

NATIONAL HEALTHCARE CORP  
Form 10-Q  
November 09, 2006

**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, 2006

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

**NATIONAL HEALTHCARE CORPORATION**

(Exact name of registrant as specified in its Charter)

Delaware 52-2057472 (State or other jurisdiction of (I.R.S.  
Employer incorporation or organization Identification No.) 100 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 is a large accelerated filer, an accelerated filer, or a non-accelerated filer (as defined in Rule 12b02 of the Exchange Act.) Large accelerated filer  Accelerated filer  Non-accelerated filer  Indicate by check mark whether the registrant is a shell company (as is defined in Rule 12b-2 of the Exchange Act). Yes  No  12,307,596 shares of common stock were outstanding as of November 2, 2006

**PART I. FINANCIAL INFORMATION**

**Item 1. Financial Statements.**

**NATIONAL HEALTHCARE CORPORATION**

**INTERIM CONDENSED CONSOLIDATED STATEMENTS OF INCOME**

(Unaudited)

Three Months Ended

Nine Months Ended

September 30

September 30

2006

2005

2006

2005

(in thousands, except share and per share amounts)

REVENUES:

Net patient revenues	\$ 128,689	\$ 119,578	\$ 375,979	\$ 354,669
Other revenues	<u>15,079</u>	<u>18,145</u>	<u>45,409</u>	<u>48,099</u>
Net revenues	<u>143,768</u>	<u>137,723</u>	<u>421,388</u>	<u>402,768</u>

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COSTS AND EXPENSES:				
Salaries, wages and benefits	72,798	72,073	223,839	214,657
Other operating	41,660	38,083	121,075	112,858
Write-off (recovery) of notes receivable	--	--	(7,309)	1,000
Rent	10,178	10,424	30,808	31,235
Depreciation and amortization	3,588	3,759	10,472	11,201
Interest	<u>241</u>	<u>387</u>	<u>761</u>	<u>1,195</u>
Total costs and expenses	<u>128,465</u>	<u>124,726</u>	<u>379,646</u>	<u>372,146</u>
INCOME BEFORE INCOME TAXES	15,303	12,997	41,742	30,622
INCOME TAX PROVISION	<u>(6,032)</u>	<u>(5,030)</u>	<u>(16,688)</u>	<u>(11,833)</u>
NET INCOME	\$ 9,271	\$ 7,967	\$ 25,054	\$ 18,789
EARNINGS PER SHARE:				
Basic	\$ .75	\$ .65	\$ 2.04	\$ 1.54
Diluted	\$ .71	\$ .62	\$ 1.94	\$ 1.47
WEIGHTED AVERAGE SHARES OUTSTANDING:				
Basic	12,300,542	12,245,395	12,292,149	12,239,684
Diluted	12,969,936	12,795,922	12,921,595	12,768,531

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

**NATIONAL HEALTHCARE CORPORATION**  
**INTERIM CONDENSED CONSOLIDATED BALANCE SHEETS**  
*(in thousands)*

**ASSETS**

	September 30 <u>2006</u> <i>(Unaudited)</i>	December 31 <u>2005</u>
CURRENT ASSETS:		
Cash and cash equivalents	\$ 50,277	\$ 60,870
Restricted cash	53,518	87,771
Restricted marketable securities	47,594	2,104
Marketable securities	61,882	51,556
Accounts receivable, less allowance for doubtful accounts of \$6,560 and \$6,101	62,525	51,260
Notes receivable	189	189
Inventory at lower of cost (first-in, first-out method) or market	6,174	5,623
Prepaid expenses and other assets	<u>1,814</u>	<u>1,206</u>
Total current assets	<u>283,973</u>	<u>260,579</u>

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PROPERTY AND EQUIPMENT:		
Property and equipment, at cost	252,819	225,928
Less accumulated depreciation and amortization	<u>(129,915)</u>	<u>(118,794)</u>
Net property and equipment	<u>122,904</u>	<u>107,134</u>
OTHER ASSETS:		
Bond reserve funds, mortgage replacement reserves and other deposits	103	57
Goodwill	3,033	3,033
Unamortized financing costs, net	42	74
Notes receivable	10,176	10,786
Notes receivable from National	10,001	10,992
Deferred income taxes	18,095	16,690
Minority equity investments and other	<u>4,145</u>	<u>1,280</u>
Total other assets	<u>45,595</u>	<u>42,912</u>
	\$452,472	\$410,625

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

The interim condensed consolidated balance sheet at December 31, 2005 is taken from the audited financial statements at that date.

**NATIONAL HEALTHCARE CORPORATION**  
**INTERIM CONDENSED CONSOLIDATED BALANCE SHEETS**  
*(in thousands, except share and per share amounts)*

**LIABILITIES AND SHAREHOLDERS' EQUITY**

	September 30 <u>2006</u> <i>(Unaudited)</i>	December 31 <u>2005</u>
CURRENT LIABILITIES:		
Current portion of long-term debt	\$ 2,525	\$ 2,461
Trade accounts payable	12,342	10,431
Accrued payroll	45,327	41,929
Amounts due to third-party payors	6,355	4,815
Accrued risk reserves	76,886	70,290
Deferred income taxes	5,050	3,855
Other current liabilities	14,394	11,295
Dividends payable	2,215	1,837
Accrued interest	<u>19</u>	<u>278</u>
Total current liabilities	<u>165,113</u>	<u>147,191</u>
LONG-TERM DEBT, LESS CURRENT PORTION	11,886	13,568
OTHER NONCURRENT LIABILITIES	13,644	14,003
DEFERRED LEASE CREDIT	5,385	6,154
MINORITY INTERESTS IN CONSOLIDATED SUBSIDIARIES	1,471	1,185
DEFERRED REVENUE	26,557	25,465

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COMMITMENTS, CONTINGENCIES AND GUARANTEES

SHAREHOLDERS' EQUITY:

Preferred stock, \$.01 par value; 10,000,000 shares authorized; none issued or outstanding	--	--
Common stock, \$.01 par value; 30,000,000 shares authorized; 12,304,038 and 12,275,693 shares, respectively, issued and outstanding	123	123
Capital in excess of par value, less notes receivable	87,239	84,431
Retained earnings	120,244	101,461
Unrealized gains on marketable securities	<u>20,810</u>	<u>17,044</u>
Total shareholders' equity	<u>228,416</u>	<u>203,059</u>
	\$452,472	\$410,625

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

The interim condensed consolidated balance sheet at December 31, 2005 is taken from the audited financial statements at that date.

**NATIONAL HEALTHCARE CORPORATION**  
**INTERIM CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**

(Unaudited)

	Nine Months Ended	
	<u>September 30</u>	
	<u>2006</u>	<u>2005</u>
CASH FLOWS FROM OPERATING ACTIVITIES:	<i>(in thousands)</i>	
Net income	\$25,054	\$18,789
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation	10,440	11,028
Write down of notes receivable	--	1,000
Provision for doubtful accounts receivable	459	1,538
Amortization of intangibles and deferred charges	32	173
Amortization of deferred income	(437)	(535)
Deferred income	996	1,024
Stock option compensation	1,985	--
Equity in earnings of unconsolidated investments	(3,016)	(164)
Amortization of deferred lease credit	(769)	(598)
Deferred income taxes	(2,647)	(1,817)
Changes in assets and liabilities:		
Accounts receivable	(11,724)	(11,699)
Tax refund	--	6,311
Inventory	(551)	(336)
Prepaid expenses and other assets	(608)	(309)
Accounts payable	1,911	(1,108)

