ENSIGN GROUP, INC
Form 10-Q
May 07, 2008

Table of Contents

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

FORM 10-Q

þ **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934.**

For the quarterly period ended March 31, 2008.

o **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: 001-33757

THE ENSIGN GROUP, INC.
(Exact Name of Registrant as Specified in Its Charter)

Delaware	**33-0861263**
(State or Other Jurisdiction of Incorporation or Organization)	(I.R.S. Employer Identification No.)

27101 Puerta Real, Suite 450
Mission Viejo, CA 92691
(Address of Principal Executive Offices and Zip Code)
(949) 487-9500
(Registrants Telephone Number, Including Area Code)
N/A
(Former Name, Former Address and Former Fiscal Year, If Changed Since Last Report)

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. þ Yes o No

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

Large accelerated filer o	Accelerated filer o	Non-accelerated filer þ (Do not check if a smaller reporting company)	Smaller reporting company o

Indicate by a check mark whether the registrant is a shell company (as defined by Rule 12b-2 or the Exchange Act).
o Yes þ No

As of April 30, 2008, 20,537,280 shares of the registrant s common stock were outstanding.

THE ENSIGN GROUP, INC.
QUARTERLY REPORT ON FORM 10-Q
FOR THE THREE MONTHS ENDED MARCH 31, 2008
TABLE OF CONTENTS

Part I. Financial Information

Part II. Other Information

ii

Table of Contents

Part I. Financial Information

Item 1. ***Financial Statements***

THE ENSIGN GROUP, INC.
CONDENSED CONSOLIDATED BALANCE SHEETS
(In thousands, except per share data)
(Unaudited)

	March 31, 2008	December 31, 2007
Assets		
Current assets:		
Cash and cash equivalents	$ 54,446	$ 51,732
Accounts receivable less allowance for doubtful accounts of $7,856 and $7,454 at March 31, 2008 and December 31, 2007, respectively	50,350	50,615
Prepaid income taxes	1,495	5,835
Prepaid expenses and other current assets	5,423	5,319
Deferred tax asset current	6,558	6,862
Total current assets	118,272	120,363
Property and equipment, net	128,356	124,861
Insurance subsidiary deposits	9,396	8,810
Deferred tax asset	5,396	4,865
Restricted and other assets	3,453	3,273
Intangible assets, net	2,692	2,335
Goodwill	2,882	2,882
Total assets	$ 270,447	$ 267,389
Liabilities and stockholders equity		
Current liabilities:		
Accounts payable	$ 12,199	$ 14,699
Accrued wages and related liabilities	20,026	21,141
Accrued self-insurance liabilities current	7,148	7,424
Other accrued liabilities	10,916	11,137
Current maturities of long-term debt	3,017	2,993
Total current liabilities	53,306	57,394
Long-term debt less current maturities	60,290	60,577
Accrued self-insurance liability	18,381	17,236
Deferred rent and other long-term liabilities	2,462	2,505
Commitments and contingencies (Note 12)		
Stockholders equity:		
Common stock; $0.001 par value; 75,000 shares authorized; 21,217 and 20,535 issued and outstanding at March 31, 2008, respectively, and 21,196 and 20,480 shares issued and outstanding at December 31, 2007, respectively	21	21
Additional paid-in capital	62,766	62,142

Retained earnings		77,632		72,119
Common stock in treasury, at cost, 682 and 716 shares at March 31, 2008 and December 31, 2007, respectively		(4,411)		(4,605)
Total stockholders equity		136,008		129,677
Total liabilities and stockholders equity	$	270,447	$	267,389

See accompanying notes to condensed consolidated financial statements.

