our primary uses of cash include salaries, wages and other operating costs of our healthcare and senior living facilities, the cost of additions to and acquisitions of real property, facility rent expenses, and dividend distributions. These sources and uses of cash are reflected in our interim condensed consolidated statements of cash flows and are discussed in further detail below. The following is a summary of our sources and uses of cash flows (*dollars in thousands*):

Nine Months Ended

September 30

Nine Month Change

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| | 2013 | 2012 | \$ | % |
|--|-----------|-----------|----------|---------|
| Cash and cash equivalents at beginning of period | \$ 66,701 | \$ 61,008 | \$ 5,693 | 9.3% |
| Cash provided by operating activities | 90,164 | 61,329 | 28,835 | 47.0% |
| Cash used in investing activities | (44,107) | (24,286) | (19,821) | (81.6)% |
| Cash used in financing activities | (24,348) | (14,344) | (10,004) | 69.7% |
| Cash and cash equivalents at end of period | \$ 88,410 | \$ 83,707 | \$ 4,703 | 5.6% |

Operating Activities

Net cash provided by operating activities for the nine months ended September 30, 2013 was \$90,164,000, as compared to \$61,329,000 in the same period last year. Cash provided by operating activities consisted of net income of \$48,024,000, adjustments for non-cash items of \$21,973,000, and \$20,167,000 provided by working capital.

Cash provided by working capital primarily consisted of an increase in accrued risk reserves (\$8,383,000), an increase in accrued payroll (\$19,402,000), and the collection of our 2012 federal income tax receivable (\$5,933,000). These items were offset by an increase in restricted cash and cash equivalents (\$8,721,000) and an increase in accounts receivable (\$5,199,000). The increase in accrued risk reserves is due to the addition of the 2013 fiscal year accrual and the timing of payments. The increase in accrued payroll is due to the timing of incentive compensation. The increase in restricted cash and cash equivalents is from NHC and other healthcare entities paying insurance premiums into NHC insurance companies, which restrict the cash payment. The increase in accounts receivable is due to the seven new skilled nursing facilities in Massachusetts and New Hampshire, which we began leasing and operating September 1, 2013.

Investing Activities

Cash used in investing activities totaled \$44,107,000 and \$24,286,000 for the nine months ended September 30, 2013 and 2012, respectively. Cash used for property and equipment additions was \$33,981,000 for the nine months ended September 30, 2013 and \$14,888,000 in the comparable period in 2012. On September 1, 2013, NHC purchased six skilled health care centers from NHI for \$21 million in cash. Cash provided by net collections of notes receivable was \$13,813,000 in 2013 compared to \$336,000 in 2012. Purchases and sales of restricted marketable securities resulted in a net use of cash of \$2,939,000 for the 2013 period compared to \$2,234,000 for the 2012 period.

Construction costs included in additions to property and equipment in 2013 include \$7,768,000 for the construction of the 90 bed skilled nursing facility in Tullahoma, Tennessee, \$4,198,000 for the 50 bed addition to our skilled nursing facility in Lexington, South Carolina, \$2,822,000 for the land and acquisition costs of a future development site in Nashville, Tennessee, and \$2,744,000 for the acquisition and future renovation of a 52-bed transitional care center in Kingsport, Tennessee.

Financing Activities

Net cash used in financing activities totaled \$24,348,000 and \$14,344,000 for the nine months ended September 30, 2013 and 2012, respectively. Attributable to the increase during the first nine months of 2013 was the use of cash of \$4,700,000 to purchase outstanding common stock under our stock repurchase program, as compared to \$-0- for the same period in 2012. Cash used for dividend payments to common and preferred stockholders totaled \$19,476,000 in the current year period compared to \$19,039,000 for the same period a year ago. In the prior period, cash of \$5,960,000 was provided by the issuance of common stock.