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Accrued payroll	3,398	3,894
Amounts due to third party payors	1,540	(96)
Accrued interest	(259)	(6)
Other current liabilities and accrued reserves	9,695	10,558
Other noncurrent liabilities	(359)	797
Entrance fee deposits	<u>533</u>	<u>694</u>
Net cash provided by operating activities	<u>35,673</u>	<u>39,138</u>
CASH FLOWS FROM INVESTING ACTIVITIES:		
Additions to and acquisitions of property and equipment, net	(26,210)	(11,265)
Investment in notes receivable	--	(1,205)
Collection of notes receivable	1,601	130
Purchase of marketable securities, net	(4,123)	(2,026)
Decrease (increase) in restricted cash	34,253	(15,175)
Sale (purchase) of restricted marketable securities, net	(45,490)	733
Distributions from unconsolidated investments	<u>151</u>	<u>147</u>
Net cash used in investing activities	<u>(39,818)</u>	<u>(28,661)</u>
CASH FLOWS FROM FINANCING ACTIVITIES:		
Increase in minority interests in subsidiaries	286	215
(Increase) decrease in bond reserve funds, mortgage replacement reserves and other deposits	(46)	4
Issuance of common shares	593	389
Tax benefit from exercise of stock options	230	--
Dividends paid to shareholders	(5,893)	(4,884)
Payments on debt	<u>(1,618)</u>	<u>(1,687)</u>
Net cash provided by (used in) financing activities	<u>(6,448)</u>	<u>(5,963)</u>
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	(10,593)	4,514
CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD	<u>60,870</u>	<u>40,601</u>
CASH AND CASH EQUIVALENTS, END OF PERIOD	\$50,277	\$45,115
Supplemental Information:		
Cash payments for interest expense	\$ 1,020	\$ 1,201
Cash payments for income taxes, net of refunds	\$15,954	\$ 7,320

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 Shareholders' Equity**  
*(in thousands, except share amounts)*  
(unaudited)

	<u>Common Stock</u>		<u>Paid in</u>	<u>Retained</u>	<u>Unrealized</u>	<u>Total Share-</u>
	<u>Shares</u>	<u>Amount</u>	<u>Capital</u>	<u>Earnings</u>	<u>Gains</u>	<u>holders'</u>
					<u>on Securities</u>	<u>Equity</u>
Balance at 12/31/04	<u>12,219,451</u>	<u>\$122</u>	<u>\$82,799</u>	<u>\$ 79,866</u>	<u>\$19,561</u>	<u>\$182,348</u>
Net income	--	--	--	18,789	--	18,789
Unrealized losses on securities (net of tax of \$326)	--	--	--	--	(545)	<u>(545)</u>
Total comprehensive income						18,244
Tax benefit from exercise of stock options	--	--	207	--	--	207
Shares sold - stock purchase plans (including 3,744						

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options exercised)	25,944	--	389	--	--	389
Dividends declared to common shareholders (\$.425 per share)	=	=	=	(5,203)	=	(5,203)
Balance at 9/30/05	<u>12,245,395</u>	\$122	<u>\$83,395</u>	<u>\$ 93,452</u>	<u>\$19,016</u>	<u>\$195,985</u>
Balance at 12/31/05	<u>12,275,693</u>	\$123	<u>\$84,431</u>	<u>\$101,461</u>	<u>\$17,044</u>	<u>\$203,059</u>
Net income	--	--	--	25,054	--	25,054
Unrealized gains on securities (net of tax of \$2,437)	--	--	--	--	3,766	<u>3,766</u>
Total comprehensive income						28,820
Stock option compensation	--	--	1,985	--	--	1,985
Tax benefit from exercise of stock options	--	--	230	--	--	230
Shares sold - stock purchase plans (including 23,541 options exercised)	28,345	--	593	--	--	593
Dividends declared to common shareholders (\$.51 per share)	=	=	=	(6,271)	=	(6,271)
Balance at 9/30/06	12,304,038	\$123	\$87,239	\$ 120,244	\$20,810	\$228,416

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

**Note 1 - Consolidated Financial Statements**

The unaudited financial statements to which these notes are attached include, in our opinion, all normal, recurring adjustments which are necessary to fairly present the financial position, results of operations and cash flows of National HealthCare Corporation ("NHC" or the "Company"). We assume that users of these interim financial statements have read or have access to the audited December 31, 2005 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. Our audited December 31, 2005 financial statements are available at our web site: [www.nhccare.com](http://www.nhccare.com).

**Note 2 - Relationship with National Health Investors, Inc.**

On March 13, 2006, we announced an agreement with National Health Investors, Inc. (NHI) to end the use of NHC's senior officers as advisors to NHI, effective on about December 31, 2006. NHC's Board believes it to be in the best interest of NHC to accentuate its independence from NHI, its largest landlord.

It is also expected that NHC's contract to provide financial accounting, data processing and administrative services to Management Advisory Source, LLC (MAS) will be terminated on or before December 31, 2006. NHC currently receives compensation of \$109,375 per month (\$1,312,500 annually) for its services under the contract which amount is reported as "other revenues" in the consolidated Statements of Income. Our board chairman, W. Andrew Adams, serves as the President of MAS. MAS serves as advisor to NHI.

**Note 3 - Other Revenues**

Other revenues include the following:

	Three Months Ended		Nine Months Ended	
	September 30		September 30	
	2006	2005	2006	2005
	(in thousands)			
Insurance services	\$ 4,925	\$ 5,819	\$14,574	\$18,081
Management and accounting service fees	4,262	7,830	12,744	16,896
Guarantee fees	--	112	9	283
Advisory fee from Management Advisory Source, LLC	328	312	984	938

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Advisory fee from NHR	125	175	375	375
Dividends and other realized gains on securities	949	901	2,844	2,697
Equity in earnings of unconsolidated investments	902	62	3,099	163
Interest income	2,407	1,713	7,434	4,730
Rental income	808	1,014	2,286	3,004
Other	<u>373</u>	<u>207</u>	<u>1,060</u>	<u>932</u>
	\$15,079	\$18,145	\$45,409	\$48,099

Revenues from insurance services include premiums for workers' compensation and professional and general liability insurance policies that our wholly-owned insurance subsidiaries have written for certain long-term health care centers to which we provide management or accounting services. Revenues from management and accounting services include management and accounting fees and revenues from other services provided to managed and other long-term health care centers. "Other" revenues include non-healthcare related earnings.

Equity in earnings of unconsolidated investments include our 25% equity in the earnings of a partnership which operates a long-term health care facility and 49.5% equity in the earnings of the recently formed Caris HealthCare, a partnership which operates a hospice program. In the quarter ended September 30, 2006, we recognized equity in earnings from Caris HealthCare of approximately \$824,000 compared to zero in the quarter ended September 30, 2005. We believe that our share of future quarterly earnings from Caris in 2006 are expected to total between \$500,000 and \$800,000 per quarter.

For the nine months ended September 30, 2006, we recognized no management fees from National or NHI. As of September 30, 2006, unrecognized and unpaid management fees from National and NHI totaled \$11,169,000 and \$4,209,000, respectively. The receipt of payment of these fees is subject to collectibility issues and negotiations. Consistent with our policy, we will only recognize these unrecognized fees and revenues if and when cash is collected.

As disclosed in Note 2 to the Interim Condensed Consolidated Financial Statements, the above advisory fee from Management Advisory Source, LLC shown in the table above is expected to be discontinued on or before December 31, 2006.

### Note 4 - Guarantees and Contingencies

#### *General and Professional Liability Lawsuits and Insurance*

Across the nation, the entire long term care industry has experienced a dramatic increase in personal injury/wrongful death claims and awards based on alleged negligence by nursing facilities and their employees in providing care to residents. As of September 30, 2006, we and/or our managed centers are currently defendants in 67 such claims covering 1995 through September 30, 2006. Two of these 67 claims are currently pending in relation to the September 25, 2003 fire that occurred at our long-term care center in Nashville, Tennessee. Fourteen of the 67 suits are in Florida, where we have not operated or managed long-term care providers since September 30, 2000. Of the 14 Florida suits, seven suits relate to events before and seven suits relate to events after our cessation of business in Florida. These latter seven suits assert allegations of continued exposure even after we ceased operations.