1

Table of Contents

THE ENSIGN GROUP, INC.
CONDENSED CONSOLIDATED STATEMENTS OF INCOME
(In thousands, except per share data)
(Unaudited)

	Three Months Ended March 31, 2008	Three Months Ended March 31, 2007
Revenue	$ 113,779	$ 97,978
Expense:		
Cost of services (exclusive of facility rent and depreciation and amortization shown separately below)	91,434	80,847
Facility rent cost of services	3,999	4,155
General and administrative expense	5,092	3,746
Depreciation and amortization	1,990	1,532
Total expenses	102,515	90,280
Income from operations	11,264	7,698
Other income (expense):		
Interest expense	(1,201)	(1,169)
Interest income	483	392
Other expense, net	(718)	(777)
Income before provision for income taxes	10,546	6,921
Provision for income taxes	4,212	2,784
Net income	$ 6,334	$ 4,137
Net income per share:		
Basic	$ 0.31	$ 0.30
Diluted	$ 0.31	$ 0.24
Weighted average common shares outstanding:		
Basic	20,498	13,420
Diluted	20,647	16,904

See accompanying notes to condensed consolidated financial statements.

Table of Contents

THE ENSIGN GROUP, INC.
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(In thousands)
(Unaudited)

	Three Months Ended March 31, 2008	2007
Cash flows from operating activities:		
Net income	$ 6,334	$ 4,137
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	1,993	1,532
Amortization of deferred financing fees	7	
Deferred income taxes	(227)	(760)
Provision for doubtful accounts	1,051	1,127
Stock-based compensation	462	249
Excess tax benefit from share based compensation	(106)	
Loss on disposition of property and equipment	152	14
Change in operating assets and liabilities		
Accounts receivable	(786)	(289)
Prepaid income taxes	4,428	
Prepaid expenses and other current assets	(104)	(753)
Insurance subsidiary deposits	(586)	(1,240)
Accounts payable	(2,500)	776
Accrued wages and related liabilities	(1,115)	(3,074)
Other accrued liabilities	(350)	250
Accrued self-insurance	869	2,140
Deferred rent liability	(46)	111
Net cash provided by operating activities	9,476	4,220
Cash flows from investing activities:		
Purchase of property and equipment	(5,578)	(2,796)
Restricted and other assets	(180)	(242)
Cash payment for acquisitions		(9,436)
Net cash used in investing activities	(5,758)	(12,474)
Cash flows from financing activities:		
Proceeds from issuance of debt		11
Payments on long term debt	(263)	(270)
Issuance of treasury stock upon exercise of options	194	
Issuance of common stock upon exercise of options	74	89
Dividends paid	(819)	(657)
Excess tax benefit from share based compensation	106	
Payments of deferred financing costs	(296)	

Net cash used in financing activities	(1,004)	(828)
Net increase (decrease) in cash and cash equivalents	2,174	(9,082)
Cash and cash equivalents beginning of period	51,732	25,491
Cash and cash equivalents end of period	$ 54,446	$ 16,409
Supplemental disclosures of cash flow information:		
Cash paid during the period for:		
Interest	$ 1,239	$ 1,169
Income taxes	$ 106	$ 2,500
Non-cash investing and financing activities:		
Conditional asset retirement obligations under FIN 47	$	$ 48

See accompanying notes to condensed consolidated financial statements

3

Table of Contents

THE ENSIGN GROUP, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Dollars and shares in thousands, except per share data)
(Unaudited)

1. DESCRIPTION OF BUSINESS

The Company The Ensign Group, Inc., through its subsidiaries (collectively, Ensign or the Company), provides skilled nursing and rehabilitative care services through the operation of 61 facilities as of March 31, 2008, located in California, Arizona, Texas, Washington, Utah and Idaho. All of these facilities are skilled nursing facilities, other than three stand-alone assisted living facilities in Arizona and Texas and four campuses that offer both skilled nursing and assisted living services located in California, Arizona and Utah. The Company s facilities, each of which strives to be the facility of choice in the community it serves, provide a broad spectrum of skilled nursing and assisted living services, physical, occupational and speech therapies, and other rehabilitative and healthcare services, for both long-term residents and short-stay rehabilitation patients. The Company s facilities have a collective capacity of over 7,400 skilled nursing, assisted living and independent living beds. As of March 31, 2008, the Company owned 26 of its 61 facilities and operated an additional 35 facilities through long-term lease arrangements, and had options to purchase or purchase agreements for 10 of those 35 facilities.