Table of Contractual Cash Obligations

Our contractual cash obligations for periods subsequent to September 30, 2013 are as follows (*in thousands*):

| | | | 1-3 | 3-5 | After |
|------------------------------------|------------|-----------|-----------|-----------|------------|
| | Total | 1 year | Years | Years | 5 Years |
| Long-term debt – principal | \$ 10,000 | \$ – | \$ – | \$ 10,000 | \$ – |
| Long-term debt – interest | 1,174 | 276 | 553 | 345 | – |
| Operating leases | 458,900 | 34,200 | 68,400 | 68,400 | 287,900 |
| Total contractual cash obligations | \$ 470,074 | \$ 34,476 | \$ 68,953 | \$ 78,745 | \$ 287,900 |

Other noncurrent liabilities for uncertain tax positions of \$4,200,000, attributable to permanent differences, at September 30, 2013 has not been included in the above table because of the inability to estimate the period in which the tax payment is expected to occur. See Note 14 of the interim condensed consolidated financial statements for a discussion on income taxes.

We started paying quarterly dividends on our common shares outstanding in 2004 and our preferred shares outstanding in 2007. We anticipate the continuation of both the common and preferred dividend payments as approved quarterly by the Board of Directors.

Short-term liquidity

We expect to meet our short-term liquidity requirements primarily from our cash flows from operating activities. In addition to cash flows from operations, our current cash on hand of \$88,410,000 at September 30, 2013, marketable securities of \$108,199,000 at September 30, 2013 and as needed, our borrowing capacity, are expected to be adequate to meet our contractual obligations and to finance our operating requirements and our growth and development plans in the next twelve months. We currently do not have any funds drawn against our revolving credit agreement and the amount of \$75,000,000 is available to be drawn for general corporate purposes, including working capital and acquisitions.

Long-term liquidity

Our \$75,000,000 revolving credit agreement matures on October 22, 2014. We currently anticipate renewing the credit agreement at that time and while we have had no indication from the lender that there is any question about renewal, there has been no commitment at this time. We entered into this loan originally on October 30, 2007, and have renewed the loan six times with one year maturities. At the inception and at each renewal, the lender offered longer maturities, but the Company chose a one-year maturity because of the terms. If we are not able to refinance our debt as it matures, we will be required to use our cash and marketable securities to meet our debt and contractual obligations and will be limited in our ability to fund future growth opportunities.

Our ability to refinance the credit agreement, to meet our long-term contractual obligations and to finance our operating requirements, and growth and development plans will depend upon our future performance, which will be affected by business, economic, financial and other factors, including potential changes in state and federal government payment rates for healthcare, customer demand, success of our marketing efforts, pressures from competitors, and the state of the economy, including the state of financial and credit markets.

Commitment and Contingencies

Governmental Regulations

Laws and regulations governing the Medicare, Medicaid and other federal healthcare programs are complex and subject to interpretation. Management believes that it is in compliance with all applicable laws and regulations in all material respects. However, compliance with such laws and regulations can be subject to future government review and interpretation as well as significant regulatory action including fines, penalties, and exclusions from the Medicare, Medicaid and other federal healthcare programs. We are not aware of any material regulatory proceeding or

investigation underway or threatened involving allegations of potential wrongdoing.

Acquisitions

We have acquired and will continue to acquire businesses with prior operating histories. Acquired companies may have unknown or contingent liabilities, including liabilities for failure to comply with healthcare laws and regulations, such as billing and reimbursement, anti-kickback and physician self-referral laws. Although we institute policies designed to conform practices to our standards following completion of acquisitions and attempts to structure our acquisitions as asset acquisitions in which we do not assume liability for seller wrongful actions, there can be no assurance that we will not become liable for past activities that may later be alleged to be improper by private plaintiffs or government agencies. Although we obtain general indemnifications from sellers covering such matters, there can be no assurance that any specific matter will be covered by such indemnifications, or if covered, that such indemnifications will be adequate to cover potential losses and fines.

Inflation

We have historically derived a substantial portion of our revenue from the Medicare and Medicaid programs, along with similar reimbursement programs. Payments under these programs generally provide for reimbursement levels that are adjusted for inflation annually based upon the state's fiscal year for the Medicaid programs and in each October for the Medicare program. The adjustments may not continue in the future, and even if received, such adjustments may not reflect the actual increase in our costs for providing healthcare services.