When bids were solicited for third party professional liability insurance coverage for 2002, only two companies would quote coverage for us. Both quotations were so onerous and expensive that we elected to pay the premiums into a wholly-owned licensed captive insurance company, incorporated in the Cayman Islands, for the purpose of managing the Company's losses related to these risks. Thus, for 2002 through September 30, 2006, insurance coverage for incidents occurring at all providers owned or leased, and most providers managed by us, is provided through this wholly-owned insurance company. Policies are written for a duration of twelve months.

Our coverages for all years include both primary policies and excess policies. Commencing with 2002, deductibles were eliminated with first dollar coverage being provided through the wholly-owned insurance company.

Both primary professional liability insurance coverage and excess coverage is provided through our wholly-owned liability insurance company in the amount of \$1 million per occurrence, \$3 million per location with an aggregate primary policy limit for the years 2002 through 2006 of \$10.0 million, \$11.0 million, \$12.0 million, \$14.0 million, and \$14.0 million, respectively. There is a \$7.5 million annual excess aggregate coverage applicable to each year.

For these professional liability insurance operations, the premium revenues reflected in the financials as "Other revenues" for the nine months ended September 30, 2006 and September 30, 2005, respectively, are \$2,883,000 and \$3,071,000. Associated losses and expenses including those for self-insurance are included in the financial statements as "Other operating costs and expenses". Related costs total \$4,944,000 and \$2,804,000 for the nine months ended September 30, 2006 and September 30, 2005.

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As a result of the terms of our insurance policies and our use of a wholly-owned insurance company, we have retained significant self-insured risk with respect to general and professional liability. We use independent actuaries to assist management to estimate our exposures for claims obligations (for both asserted and unasserted claims) related to exposures in excess of coverage limits, and we maintain reserves for these obligations. **It is possible that claims against us could exceed our coverage limits and our reserves, which would have a material adverse effect on our financial position, results of operations and cash flows.**

### *Debt Guarantees--*

In addition to our primary debt obligations, which are included in our condensed consolidated balance sheet, we have guaranteed the debt obligations of certain other entities. Those guarantees, which are not included as debt obligations in our consolidated financial statements, total \$10,850,000 at September 30, 2006 and include \$5,214,000 of debt of managed and other long-term health care centers and \$5,636,000 of debt of National Health Corporation ("National") and the National Health Corporation Leveraged Employee Stock Ownership Plan (the "ESOP").

The \$5,214,000 of guarantees of debt of managed and other long-term health care centers relates to first mortgage debt obligations of two long-term health care centers to which we provide management or accounting services. We have agreed to guarantee these obligations in order to obtain management or accounting services agreements. For this service, we charge an annual guarantee fee of 0.5% to 2.0% of the outstanding principal balance guaranteed, which fee is in addition to our management or accounting services fee. All of this guaranteed indebtedness is secured by first mortgages, pledges of personal property, accounts receivable, marketable securities and, in certain instances, the personal guarantees of the owners of the facilities.

The \$5,636,000 of guarantees of debt of National and the ESOP relates to senior secured notes held by financial institutions. The total outstanding balance of National and the ESOP's obligations under these senior secured notes is \$9,090,000. Of this obligation, \$3,454,000 has been included in our debt obligations because we are a direct obligor on this indebtedness. The remaining \$5,636,000, which is not included in our debt obligations because we are not a direct obligor, is due from NHI to National and the ESOP. Additionally, under the amended terms (dated March 31, 2005) of these note agreements, the right of the lending institutions to require NHC to purchase the notes at par value under a guaranty and contingency purchase agreement has been removed.

As of September 30, 2006, our maximum potential loss related to the aforementioned debt is \$10,850,000 which is the outstanding balance of our guarantee. We have accrued approximately \$1,044,000 for potential losses as a result of our guarantees.

### *Debt Cross Defaults-*

Through a guarantee agreement, our \$3,454,000 senior secured notes and our \$5,636,000 guarantee described above have cross-default provisions with other debt of National and the ESOP. We currently believe that National and the ESOP are in compliance with the terms of their debt agreements.

### *Outstanding Offer to Purchase Facility-*

Under the terms of our management agreement for a 176-bed long-term care center located in Aiken, South Carolina, we have attempted to exercise our right of first refusal to purchase the center for \$8,448,000. Our right to purchase the facility is being disputed by the owner. A prospective buyer of the center has been granted the right to intervene in the case and has filed a motion for summary judgment with the court. On October 23, 2006, the Circuit Court in the County of Aiken, South Carolina granted the prospective buyer's motion for summary judgment. On November 2, 2006, we filed a motion to alter the order granting summary judgment. We currently are continuing to manage operations of the facility and earn approximately \$500,000 annually in management fee revenues from the facility.

### **Note 5 - Notes Receivable**

On June 30, 2006, we collected a note receivable in the amount of \$7,309,000 which had previously been written off. The collection is reported as a recovery of notes receivable in the condensed consolidated statements of income.

In March, 2005, we recorded a \$1,000,000 writedown of a note receivable due from a 120-bed long-term health care center in Missouri that we manage. The writedown was recorded as a result of the lack of increase in reimbursement rates, the cash flow of this center declined, and the center has not made a principal payment on this note since December 31, 2001. Based on an analysis consistent with the provisions of Statement of Financial Accounting Standards No. 114, "Accounting by Creditors for Impairment of a Loan - an Amendment of FASB Statement No. 5 and 15", we concluded that the writedown of \$1,000,000 was required. As of September 30, 2006, no further impairment charge is deemed necessary.

### **Note 6 - New Accounting Pronouncements**



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In February 2006, the FASB issued FAS No. 155, "Accounting for Certain Hybrid Financial Instruments - an amendment to FASB Statements No. 133 and 140" (FAS 155). FAS 155 simplifies the accounting for certain hybrid financial instruments containing embedded derivatives. FAS 155 allows fair value measurement for any hybrid financial instrument that contains an embedded derivative that otherwise would require bifurcation under FAS 133. In addition, it amends FAS 140 to eliminate the prohibition on a qualifying special-purpose entity from holding a derivative financial instrument that pertains to a beneficial interest other than another derivative financial instrument. The Company will adopt the provisions of FAS 155 beginning in fiscal 2007. The implementation of FAS 155 is not expected to have a material impact on the Company's consolidated financial statements.

In March 2006, the FASB issued SFAS No. 156, "Accounting for Servicing of Financial Assets - an amendment of FASB Statement No. 140." This Statement amends FASB Statement No. 140, "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities," with respect to the accounting for separately recognized servicing assets and servicing liabilities. This Statement clarifies when servicing rights should be separately accounted for, requires companies to account for separately recognized servicing rights initially at fair value, and gives companies the option of subsequently accounting for those servicing rights at either fair value or under the amortization method. SFAS 156 is effective for the Company beginning January 1, 2007. The implementation of FAS 156 is not expected to have a material impact on the Company's consolidated financial statements.

In July 2006, the FASB issued Interpretation No. 48 ("FIN 48"), "Accounting for Uncertainty in Income Taxes - An Interpretation of FASB Statement No. 109." FIN 48 prescribes a recognition threshold and measurement attribute for how a company should recognize, measure, present, and disclose in its financial statements uncertain tax positions that the company has taken or expects to take on a tax return. FIN 48 will require that the financial statements reflect expected future tax consequences of such positions presuming the taxing authorities' full knowledge of the position and all relevant facts, but without considering time values. FIN 48 is effective for annual periods beginning after December 15, 2006. We are currently evaluating the impact of adopting FIN 48 on our financial statements. Upon adoption, the cumulative effect of applying the provision of FIN 48 will be reported as an adjustment to the opening balance of retained earnings for that fiscal year.