The Ensign Group, Inc. is a holding company with no direct operating assets, employees or revenue. All of the Company s facilities are operated by separate, wholly-owned, independent subsidiaries, each of which has its own management, employees and assets. One of the Company s wholly-owned subsidiaries, sometimes referred to as the Service Center, provides centralized accounting, payroll, human resources, information technology, legal, risk management and other centralized services to the other operating subsidiaries through contractual relationships with such subsidiaries. The Company also has a wholly-owned captive insurance subsidiary (the Captive) that provides some claims-made coverage to the Company s operating subsidiaries for general and professional liability, as well as coverage for certain workers compensation insurance liabilities.

Like the Company s facilities, the Service Center and the captive insurance subsidiary are operated by separate, wholly-owned, independent subsidiaries that have their own management, employees and assets. References herein to the consolidated Company and its assets and activities, as well as the use of the terms we, us, our and similar ve in this quarterly report is not meant to imply that the Ensign Group, Inc. has direct operating assets, employees or revenue, or that any of the facilities, the Service Center or the captive insurance subsidiary are operated by the same entity.

Other Information The accompanying condensed consolidated financial statements as of March 31, 2008 and for the three month periods ended March 31, 2008 and 2007 (collectively, the Interim Financial Statements), are unaudited. Certain information and footnote disclosures normally included in annual consolidated financial statements have been condensed or omitted, as permitted under applicable rules and regulations. Readers of the Interim Financial Statements should refer to the Company s audited consolidated statements and notes thereto for the year ended December 31, 2007 which are included in the Company s annual report on Form 10-K, File No. 001-33757 (the Annual Report) filed with the Securities and Exchange Commission (the SEC). Management believes that the Interim Financial Statements reflect all adjustments which are of a normal and recurring nature necessary to present fairly the Company s financial position and results of operations in all material respects. The results of operations presented in the Interim Financial Statements are not necessarily representative of operations for the entire year.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation The accompanying condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America. The Company is the sole member or shareholder of various consolidated limited liability companies and corporations; each established to operate various acquired skilled nursing and assisted living facilities. All intercompany transactions and balances have been eliminated in consolidation.

Estimates and Assumptions The preparation of consolidated financial statements in conformity with U.S. generally accepted accounting principles (GAAP) requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the reporting periods. The most significant estimates in the Company s consolidated financial statements relate to revenue, allowance for doubtful accounts, intangible assets and goodwill, impairment of long-lived assets, patient liability, general and professional liability, worker s compensation, and healthcare claims included in accrued self-insurance liabilities, stock-based compensation and income taxes. Actual results could differ from those estimates.

Business Segments The Company has a single reporting segment long-term care services, which includes the operation of skilled nursing and assisted living facilities, and related ancillary services at the facilities. The Company s single reporting segment is made up of several individual operating segments grouped together principally based on their geographical locations within the United States. Based on the similar economic and other characteristics of each of the operating segments, management believes the Company meets the criteria for aggregating its operations into a single reporting segment.

Fair Value of Financial Instruments The Company s financial instruments consist principally of cash and cash equivalents, accounts receivable, insurance subsidiary deposits, accounts payable and borrowings. The Company believes all of the financial instruments recorded values approximate fair values because of their nature and respective durations. The Company s fixed-rate debt instruments do not actively trade in an established market. The fair values of this debt are estimated by discounting the principal and interest payments at rates available to the Company for debt with similar terms and maturities.

Revenue Recognition The Company follows the provisions of Staff Accounting Bulletin (SAB) No. 104, *Revenue Recognition in Financial Statements* (SAB 104), for revenue recognition. Under SAB 104, four conditions must be met before revenue can be recognized: (i) there is persuasive evidence that an arrangement exists; (ii) delivery has occurred or service has been rendered; (iii) the price is fixed or determinable; and (iv) collection is reasonably assured. The Company s revenue is derived primarily from providing long-term healthcare services to residents and is recognized on the date services are provided at amounts billable to individual residents. For residents under reimbursement arrangements with third-party payors, including Medicaid, Medicare and private insurers, revenue is recorded based on contractually agreed-upon amounts on a per patient, daily basis.