New Accounting Pronouncements

See Note 2 to the Interim Condensed Consolidated Financial Statements for the impact of new accounting standards.

Forward-Looking Statements

References throughout this document to the Company include National HealthCare Corporation and its wholly-owned subsidiaries. In accordance with the Securities and Exchange Commission's "Plain English" guidelines, this Quarterly Report on Form 10-Q has been written in the first person. In this document, the words "we", "our", "ours" and "us" refer only to National HealthCare Corporation and its wholly-owned subsidiaries and not any other person.

This Quarterly Report on Form 10-Q and other information we provide from time to time, contains certain "forward-looking" statements as that term is defined by the Private Securities Litigation Reform Act of 1995. All statements regarding our expected future financial position, results of operations or cash flows, continued performance improvements, ability to service and refinance our debt obligations, ability to finance growth opportunities, ability to control our patient care liability costs, ability to respond to changes in government regulations, ability to execute our three-year strategic plan, and similar statements including, without limitations, those containing words such as "believes", "anticipates", "expects", "intends", "estimates", "plans", and other similar expressions are forward-looking statements.

Forward-looking statements involve known and unknown risks and uncertainties that may cause our actual results in future periods to differ materially from those projected or contemplated in the forward-looking statements as a result of, but not limited to, the following factors:

.
national and local economic conditions, including their effect on the availability and cost of labor, utilities and materials;

.
the effect of government regulations and changes in regulations governing the healthcare industry, including our compliance with such regulations;

.
changes in Medicare and Medicaid payment levels and methodologies and the application of such methodologies by the government and its fiscal intermediaries;

.
liabilities and other claims asserted against us, including patient care liabilities, as well as the resolution of current litigation (see Note 15: Guarantees and Contingencies);

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the ability of third parties for whom we have guaranteed debt, if any, to refinance certain short term debt obligations;

.
the ability to attract and retain qualified personnel;

.
the availability and terms of capital to fund acquisitions and capital improvements;

.
the ability to refinance existing debt on favorable terms;

.
the competitive environment in which we operate;

.
the ability to maintain and increase census levels; and

demographic changes.

See the notes to the quarterly financial statements, and “Item 1. Business” in our 2012 Annual Report on Form 10-K for a discussion of various governmental regulations and other operating factors relating to the healthcare industry and the risk factors inherent in them. This may be found on our web site at www.nhccare.com.

You should carefully consider these risks before making any investment in the Company. These risks and uncertainties are not the only ones facing us. There may be additional risks that we do not presently know of or that we currently deem immaterial. If any of the risks actually occur, our business, financial condition or results of operations could be materially adversely affected. In that case, the trading price of our shares of stock could decline, and you may lose all or part of your investment. 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.

Item 3.

Quantitative and Qualitative Disclosures About Market Risk.

Market risk represents the potential economic loss arising from adverse changes in the fair value of financial instruments. Currently, our exposure to market risk relates primarily to our fixed-income and equity portfolios. These investment portfolios are exposed primarily to, but not limited to, interest rate risk, credit risk, equity price risk, and concentration risk. We also have exposure to market risk that includes our cash and cash equivalents, notes receivable, revolving credit facility, and long-term debt. The Company's senior management has established comprehensive risk management policies and procedures to manage these market risks.

Interest Rate Risk

The fair values of our fixed-income investments fluctuate in response to changes in market interest rates. Increases and decreases in prevailing interest rates generally translate into decreases and increases, respectively, in the fair values of those instruments. Additionally, the fair values of interest rate sensitive instruments may be affected by the creditworthiness of the issuer, prepayment options, the liquidity of the instrument and other general market conditions. At September 30, 2013, we have available for sale debt securities in the amount of \$141,861,000. The fixed maturity portfolio is comprised of investments with primarily short-term and intermediate-term maturities. The portfolio composition allows flexibility in reacting to fluctuations of interest rates. The fixed maturity portfolio allows our insurance company subsidiaries to achieve an adequate risk-adjusted return while maintaining sufficient liquidity to meet obligations.