### Note 7 - Earnings per Share

Basic earnings per share is based on the weighted average number of common shares outstanding during the period.

Diluted earnings per share assumes the exercise of options using the treasury stock method.

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

	Three Months Ended		Nine Months Ended	
	September 30		September 30	
	<u>2006</u>	<u>2005</u>	<u>2006</u>	<u>2005</u>
Basic:				
Weighted average common shares	12,300,542	12,245,395	12,292,149	12,239,684
Net income	\$ 9,271,000	\$ 7,967,000	\$25,054,000	\$18,789,000
Earnings per common share, basic	\$ .75	\$ .65	\$ 2.04	\$ 1.54
Diluted:				
Weighted average common shares	12,300,542	12,245,395	12,292,149	12,239,684
Incremental shares	<u>669,394</u>	<u>550,527</u>	<u>629,446</u>	<u>528,847</u>
Assumed average common shares outstanding	12,969,936	12,795,922	12,921,595	12,768,531
Net income	<u>\$ 9,271,000</u>	<u>\$ 7,967,000</u>	<u>\$25,054,000</u>	<u>\$18,789,000</u>
Earnings per common share, diluted	\$ .71	\$ .62	\$ 1.94	\$ 1.47

### Note 8 - Stock Option Plans

Our shareholders approved the 2005 Stock Option, Employee Stock Purchase, Physician Stock Purchase and Stock Appreciation Rights Plan (the "Plan") which provides for the grant of stock options to key employees, directors and non-employee consultants. Under the Plan, the Compensation Committee of the Board of Directors ("the Committee") has the authority to select the participants to be granted options; to

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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 100% of 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 100% of the fair market value of the shares of common stock on the date granted unless so determined by the Committee.

Under the Plan, options issued to non-employee directors are granted automatically on the date of our annual shareholder meeting, vest immediately upon grant and have a maximum five year term. Options issued to employees in 2000 vest over a six year period and have a maximum six year term. Options issued to employees in 2004 vest over a five year period and have a maximum five year term.

The fair value of each option award is estimated on the grant date, using the Black-Scholes option valuation model with the weighted average assumptions indicated in the following table. Generally, awards are subject to cliff vesting. Each grant is valued as a single award with an expected term based upon expected participants and termination behavior. Compensation cost is recognized ratably over the requisite service period. The straight-line attribution method requires that compensation expense is recognized at least equal to the portion of the grant-date fair value that is vested at that date. The expected volatility is derived using daily historical data for periods immediately preceding the date of grant. The risk-free interest rate is the approximate yield on the United States Treasury Strips having a life equal to the expected option life on the date of grant. The expected life is an estimate of the number of years an option will be held before it is exercised.

	Nine Months Ended	
	<u>September 30</u>	
	<u>2006</u>	<u>2005</u>
Risk-free interest rate	4.77%	3.81%
Expected volatility	27.2%	29.3%
Expected life, in years	2.6 years	5 years
Expected dividend yield	1.98%	2.79%
Expected forfeiture rate	1.48%	0.00%

Information regarding stock option activity for the nine months ended September 30, 2006 is summarized below:

	Number of <u>Shares</u>	Weighted Average <u>Exercise Price</u>	Weighted Average Remaining <u>Contractual life (Years)</u>	Aggregate Intrinsic <u>Value</u>
<i>(dollars in thousands)</i>				
Options outstanding at December 31, 2005	1,431,000	21.72		
Options granted	122,394	42.33		
Options forfeited	(667)	37.00		
Options exercised	<u>(35,000)</u>	22.66		
Options outstanding at September 30, 2006	1,517,727	\$23.36	2.6	\$34,147
Options exercisable and vested Sept. 30, 2006	265,000	\$33.07	3.4	\$ 4,300

Included in the above tables, our employee stock purchase plan ("ESPP") allows employees to purchase shares of NHC common stock through payroll deductions. The ESPP allows employees to terminate participation at any time.

We have reserved 1,100,106 shares of common stock for issuance as new shares under the Plan.

The weighted average fair values of options granted during the nine months ended September 30, 2006 and September 30, 2005 were \$8.20 (\$1,004,000) and \$7.69 (\$692,000) per share, respectively. The total intrinsic value of stock options exercised during the nine months ended September 30, 2006 was \$1,087,000.

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Effective January 1, 2006, we adopted Statement of Financial Accounting Standards No. 123(R), "Share-Based Payment" ("SFAS 123(R)"), using the modified prospective application transition method. Under this method, compensation cost is recognized, beginning January 1, 2006, based on the requirements of SFAS 123(R) for all share-based payments granted after the effective date, and based on Statement of Financial Accounting Standards No. 123, "Accounting for Stock-Based Compensation" ("SFAS 123"), for all awards granted to employees prior to January 1, 2006 that remain unvested on the effective date. Prior to January 1, 2006, we applied Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees" ("APB 25") and related interpretations in accounting for our employee stock benefit plans. Accordingly, no compensation cost was recognized for stock options granted under the plans because the exercise prices for options granted were equal to the quoted market prices on the option grant dates and all option grants were to employees or directors. Results for prior periods have not been restated.

As a result of adopting SFAS 123(R), income before taxes for the quarter and nine months ended September 30, 2006 was \$373,000 and \$1,985,000, respectively, lower than if we had continued to account for share-based compensation under APB 25. SFAS 123(R) requires that the benefits of tax deductions in excess of amounts recognized as compensation cost be reported as a financing cash flow, rather than an operating cash flow, as required under prior accounting guidance. Tax deductions in excess of amounts recognized as compensation costs totaled \$99,000 in the third quarter of 2006 (\$131,000 in the first quarter and zero in the second quarter) and were reported as financing cash flows for the three months and nine months ended September 30, 2006 and in operating cash flows in the prior year amounts of zero and \$207,000 for the quarter and nine months ended September 30, 2005, respectively. No share base compensation cost was capitalized during the periods presented. The total compensation cost related to non-vested awards not yet recognized is \$4,300,000 and the weighted average period over which it is to be recognized is 3.4 years.

For periods prior to adoption of SFAS 123(R), SFAS 123 required us to determine and disclose pro forma net income and earnings per share as if compensation cost for our employee stock option and stock purchase plans had been determined based upon fair values at the grant dates. These pro forma amounts for the three months and nine months ended September 30, 2005 are as follows:

	Three Months Ended <u>Sept. 30, 2005</u>	Nine Months Ended <u>Sept. 30, 2005</u>
<i>(dollars in thousands, except per share amounts)</i>		
Net income - as reported	\$7,967	\$18,789
Less compensation cost that would be recognized under fair value method	<u>205</u>	<u>1,030</u>
Net income - pro forma	7,762	17,759
Net earnings per share - as reported		
Basic	\$.65	\$ 1.54
Diluted	\$.62	\$ 1.47
Net earnings per share - pro forma		
Basic	\$.63	\$ 1.45
Diluted	\$.61	\$ 1.39

### **Note 9 - Purchase of Health Care Center**

In March 2006, we purchased for \$5,400,000 a 200-bed long-term health care center located in Town and Country, Missouri. We had managed the center since 2001.

### **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 long-term health care services. We operate or manage 74 long-term health care centers with 9,185 beds in 10 states and provide other services in two additional states. These operations are provided by

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separately funded and maintained subsidiaries. We provide long-term health care services to patients in a variety of settings including long-term nursing centers, managed care specialty units, sub-acute care units, Alzheimer's care units, homecare programs, assisted living centers and independent living centers. In addition, we provide management and accounting services to owners of long-term health care centers and advisory services to National Health Realty, Inc., ("NHR") and prior to November 1, 2004 to National Health Investors, Inc. ("NHI").