Revenue from the Medicare and Medicaid programs accounted for approximately 75% and 74% of the Company s revenue for the three months ended March 31, 2008 and 2007, respectively. The Company records revenue from these governmental and managed care programs as services are performed at their expected net realizable amounts under these programs. The Company s revenue from governmental and managed care programs is subject to audit and retroactive adjustment by governmental and third-party agencies. Consistent with healthcare industry accounting practices, any changes to these governmental revenue estimates are recorded in the period the change or adjustment becomes known based on final settlements. The Company recorded retroactive adjustments that increased revenue by $325 and $709 for the three months ended March 31, 2008 and 2007, respectively. The Company records revenue from private pay patients as services are performed.

Accounts Receivable Accounts receivable consist primarily of amounts due from Medicare and Medicaid programs, other government programs, managed care health plans and private payor sources. Estimated provisions for doubtful accounts are recorded to the extent it is probable that a portion or all of a particular account will not be collected.

In evaluating the collectibility of accounts receivable, the Company considers a number of factors, including the age of the accounts, changes in collection patterns, the composition of patient accounts by payor type and the status of ongoing disputes with third-party payors. The percentages applied to the aged receivable balances are based on the Company s historical experience and time limits, if any, for managed care, Medicare and Medicaid. The Company periodically refines its procedures for estimating the allowance for doubtful accounts based on experience with the estimation process and changes in circumstances.

Impairment of Long-Lived Assets The Company reviews the carrying value of long-lived assets that are held and used in the Company s operations for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of these assets is determined based upon expected undiscounted future net cash flows from the operations to which the assets relate, utilizing management s best estimate, appropriate assumptions, and projections at the time. If the carrying value is determined to be unrecoverable from future operating cash flows, the asset is deemed impaired and an impairment loss would be recognized to the extent the carrying value exceeded the estimated fair value of the asset. The Company estimates the fair value of assets based on the estimated future discounted cash flows of the asset. The Company s management has evaluated its long-lived assets and has not identified any impairment as of March 31, 2008 and December 31, 2007.

Intangible Assets and Goodwill Intangible assets consist primarily of deferred financing costs, lease acquisition costs and trade names. Deferred financing costs are amortized over the term of the related debt, ranging from five to

26 years. Lease acquisition costs are amortized over the life of the lease of the facility, ranging from ten to 20 years. Trade names are amortized over 30 years.

Goodwill is accounted for under Statement of Financial Accounting Standards (SFAS) No. 141, *Business Combinations* (SFAS 141) and represents the excess of the purchase price over the fair value of identifiable net assets acquired in business combinations. In accordance with SFAS No. 142, *Goodwill and Other Intangible Assets* (SFAS 142), goodwill is subject to annual testing for impairment. In addition, goodwill is tested for impairment if events occur or circumstances change that would reduce the fair value of a reporting unit below its carrying amount. The Company defines reporting units as the individual facilities. The Company performs its annual test for impairment during the fourth quarter of each year. The Company did not record any impairment charges during the three months ended March 31, 2008 or in 2007.

Self-Insurance The Company is partially self-insured for general and professional liability up to a base amount per claim (the self-insured retention) with an aggregate, one time deductible above this limit. Losses beyond these amounts are insured through third-party policies with coverage limits per occurrence, per location and on an aggregate basis for the Company. For claims made in the first quarter of 2008, the self-insured retention was $350 per claim with a $900 deductible. The third-party coverage above these limits for all periods presented was $1,000 per occurrence, $3,000 per facility with a $6,000 blanket aggregate.

The self-insured retention and deductible limits for general and professional liability and worker s compensation are self-insured through the Captive, the related assets and liabilities of which are included in the accompanying consolidated financial statements. The Captive is subject to certain statutory requirements as an insurance provider. These requirements include, but are not limited to, maintaining statutory capital. The Company s policy is to accrue amounts equal to the estimated costs to settle open claims of insureds, as well as an estimate of the cost of insured claims that have been incurred but not reported. The Company develops information about the size of the ultimate claims based on historical experience, current industry information and actuarial analysis, and evaluates the estimates for claim loss exposure on a quarterly basis. Accrued general liability and professional malpractice liabilities recorded on an undiscounted basis in the accompanying condensed consolidated balance sheets were $19,215 and $18,596 as of March 31, 2008 and December 31, 2007, respectively.