As of September 30, 2013, both our long-term debt and revolving credit facility bear interest at variable interest rates. Currently, we have long-term debt outstanding of \$10.0 million and the revolving credit facility is zero. However, we do intend to borrow funds on our credit facility in the future. Based on a hypothetical credit facility borrowing of \$75.0 million and our outstanding long-term debt, a 1% change in interest rates would change our annual interest cost by approximately \$850,000.

Approximately \$2.8 million of our notes receivable bear interest at variable rates (generally at the prime rate plus 2%). Because the interest rates of these instruments are variable, a hypothetical 1% change in interest rates would result in a related increase or decrease in interest income of approximately \$28,000.

Our cash and cash equivalents consist of highly liquid investments with a maturity of less than three months when purchased. As a result of the short-term nature of our cash instruments, a hypothetical 1% change in interest rates would have minimal impact on our future earnings and cash flows related to these instruments.

We do not currently use any derivative instruments to hedge our interest rate exposure. We have not used derivative instruments for trading purposes and the use of such instruments in the future would be subject to approvals by the Investment Committee of the Board.

Credit Risk

Credit risk is managed by diversifying the fixed maturity portfolio to avoid concentrations in any single industry group or issuer and by limiting investments in securities with lower credit ratings.

Equity Price and Concentration Risk

Our available for sale equity securities are recorded at their fair market value based on quoted market prices. Thus, there is exposure to equity price risk, which is the potential change in fair value due to a change in quoted market prices. At September 30, 2013, the fair value of our equity marketable securities is approximately

\$108,199,000. Of the \$108.2 million equity securities portfolio, our investment in National Health Investors, Inc. (“NHI”) comprises approximately \$92.8 million, or 85.7%, of the total fair value. We manage our exposure to NHI by closely monitoring the financial condition, performance, and outlook of the company. Hypothetically, a 10% change in quoted market prices would result in a related increase or decrease in the fair value of our equity investments of approximately \$10.8 million. At September 30, 2013, our equity securities had unrealized gains of \$78.0 million. Of the \$78.0 million of unrealized gains, \$68.0 million is related to our investment in NHI.

Item 4. Controls and Procedures.

As of September 30, 2013, an evaluation was performed under the supervision and with the participation of the Company’s management, including the Chief Executive Officer (“CEO”) and Principal Accounting Officer (“PAO”), of the effectiveness of the design and operation of the Company’s disclosure controls and procedures. Based on that evaluation, the Company’s management, including the CEO and PAO, concluded that the Company’s disclosure controls and procedures were effective as of September 30, 2013. There have been no changes in the Company’s internal control over financial reporting during the quarter ended September 30, 2013 that have materially affected, or are reasonably likely to materially affect, the Company’s internal control over financial reporting.

PART II. OTHER INFORMATION

Item 1. Legal Proceedings.

For a discussion of prior, current and pending litigation of material significance to NHC, please see Note 15 and Note 17 of this Form 10-Q.

Item 1A. Risk Factors.

During the nine months ended September 30, 2013, there were no material changes to the risk factors that were disclosed in Item 1A of National HealthCare Corporation's Annual Report on Form 10-K for the year ended December 31, 2012.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds. Not applicable

Item 3. Defaults Upon Senior Securities. None

Item 5. Other Information. None

Item 6. Exhibits.

(a)

List of exhibits

| <u>Exhibit No.</u> | <u>Description</u> |
|--------------------|--------------------|
|--------------------|--------------------|

| | |
|-----|---|
| 2.1 | Agreement and Plan of Merger, dated December 20, 2006, by and among Davis Acquisition Sub LLC, NHC/OP, L.P., NHC and NHR (incorporated by reference to Exhibit 2.1 to the current report on Form 8-K, filed with the SEC on December 20, 2006). |
|-----|---|

| | |
|-----|---|
| 2.2 | Amendment and Waiver No. 1 to Agreement and Plan of Merger, dated April 6, 2007, by and among Davis Acquisition Sub LLC, NHC/OP, L.P., NHC and NHR (incorporated by reference to Exhibit 10.1 to the current report on Form 8-K filed on April 11, 2007). |
|-----|---|

- 2.3 Amendment No. 2 to Agreement and Plan of Merger, dated August 3, 2007, by and among Davis Acquisition Sub LLC, NHC/OP, L.P., NHC and NHR (incorporated by reference to Exhibit 2.1 to the current report on Form 8-K filed on August 6, 2007).