### 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. Because of changes in government reimbursement methodology, revenues from Medicare have increased by approximately 6% through September 30, 2006 compared to the prior year, and are expected to increase by 6% for the entire year. Medicaid revenues are remaining relatively flat compared to the prior year. Inflationary increases in our costs may offset much of the increases in our patient revenues.

*Development and Growth* - During the third quarter of 2005, we began construction of a 30 bed addition to an existing long-term care facility located in Farragut, Tennessee and a 60 bed addition to an existing long-term care facility located in Mauldin, South Carolina. During the first quarter of 2006, we started construction on 60 bed additions to existing long-term care facilities located in Garden City and Columbia, South Carolina. All four of these additions are to facilities that we lease from NHR. The additions at Farragut and Mauldin were completed in the third quarter of 2006 at a cost of approximately \$9,511,000. We estimate that the costs of the additions at Garden City and Columbia, South Carolina will be approximately \$10,976,000 and we have incurred accumulated costs of approximately \$4,602,000 at September 30, 2006. In addition, we completed a renovation project in March 2006 at a facility we lease from NHI located in Lewisburg, Tennessee. The cost of the renovation was approximately \$1,560,000.

As such time as our lease with NHR is terminated for any reason, NHR is contractually committed to purchase from us at fair market value building additions constructed by us at centers owned by NHR. Our lease with NHR currently expires on December 31, 2017, with an option to extend the lease for an additional ten years at fair market value. The fair market value of the building additions at the time of the lease termination shall be calculated as the lesser of (1) the appraised value of the addition or (2) the construction cost incurred by us plus 50% of any appraised value increase over cost. In addition, we agreed, at NHR's request, to finance NHR's purchase of the addition with a floating rate, interest only note at the prime rate of interest for a period of up to two years.

In March, 2006, we purchased for \$5,400,000 a 200 bed long-term care facility located in Town and Country Missouri. We had managed the center since 2001.

In 2006 we are continuing to develop an active hospice program in selected areas through our partnership with Caris Healthcare and are also exploring opportunities to expand our home health care services. Also during 2006, 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.

*NHI Advisory Management Changes* - On March 13, 2006, we reached an agreement with NHI to end the use of NHC's senior officers as advisors to NHI, to be effective on or about December 31, 2006. NHC's Board believes it to be in the best interest of NHC to accentuate its independence from NHI, its largest landlord. It is expected that the income from NHC's advisory service fees which totaled \$984,000 in the nine months ended September 30, 2006 will be discontinued at year end.

*Accrued Risk Reserves* - Our accrued professional liability reserves, workers' compensation reserves and health insurance reserves totaled \$76,886,000 at September 30, 2006 and are a primary area of management focus. We have set aside restricted cash and marketable securities to fully fund our professional liability and workers' compensation liabilities. As to the tragic fire on September 25, 2003 at the Nashville skilled nursing subsidiary, we have settled 30 of the 32 lawsuits filed against the company. On October 20, 2006, a ruling was made in the Davidson County, Tennessee Circuit Court that the plaintiffs in the two remaining lawsuits may seek a punitive damage claim. We will continue to vigorously defend against the allegations in the lawsuits while seeking settlement and final resolution with the families.

As to the risks of fire, we have installed fire sprinklers in all of our owned and leased long-term care centers that were not already so equipped. In addition, we have implemented a comprehensive fire safety training program at all of our centers and reviewed and modified, where considered necessary, our priority safety procedures.

As to exposure for professional liability claims, we have developed for our centers performance certification criteria to measure and bring focus to the patient care issues most likely to produce harm to our patients and 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. Furthermore, we are continuing efforts to identify and restructure the ownership or management of our higher risk operations and locations to eliminate NHC liability exposure.

As to workers' compensation claims, we have implemented safety awareness and award programs at all of our locations. In addition, since August 2004, we have engaged a loss control coordinator to work closely with the locations to recognize and eliminate factors contributing to

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workers' compensation losses. As to health insurance claims, in 2005 we changed our health plan network provider to obtain better discounts, and we continue to evaluate our health plan design to identify opportunities for improvements and cost savings.

### Application of Critical Accounting Policies

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 cause our reported net income to vary significantly from period to period.

Our critical accounting policies that are both important to the portrayal of our financial condition and results and require our most difficult, subjective or complex judgments are as follows:

*Revenue Recognition - Third Party Payors* - Over the past few years, approximately 60 to 66% of our net 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. In our opinion, adequate provision has been made for any adjustments that may result from these reviews. Any differences between our estimates of settlements and final determinations are reflected in operations in the year finalized.

*Revenue Recognition - Private Pay* - For private pay patients in skilled nursing or assisted living facilities, we bill room and board in advance for the current month with payment being due upon receipt of the statement 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. All billings are recognized as revenue when the services are performed.

*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 a significant portion of our workers' compensation and professional and general liability claims is to use an actuary to support the estimates recorded for incurred but unreported 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 a dramatic 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, 2006, we and/or our managed centers are defendants in 67 such claims inclusive of years 1995 through 2006. It remains possible that these pending matters plus potential unasserted claims could exceed our reserves, which would have a material adverse effect on our 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 provider locations owned, leased or managed by us. The coverages include both primary policies and umbrella policies.

For 2002-2006, we maintain both primary and excess coverage through our own insurance subsidiary. In all years, settlements, if any, in excess of available insurance policy limits and our own reserves would be expensed by us. *Revenue Recognition - 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% of net revenues for our management services and a predetermined fixed rate per bed for the accounting and financial services. Generally 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, there are certain of the third parties with which we have contracted to provide services and which we have determined, based on insufficient historical collections and the lack of expected future collections, that the service revenue realization is uncertain and our policy is to recognize income only in the period in which the amounts are collected. It is possible that future events could cause us to make significant adjustments or revisions to these estimates and cause our reported net income to vary significantly from period to period. Certain of our accounts receivable from private paying patients and certain of our notes receivable are subject to credit losses. We have attempted to reserve for expected accounts receivable credit losses based on our past experience with similar accounts receivable and believe our reserves to be adequate.

We continually monitor and evaluate the carrying amount of our notes receivable in accordance with Statement of Financial Accounting Standards No. 114, "Accounting by Creditors for Impairment of a Loan - An Amendment of FASB Statements No. 5 and 15." It is possible, however, that the accuracy of our estimation process could be materially impacted as the composition of the receivables changes over time. We continually review and refine our estimation process to make it as reactive to these changes as possible. However, we cannot guarantee that we will be able to accurately estimate credit losses on these balances. It is possible that future events could cause us to make significant adjustments or revisions to these estimates and cause our reported net income to vary significantly from period to period.

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*Potential Recognition of Deferred Income* - During 1988, we sold the assets of eight long-term health care centers to National Health Corporation ("National"), our administrative general partner at the time of the sale. The resulting profit of \$15,745,000 was deferred and will be amortized into income beginning with the collection of the note receivable (up to \$12,000,000) with the balance (\$3,745,000) of the profit being amortized into income on a straight-line basis over the management contract period. \$10,000,000 of the previously deferred income will be recognized as income at the time of and in proportion to the collection of the associated \$10,000,000 note. Additional deferred income of \$2,000,000 will be reported when the company no longer has an obligation to advance the \$2,000,000 working capital loan. The collection (or alternatively, the offset against certain payables to National) of up to \$12,000,000 of notes receivable would result in the immediate recognition of up to \$12,000,000 of pretax net income. Currently, the notes are due December 31, 2007.

*Guarantees* - We guarantee the debt of managed and other long-term health care centers (\$5,214,000) and the debt of National and the ESOP (\$5,636,000). We recorded a liability in the amount of \$1,044,000 related to our guarantee of \$1,108,000 of debt of six long-term health care centers in Florida. We recorded this liability based upon our estimate of the value of the underlying collateral of the loans. It is possible that future events could cause us to make significant adjustments to our estimates and liability under these guarantees and cause our reported net income to vary significantly from period to period.