The Company s operating subsidiaries are self-insured for workers compensation liability in California. To protect itself against loss exposure in California, with this policy, the Company has purchased individual stop-loss insurance coverage that insures individual claims that exceed $600 for each claim. In Texas, the operating subsidiaries have elected non-subscriber status for workers compensation claims. The Company s operating subsidiaries in other states have third party guaranteed cost coverage. In California and Texas, the Company accrues amounts equal to the estimated costs to settle open claims, as well as an estimate of the cost of claims that have been incurred but not reported. The Company uses actuarial valuations to estimate the liability based on historical experience and industry information. Accrued workers compensation liabilities are recorded on an undiscounted basis in the accompanying condensed consolidated balance sheets and were $4,343 and $4,145 as of March 31, 2008 and December 31, 2007, respectively.

During 2003 and 2004, the Company s California and Arizona operating subsidiaries were insured for workers compensation liability by a third-party carrier under a policy where the retrospective premium was adjusted annually based on incurred developed losses and allocated expenses. Based on a comparison of the computed retrospective premium to the actual payments funded, amounts will be due to the insurer or insured. The funded accrual in excess of the estimated liabilities is included in prepaid expenses and other current assets in the accompanying condensed consolidated balance sheets and was $446 and $431 as of March 31, 2008 and December 31, 2007, respectively.

Effective May 1, 2006, the Company began to provide self-insured medical (including prescription drugs) and dental healthcare benefits to the majority of its employees. Prior to this, the Company had multiple third-party HMO and PPO plans, of which certain HMO plans are still active. The Company is not aware of any run-off claim liabilities from the prior plans. The Company is fully liable for all financial and legal aspects of these benefit plans. To protect itself against loss exposure with this policy, the Company has purchased individual stop-loss insurance coverage that insures individual claims that exceed $200 for each covered person which resets every plan year or a maximum of $6,000 per each covered person s lifetime on the PPO plan and unlimited on the HMO plan. The Company has also purchased aggregate stop-loss coverage that reimburses the plan up to $5,000 to the extent that paid claims exceed $7,225. The aforementioned coverage only applies to claims paid during the plan year. The Company s accrued liability under these plans recorded on an undiscounted basis in the accompanying condensed consolidated balance sheets was $1,971 and $1,919 at March 31, 2008 and December 31, 2007, respectively.

The Company believes that adequate provision has been made in the consolidated financial statements for liabilities that may arise out of patient care, workers compensation, healthcare benefits and related services provided to date. The amount of the Company s reserves was determined based on an estimation process that uses information obtained from both company-specific and industry data. This estimation process requires the Company to continuously monitor and evaluate the life cycle of the claims. Using data obtained from this monitoring and the Company s assumptions about emerging trends, the Company, with the assistance of an independent actuary, develops information about the size of ultimate claims based on the Company s historical experience and other available industry information. The most significant assumptions used in the estimation process include determining the trend in costs, the expected cost of claims incurred but not reported and the expected costs to settle or pay damage awards with respect to unpaid claims. It is possible, however, that the actual liabilities may exceed the Company s estimate of loss.

The self-insured liabilities are based upon estimates, and while management believes that the estimates of loss are reasonable, the ultimate liability may be in excess of or less than the recorded amounts. Due to the inherent volatility of actuarially determined loss estimates, it is reasonably possible that the Company could experience changes in estimated losses that could be material to net income. If the Company s actual liability exceeds its estimate of loss, its future earnings and financial condition would be adversely affected.

Income Taxes Income taxes are accounted for in accordance with SFAS No. 109, *Accounting for Income Taxes* (SFAS 109). Under this method, deferred tax assets and liabilities are established for temporary differences between the financial reporting basis and the tax basis of the Company s assets and liabilities at tax rates expected to be in effect when such temporary differences are expected to reverse. The temporary differences are primarily attributable to compensation accruals, straight line rent adjustments and reserves for doubtful accounts and insurance liabilities. When necessary, the Company records a valuation allowance to reduce its net deferred tax assets to the amount that is more likely than not to be realized. In considering the need for a valuation allowance against some portion or all of its deferred tax assets, the Company must make certain estimates and assumptions regarding future taxable income, the feasibility of tax planning strategies and other factors.