- 3.1 Certificate of Incorporation of National HealthCare Corporation (incorporated by reference to Exhibit 3.1 to the Registrant's registration statement on Form S-4 (File No. 333-37185) dated October 3, 1997).

- 3.2 Certificate of Amendment to the Certificate of Incorporation of National HealthCare Corporation (incorporated by reference to Exhibit 3.2 to the Registrant's registration statement on Form 8-A, dated October 31, 2007).

- 3.3 Certificate of Designations of Series A Convertible Preferred Stock of National HealthCare Corporation (incorporated by reference to Exhibit 2.1 to the current report on Form 8-K filed on December 20, 2006).

- 3.4 Certificate of Designation Series B Junior Participating Preferred Stock (incorporated by reference to Exhibit 3.1 to the Registrant's registration statement on Form 8-A, dated August 3, 2007).

- 3.5 Restated Bylaws as amended February 14, 2013 (incorporated by reference to Exhibit 3.5 to the quarterly report on Form 10-Q filed on May 8, 2013).

- 4.1 Form of Common Stock (incorporated by reference to Exhibit A attached to Form S-4, (Proxy Statement-Prospectus), amended, Registration No. 333-37185, (December 5, 1997).

- 4.2 Form of Series A Convertible Preferred Stock Certificate (incorporated by reference to Exhibit A to Exhibit 3.5 to the Registrant's registration statement on Form 8-A, dated October 31, 2007).

- 4.3 Rights Agreement, dated as of August 2, 2007, between National HealthCare Corporation and Computershare Trust Company, N.A. (incorporated by reference to Exhibit 4.1 to the Registrant's registration statement on Form 8-A, dated August 3, 2007).
- 10.1 Amendment to Purchase and Sale Agreement with Modifications to Master Agreement to Lease between National Health Investors, Inc. and National HealthCare Corporation
- 10.2 Amended and Restated Amendment No. 6 to Master Agreement to Lease
- 10.3 Amendment No. 7 to Master Agreement to Lease
- 10.4 Agreement to Lease between NHI-REIT of Northeast, LLC, Landlord and NHC/OP, L.P. and National HealthCare Corporation, Co-Tenants
- 10.5 Sixth Amendment to Credit Agreement, dated October 23, 2013, between National HealthCare Corporation and Bank of America, N.A. (incorporated by reference to exhibit 10.1 to our current report on Form 8-K filed October 24, 2013)
- 31.1 Rule 13a-14(a)/15d-14(a) Certification of Chief Executive Officer
- 31.2 Rule 13a-14(a)/15d-14(a) Certification of Principal Financial Officer
- 32 Certification pursuant to 18 U.S.C. Section 906 by Chief Executive Officer and Principal Financial Officer
- 101.INS XBRL Instance Document
- 101.SCH XBRL Taxonomy Extension Schema Document
- 101.CAL XBRL Taxonomy Extension Calculation Linkbase Document
- 101.DEF XBRL Taxonomy Extension Definition Linkbase Document
- 101.LAB XBRL Taxonomy Extension Label Linkbase Document
- 101.PRE XBRL Taxonomy Extension Presentation Linkbase Document

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

NATIONAL HEALTHCARE
CORPORATION

(Registrant)

Date: November 5, 2013

/ s / R o b e r t G . A d a m s

Robert G. Adams
Chief Executive Officer

Date: November 5, 2013

/ s / D o n a l d K . D a n i e l

Donald K. Daniel
Senior Vice President and Controller
(Principal Financial Officer)