*Tax Contingencies* - NHC continually evaluates for tax related contingencies. Contingencies 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 adequate provisions for tax contingencies. 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.

The above listing is not intended to be a comprehensive list of all of our accounting policies. In many cases, the accounting treatment of a particular transaction is specifically dictated by generally accepted accounting principles, with no 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 consolidated financial statements and notes thereto which contain accounting policies and other disclosures required by generally accepted accounting principles.

### Government Program Financial Changes

Cost containment will continue to be a priority for Federal and State governments for health care services, including the types of services we provide.

#### *Medicare--*

Including inflation, total Medicare payments to all providers in FY 2006 as projected by CMS will be the same as total payments made to all providers in FY 2005. However, the final rule has caused a redistribution of payments among providers. This is accomplished by refinements expanding the Resource Utilization Groups (RUGs) from 44 RUG groups to 53 RUG groups and by eliminating temporary rate add-ons. The elimination of temporary add-ons has always been correlated to the long awaited RUG refinement. RUG refinement increases the case mix weight that applies to both nursing and non-ancillary therapy ancillary costs. This is a permanent change in the PPS methodology. Including the 3.1% annual inflation update factor, under RUG refinement our Medicare payment rates have increased by approximately 6.0% or \$5,100,000 on a same facility basis in the nine months ended September 30, 2006 compared to the same period in 2005.

The Deficit Reduction Act (DRA) of 2005 mandates the reduction of Medicare bad debt payments, which payments are included in patient revenues, to skilled nursing facilities. The act excludes dual eligibles, those eligible for Medicare and Medicaid, from the reduction. The reduction is effective for cost reports ending after October 1, 2005. Medicare bad debts for non-dual eligibles will be limited to 70% reimbursement, a 30% reduction. The effect is expected to be less than \$150,000 for FY 2006.

The Deficit Reduction Act (DRA) of 2005 freezes the home health payment rate for 2006. HHAs serving rural beneficiaries receive a one-year, five percent add-on payment under the legislation. The rural add-on payment provides for a 2.5% increase in total payments for our homecare operations that is expected to total approximately \$1.0 million in FY 2006 due to a significant number our homecares serving rural counties.

#### *Medicaid--*

Tennessee Medicaid rate increases were delayed in 2005 due to submission of a new plan to CMS. The plan substitutes a new funding methodology called Certified Patient Expenditures (CPE) for inter-governmental transfers (IGT). In effect, our rates in Tennessee were frozen since July 2005. In March 2006, we were notified that CMS had approved the new state plan. This annual update is effective October 1, 2005 instead of July 1, 2005 as anticipated. The state indicated that funds were not available to reimburse facilities for the first quarter of the state's

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fiscal year and keep the 65<sup>th</sup> percentile rate methodology intact. On August 16, 2006, rate increases were retroactively issued effective July 1, 2006. These increases amounted to \$623,000 for the quarter ended September 30, 2006.

South Carolina Medicaid annual per diem rate increases resulted in additional revenues of approximately \$1,662,000 for the nine months ended September 30, 2006.

### *Proposed Reduction in Provider Taxes--*

The President's FY 2007 Budget includes a proposal to decrease states' provider taxes from 6% to 3%. This percentage decrease, if implemented, would reduce the amount of Medicaid funding available to states to pay for long-term care services. It is reported that this provider tax reduction, as proposed, would save approximately \$2.1 billion overall. Although the House and Senate budgets do not include this proposed reduction, the Centers for Medicare and Medicaid Services could act administratively to reduce the provider tax from 6% to 3% at any time. We believe that such a reduction would have a material adverse effect on our operating results.

### Results of Operations

#### *Three Months Ended September 30, 2006 Compared to Three Months Ended September 30, 2005.*

Results for the three month period ended September 30, 2006 include a 4.4% increase in net revenues and a 16.4% increase in net income compared to the same period in 2005.

Net patient revenues increased \$9,111,000 or 7.6% compared to the same period last year. Medicaid rate changes that became effective October 1, 2005 increased our revenues for the 2006 third quarter by approximately \$1,154,000. In addition to the 2005 increases, effective July 1, 2006, the Tennessee Medicaid rate was increased which increased our third quarter revenue by approximately \$623,000. The acquisition of our 200 bed long-term care facility located in Town and Country, Missouri added approximately \$2,111,000 to net patient revenues.

The total census at owned and leased centers for the quarter averaged 93.7% compared to an average of 94.1% for the same quarter a year ago.

Other revenues decreased \$3,066,000 or 16.9% in 2006 to \$15,079,000 from \$18,145,000 in 2005. The prior year quarter included approximately \$4,500,000 of management fees that previously had been doubtful of collection. Decreases in other revenues were offset in part due to the recognition of our equity in the earnings of an unconsolidated investment (Caris HealthCare L.P.) of approximately \$824,000 during the current period (zero in 2005).

Total costs and expenses for the 2006 third quarter increased \$3,739,000 or 3.0% to \$128,465,000 from \$124,726,000. Salaries, wages and benefits, the largest operating costs of this service company, increased \$725,000 or 1.0% to \$72,798,000 from \$72,073,000. Other operating expenses increased \$3,577,000 or 9.4% to \$41,660,000 for the 2006 period compared to \$38,083,000 in the 2005 period. Rent expense decreased \$246,000 to \$10,178,000 compared to \$10,424,000 in the 2005 period. Depreciation and amortization decreased \$171,000 or 4.5% to \$3,588,000 from \$3,759,000. Interest costs decreased \$146,000 to \$241,000.

Increases in salaries, wages and benefits compared to the quarter last year are due to inflationary wage increases and share compensation costs. Share compensation costs totaled \$373,000 in the third quarter of 2006 and are being expensed by us beginning on January 1, 2006 due to the adoption of SFAS 123(R), Share-Based Payment. These comparative costs increases were offset in part by approximately \$4,268,000 in decreased health insurance and workers compensation claims accrued. Increases in other operating costs are due to inflationary increases and increases in accruals for professional liability claims of \$1,996,000. These increases were offset in part due to decreases in workers compensation (\$226,000). In addition, salaries, wages and benefits and other operating expenses increased by \$1,198,000 and \$1,012,000 due to the acquisition of our 200 long-term care beds facility in March 2006.

#### *Nine Months Ended September 30, 2006 Compared to Nine Months Ended September 30, 2005.*

Results for the nine month period ended September 30, 2006 include a 4.6% increase in net revenues compared to the same period in 2005. Net income increased 10.0% after excluding the consideration of the after tax effect of the recovery of a note receivable previously written off. Net patient revenues increased \$21,310,000 or 6.0% compared to the same period last year. Medicaid rate changes that became effective October 1, 2005 increased our revenues for the 2006 period by approximately \$4,085,000. The acquisition of our 200 bed long-term care facility located in Town and Country, Missouri added approximately \$4,925,000 to net patient revenues.

The total census at owned and leased centers for the nine months averaged 93.9% which is unchanged from the same period a year ago.

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Other revenues decreased \$2,690,000 or 5.6% in 2006 to \$45,409,000 from \$48,099,000 in 2005. The decrease is primarily due to decreased collections (compared to the prior year) of approximately \$5,208,000 in management and accounting service fees and \$3,507,000 in insurance service revenues. The prior year nine month period included approximately \$4,500,000 of management fees that previously had been doubtful of collection. Insurance services revenues decreased due to decreased premiums for workers' compensation from our wholly-owned insurance subsidiary, partially offset by increased premiums for health insurance. As described in our critical accounting policies, revenues from accounting services fluctuate from period to period because collections for some customers are not certain of receipt. In the 2005 nine month period, we recognized \$4,500,000 of fees received in 2005 but had been doubtful of collection in prior years. During the nine months ended September 30, 2006, NHC provided management and accounting and financial services for 32 facilities as compared to 37 facilities during the nine months ended September 30, 2005.