Estimates and judgments regarding deferred tax assets and the associated valuation allowance, if any, are based on, among other things, knowledge of operations, markets, historical trends and likely future changes and, when appropriate, the opinions of advisors with knowledge and expertise in certain fields. However, due to the nature of certain assets and liabilities, there are risks and uncertainties associated with some of the Company s estimates and judgments. Actual results could differ from these estimates under different assumptions or conditions. The net deferred tax assets as of March 31, 2008 and December 31, 2007 were $11,954 and $11,727, respectively. The Company expects to fully utilize these deferred tax assets; however, their ultimate realization is dependent upon the amount of future taxable income during the periods in which the temporary differences become deductible.

As of January 1, 2007, the Company adopted Financial Accounting Standards Board (FASB) Interpretation No. 48, *Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109* (FIN 48). FIN 48 requires the Company to maintain a liability for underpayment of income taxes and related interest and penalties, if any, for uncertain income tax positions. In considering the need for and magnitude of a liability for uncertain income tax positions, the Company must make certain estimates and assumptions regarding the amount of income tax benefit that will ultimately be realized. The ultimate resolution of an uncertain tax position may not be known for a number of years, during which time the Company may be required to adjust these reserves, in light of changing facts and circumstances.

The Company used an estimate of its annual income tax rate to recognize a provision for income taxes in financial statements for interim periods. However, changes in facts and circumstances could result in adjustments to the Company s effective tax rate in future quarterly or annual periods.

Stock-Based Compensation As of January 1, 2006, the Company adopted SFAS No. 123(R), *Share-Based Payment* (SFAS 123(R)), which requires the measurement and recognition of compensation expense for all share-based payment awards made to employees and directors including employee stock options based on estimated fair values, ratably over the requisite service period of the award. Net income will be reduced as a result of the recognition of the fair value of all stock options issued on and subsequent to January 1, 2006, the amount of which is contingent upon the number of future options granted and other variables. Prior to the adoption of SFAS 123(R), the Company accounted for stock-based awards to employees and directors using the intrinsic value method in accordance with Accounting Principles Board (APB) Opinion No. 25, *Accounting for Stock Issued to Employees* (APB 25) as allowed under SFAS No. 123, *Accounting for Stock-Based Compensation* (SFAS 123).

The Company adopted SFAS 123(R) using the prospective transition method. The Company s consolidated financial statements as of and for the periods ended March 31, 2008 and 2007 reflect the impact of SFAS 123(R). In accordance with the prospective transition method, the Company s consolidated financial statements for periods prior to January 1, 2006 have not been restated to reflect, and do not include, the impact of SFAS 123(R).

Historically, no compensation expense was recognized by the Company in its financial statements in connection with the awarding of stock option grants to employees provided that, as of the grant date, all terms associated with the award were fixed and the fair value of its stock, as of the grant date, was equal to or less than the amount an employee must pay to acquire the stock. The Company would have recognized compensation expense in situations where the fair value of its common stock on the grant date was greater than the amount an employee must pay to acquire the stock. Stock-based compensation expense recognized in the Company s consolidated statements of income for the three months ended March 31, 2008 does not include compensation expense for share-based payment awards granted prior to, but not yet vested as of January 1, 2006, in accordance with the pro forma provisions of SFAS 123, but does include compensation expense for the share-based payment awards granted subsequent to January 1, 2006 based on the fair value on the grant date estimated in accordance with the provisions of SFAS 123(R). Existing options at January 1, 2006 will continue to be accounted for in accordance with APB 25 unless such options are modified, repurchased or canceled after the effective date of SFAS 123(R).