Decreases in other revenues were offset in part due to the recognition of our equity in the earnings of an unconsolidated investment (Caris HealthCare, L.P.) of approximately \$2,892,000. In future quarters, earnings from Caris in 2006 are expected to total between \$500,000 and \$800,000 per quarter. Other revenues also increased due to increases in interest income.

Total costs and expenses for the 2006 nine months increased \$7,500,000 or 2.0% to \$379,646,000 from \$372,146,000. Salaries, wages and benefits, the largest operating costs of this service company, increased \$9,182,000 or 4.3% to \$223,839,000 from \$214,657,000. Other operating expenses increased \$8,217,000 or 7.3% to \$121,075,000 for the 2006 period compared to \$112,858,000 in the 2005 period. Rent expense decreased \$427,000 to \$30,808,000 compared to \$31,235,000 in the 2005 period. Depreciation and amortization decreased \$729,000 or 6.5% to \$10,472,000 from \$11,201,000. Interest costs decreased \$434,000 to \$761,000.

Increases in salaries, wages and benefits compared to the nine months last year are due to inflationary wage increases and share compensation costs. Share compensation costs totaled \$1,985,000 in the 2006 nine month period and are being expensed by us in 2006 due to the adoption of SFAS 123(R), Share-Based Payment. Approximately \$860,000 of the \$1,985,000 cost relates to the grant of stock options to independent directors which vested immediately upon grant and, therefore, will not add any expense in future quarters. These comparative cost increases were offset in part by approximately \$4,339,000 in decreased workers compensation and health insurance claims accrued. Increases in other operating costs are due to inflationary increases offset in part due to decreases in the cost of health insurance (\$1,347,000) and workers compensation (\$851,000). In addition, salaries, wages and benefits and other operating expenses increased by \$2,883,000 and \$2,309,000 due to the acquisition of our 200 long-term care beds facility in March 2006.

Expenses for the nine months ended September 30, 2006 include the recovery of a note receivable (\$7,309,000) from a health care center we manage in Nashville, Tennessee which had been previously written off. Expenses for the nine months ended September 30, 2005 included a loss of \$1,000,000 for the write-off of a note receivable. This note receivable is due from a 120-bed long-term health care center in Missouri that we manage. During the nine months ended September 30, 2005, as a result of increased operating costs and the lack of increase in reimbursement rates, the cash flows of this center declined and the center has not made a principal payment on this note since December 31, 2001. Based on an analysis consistent with the provisions of Statement of Financial Accounting Standards No. 114, "Accounting by Creditors for Impairment of a Loan - an Amendment of FASB Statements No. 5 and 15", we concluded that a write-down of \$1,000,000 was required. We continue to monitor closely our other notes receivable from centers to which we provide management or accounting services.

### Liquidity and Capital Resources

#### *Sources and Uses of Funds*

Our primary sources of cash include revenues from the healthcare and senior living facilities we operate, insurance services, management services and accounting services. Our primary uses of cash include salaries, wages and other operating costs of our home office and the facilities we operate, the cost of additions to and acquisitions of real property, rent expenses, debt service payments (including principal and interest) and dividend distributions. These sources and uses of cash are reflected in our 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):

Three Months		Three Month		Nine Months		Nine Month	
Ended		Change		Ended		Change	
<u>September 30</u>		<u>Change</u>		<u>September 30</u>		<u>Change</u>	
<u>2006</u>	<u>2005</u>	\$	%	<u>2006</u>	<u>2005</u>	\$	%



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Cash and Cash equivalents at								
beginning of period	\$66,716	\$40,764	\$25,952	63.7%	\$60,870	\$40,601	\$20,269	49.9%
Cash provided from operating activities	8,666	11,620	(2,954)	25.4%	35,673	39,138	(3,465)	8.9%
Cash used in investing activities	(22,812)	(5,201)	(17,611)	338.6%	(39,818)	(28,661)	(11,157)	38.9%
Cash provided by (used in) financing activities	<u>(2,293)</u>	<u>(2,068)</u>	<u>(225)</u>	10.8%	<u>(6,448)</u>	<u>(5,963)</u>	<u>(485)</u>	8.1%
Cash and cash equivalents at end of period	\$50,277	\$45,115	\$ 5,162	11.4%	\$50,277	\$45,115	\$ 5,162	11.4%

Net cash provided by operating activities during the first nine months of 2006 totaled \$35,673,000 compared to \$39,138,000 provided in the same period last year. Cash provided by operating activities is composed primarily of net income plus depreciation and increases in accrued liabilities and reserves and deferred income and other non-current liabilities, offset by increases in accounts receivable and decreases in accrued payroll.

Cash flows used in investing activities during the first nine months of 2006 totaled \$39,818,000 compared to \$28,661,000 used in investing activities in the same period in 2005. Cash used for additions to property and equipment totaled \$26,210,000 in 2006 compared to \$11,265,000 in 2005. Construction of one 30 bed and of one 60 bed addition have been completed this year, while construction is ongoing on two additional 60 bed additions. Additions also include the acquisition of one 200 bed center.

Investments in notes receivable were zero in 2006, compared to \$1,205,000 used last year. Collections of notes receivable generated \$1,601,000 in 2006 compared to \$130,000 in 2005. Cash used to purchase marketable securities totaled \$4,123,000 compared to \$2,026,000 of cash used to purchase marketable securities in 2005. Distribution for unconsolidated investments totaled \$151,000 in 2006 compared to \$147,000 in 2005. In 2006, cash in the amount of \$45,490,000 was used to purchase restricted marketable securities and cash was provided in the amount of \$34,253,000 by a decrease in restricted cash. In the prior year, cash flows were decreased \$15,175,000 for increases in restricted cash and cash in the amount of \$733,000 was provided by the sale of restricted marketable securities. Restricted cash is primarily related to professional liability insurance, workers' compensation insurance and health insurance. Restricted marketable securities are related to professional liability insurance, workers' compensation insurance and health insurance.

Cash used in financing activities totaled \$6,448,000 in the nine months ended September 30, 2006 compared to \$5,936 used in financing activities for the same period in 2005. Cash used for payments of debt totaled \$1,618,000 and dividend payments to shareholders totaled \$5,893,000. In the prior year, cash flows used totaled \$1,687,000 for payments on debt and \$4,884,000 for payments of dividends. Tax benefits from exercise of stock options provided cash of \$230,000 in 2006 and zero in 2005.

At September 30, 2006, our ratio of long-term debt to total capitalization (total debt plus deferred income plus shareholders equity) is 4.9%.

Table of Contractual Cash Obligations

Our contractual cash obligations for periods subsequent to September 30, 2006 are as follows:

	Total	Less than 1 Year	2-3 Years	4-5 years	After 5 Years
			<i>(in thousands)</i>		
Long-term debt - principal	\$ 14,411	\$ 2,525	\$11,886	\$ --	\$ --
Long-term debt - interest	1,324	1,048	276	--	--
Guaranteed debt	1,044	--	--	--	1,044
Obligation to complete construction	6,374	6,374	--	--	--
Obligation to purchase senior secured notes from					

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financial institutions	5,636	2,871	2,765	--	--
Operating leases	<u>691,912</u>	<u>48,097</u>	<u>99,320</u>	<u>99,320</u>	<u>445,175</u>
Total Contractual Cash Obligations	\$720,701	\$60,915	\$114,247	\$99,320	\$446,219

The guaranteed debt obligation of \$1,044,000 represents our estimated obligation under a loan guarantee to a long-term health care center. As discussed in the section "Debt Guarantees", the \$5,636,000 obligation represents our estimated obligation related to senior secured notes between National and the National Health Corporation Leveraged Employee Stock Ownership Plan (the "ESOP") and certain lending institutions. In addition to the guaranteed debt obligation shown in the table above, we have guaranteed debt obligations of certain other entities totaling approximately \$5,214,000. These guarantees are not included in the table above because we do not anticipate material obligations under these commitments.

Our current cash on hand, marketable securities, short-term notes receivable, operating cash flows, and as needed, our borrowing capacity are expected to be adequate to meet these contractual obligations and to finance our operating requirements, growth and development plans.

We started paying quarterly dividends in the second quarter of 2004 and anticipate the continuation of dividend payments as approved quarterly by the Board of Directors.

### Guarantees and Contingencies

#### *Debt Guarantees-*

In addition to our primary debt obligations, which are included in our consolidated financial statements, we have guaranteed the debt obligations of certain other entities. Those guarantees, which are not included as debt obligations in our consolidated financial statements, total \$10,850,000 at September 30, 2006 and include \$5,214,000 of debt of managed and other long-term health care centers and \$5,636,000 of debt of National Health Corporation ("National") and the National Health Corporation Leveraged Employee Stock Ownership Plan (the "ESOP").

The \$5,214,000 of guarantees of debt of managed and other long-term health care centers relates to first mortgage debt obligations of three long-term health care centers to which we provide management or accounting services. We have agreed to guarantee these obligations in order to obtain management or accounting services agreements. For this service, we charge an annual guarantee fee of 1.0% to 2% of the outstanding principal balance guaranteed, which fee is in addition to our management or accounting services fee. All of this guaranteed indebtedness is secured by first mortgages, pledges of personal property, accounts receivable, marketable securities and, in certain instances, the personal guarantees of the owners of the facilities.

The \$5,636,000 of guarantees of debt of National and the ESOP relates to senior secured notes held by financial institutions. The total outstanding balance of National and the ESOP's obligations under these senior secured notes is \$9,090,000. Of this obligation, \$3,454,000 has been included in our debt obligations because we are a direct obligor on this indebtedness. The remaining \$5,636,000, which is not included in our debt obligations because we are not a direct obligor, is due from NHI to National and the ESOP. Additionally, under the amended terms (dated March 31, 2005) of these note agreements, the right of the lending institutions to require NHC to purchase the notes at par value under a guaranty and contingent purchase agreement has been removed.

As of September 30, 2006, our maximum potential loss related to the guarantees is \$10,850,000 which is the outstanding balance of the guaranteed debt obligations. We have accrued approximately \$1,044,000 representing the estimated fair value of our guarantees, which is included in other non-current liabilities in the consolidated balance sheets.

### Debt Cross Defaults

Through a guarantee agreement, our \$3,454,000 senior secured notes and our \$5,636,000 guarantee described above have cross-default provisions with other debt of National and the ESOP. We currently believe that National and the ESOP are in compliance with the terms of their debt agreements.

### New Accounting Pronouncements

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In February 2006, the FASB issued FAS No. 155, "Accounting for Certain Hybrid Financial Instruments - an amendment to FASB Statements No. 133 and 140" (FAS 155). FAS 155 simplifies the accounting for certain hybrid financial instruments containing embedded derivatives. FAS 155 allows fair value measurement for any hybrid financial instrument that contains an embedded derivative that otherwise would require bifurcation under FAS 133. In addition, it amends FAS 140 to eliminate the prohibition on a qualifying special-purpose entity from holding a derivative financial instrument that pertains to a beneficial interest other than another derivative financial instrument. The Company will adopt the provisions of FAS 155 beginning in fiscal 2007. The implementation of FAS 155 is not expected to have a material impact on the Company's consolidated financial statements.

In March 2006, the FASB issued SFAS No. 156, "Accounting for Servicing of Financial Assets - an amendment of FASB Statement No. 140." This Statement amends FASB Statement No. 140, "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities," with respect to the accounting for separately recognized servicing assets and servicing liabilities. This Statement clarifies when servicing rights should be separately accounted for, requires companies to account for separately recognized servicing rights initially at fair value, and gives companies the option of subsequently accounting for those servicing rights at either fair value or under the amortization method. SFAS 156 is effective for the Company beginning January 1, 2007. The implementation of FAS 156 is not expected to have a material impact on the Company's consolidated financial statements.

In July 2006, the FASB issued Interpretation No. 48 ("FIN 48"), "Accounting for Uncertainty in Income Taxes - An Interpretation of FASB Statement No. 109." FIN 48 prescribes a recognition threshold and measurement attribute for how a company should recognize, measure, present, and disclose in its financial statements uncertain tax positions that the company has taken or expects to take on a tax return. FIN 48 will require that the financial statements reflect expected future tax consequences of such positions presuming the taxing authorities' full knowledge of the position and all relevant facts, but without considering time values. FIN 48 is effective for annual periods beginning after December 15, 2006. We are currently evaluating the impact of adopting FIN 48 on our financial statements. Upon adoption, the cumulative effect of applying the provision of FIN 48 will be reported as an adjustment to the opening balance of retained earnings for that fiscal year.

### 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 5: Legal Proceedings);
- \* the ability of third parties for whom we have guaranteed debt 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 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" as is found in our 2005 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](http://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 Disclosure About Market Risk.**

#### *Interest Rate Risk*

Our cash and cash equivalents consist of highly liquid investments with an original maturity of less than three months. As a result of the short-term nature of our cash instruments, a hypothetical 10% change in interest rates would have no impact on our future earnings and cash flows related to these instruments. Approximately \$19.2 million of our notes receivable bear interest at fixed interest rates. As the interest rates on these notes receivable are fixed, a hypothetical 10% change in interest rates would have no impact on our future earnings and cash flows related to these instruments. Approximately \$1.2 million of our notes receivable bear interest at variable rates (generally at prime plus 2%). Because the interest rates of these instruments are variable, a hypothetical 10% change in interest rates would result in a related increase or decrease in annual interest income of approximately \$12,000. As of September 30, 2006, \$10.3 million of our long-term debt bear interest at fixed interest rates. Because the interest rates of these instruments are fixed, a hypothetical 10% change in interest rates would have no impact on our future earnings and cash flows related to these instruments. The remaining \$4.1 million of our long-term debt and debt serviced by other parties bear interest at variable rates. Because the interest rates of these instruments are variable, a hypothetical 10% change in interest rates would result in a related increase or decrease in annual interest expense of approximately \$24,000.

#### *Equity Price Risk*

We consider our investments in marketable securities as "available for sale" securities and unrealized gains and losses are recorded in stockholders' equity in accordance with Statement of Financial Accounting Standards No. 115. The investments in marketable 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 price. Hypothetically, a 10% change in quoted market prices would result in a related 10% change in the fair value of our investments in marketable securities.

### **Item 4. Controls and Procedures.**

As of September 30, 2006, 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, 2006. There have been no changes in the Company's internal controls over financial reporting during the quarter ended September 30, 2006 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 4 of this Form 10-Q.

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Item 1A. Risk Factors.

During the nine months ended September 30, 2006, 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, 2005.

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

Item 3. Defaults Upon Senior Securities. None

Item 4. Submission of Matters to Vote of Security Holders. None

Item 5. Other Information. None

Item 6. Exhibits.

(a) List of exhibits

<u>Exhibit No.</u>	<u>Description</u>
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 1350 by Chief Executive Officer and Principal Financial Officer

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 9, 2006

/s/ Robert G. Adams

Robert G. Adams

President

Chief Executive Officer

Date November 9, 2006

/s/ Donald K. Daniel

Donald K. Daniel

Senior Vice President and Controller

(Principal Financial Officer)