New Accounting Pronouncements In December 2007, the FASB issued SFAS No. 141(R), *Business Combinations* (SFAS 141(R)), which replaces SFAS 141. The provisions of SFAS 141(R) are similar to those of SFAS 141; however, SFAS 141(R) requires companies to record most identifiable assets, liabilities, noncontrolling interests, and goodwill acquired in a business combination at full fair value. SFAS 141(R) also requires companies to record fair value estimates of contingent consideration and certain other potential liabilities during the original purchase price allocation and to expense acquisition costs as incurred. This statement applies to all business combinations, including combinations by contract alone. Further, under SFAS 141(R), all business combinations will be accounted for by applying the acquisition method. SFAS 141(R) is effective for fiscal years beginning on or after December 15, 2008. Accordingly, any business combinations the Company engages in will be recorded and disclosed according to SFAS 141, *Business Combinations*, until January 1, 2009. The Company expects SFAS No. 141(R) will have an impact on its consolidated financial statements when effective, but the nature and magnitude of the specific effects will depend upon the nature, terms and size of the acquisitions, if any, that the Company consummates after the effective date.

In December 2007, the FASB issued SFAS No. 160, *Noncontrolling Interests in Consolidated Financial Statements* (SFAS 160), which will require noncontrolling interests (previously referred to as minority interests) to be treated as a separate component of equity, not as a liability or other item outside of permanent equity. This Statement applies to the accounting for noncontrolling interests and transactions with non-controlling interest holders in consolidated financial statements. SFAS 160 will be applied prospectively to all noncontrolling interests, including any that arose before the effective date except that comparative period information must be recast to classify noncontrolling interests in equity, attribute net income and other comprehensive income to noncontrolling interests, and provide other disclosures required by Statement 160. SFAS 160 is effective for periods beginning on or after December 15, 2008. The Company is currently evaluating the impact that SFAS 160 will have on its consolidated financial statements.

Adoption of New Accounting Pronouncements In September 2006, the FASB issued SFAS 157, *Fair Value Measurements,* which defines fair value, establishes a framework for measuring fair value in accordance with GAAP, and requires enhanced disclosures about fair value measurements. SFAS 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007. In February 2008 the FASB issued FSP 157-2, *Effective Date of FASB Statement No. 157*, which delays the effective date of SFAS 157 for non-financial assets and liabilities, other than those that are recognized or disclosed at fair value on a recurring basis, to fiscal years beginning after November 15, 2008. The adoption of SFAS 157 related to financial assets and liabilities had no impact on the Company s consolidated financial statements. The Company is currently evaluating the impact, if any, that SFAS 157 may have on its future consolidated financial statements related to non-financial assets and liabilities.

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities Including an amendment of FASB Statement No. 115* (SFAS 159). SFAS 159 permits all entities to choose, at specified election dates, to measure certain financial instruments and other items at fair value (fair value option). A business entity must report unrealized gains and losses on items for which the fair value option has been elected in earnings at each subsequent reporting date. Upfront costs and fees related to items for which the fair value option is elected shall be recognized in earnings as incurred and not deferred. SFAS 159 is effective as of the beginning of an entity s first fiscal year that begins after November 15, 2007. The Company s adoption of SFAS 159 at the beginning of fiscal 2008 had no impact on its consolidated financial position or results of operations.

In June 2007, the FASB ratified EITF Issue No. 06-11, *Accounting for Income Tax Benefits of Dividends on Share-Based Payment Awards* (EITF 06-11). This EITF prescribes that the tax benefit received on dividends associated with non-vested share-based awards that are charged to retained earnings should be recorded in additional paid-in capital and included in the pool of excess tax benefits available to absorb potential future tax deficiencies of share based payment awards. EITF 06-11 is effective for the tax benefits of dividends declared in fiscal years beginning after December 15, 2007. The Company s adoption of EITF 06-11 at the beginning of fiscal 2008 did not have a material impact on its consolidated financial position or results of operations.

Table of Contents

3. COMPUTATION OF NET INCOME PER COMMON SHARE

Basic net income per share is computed by dividing net income attributable to common shares by the weighted average number of outstanding common shares for the period. The computation of diluted net income per share is similar to the computation of basic net income per share except that the denominator is increased to include contingently returnable shares and the number of additional common shares that would have been outstanding if the dilutive potential common shares had been issued. In addition, in computing the dilutive effect of convertible securities, the numerator is adjusted to add back (a) any convertible preferred dividends and (b) the after-tax amount of interest, if any, recognized in the period associated with any convertible debt.

A reconciliation of the numerator and denominator used in the calculation of basic net income per common share follows:

	Three Months Ended March 31,	
	2008	**2007**
Numerator:		
Net income	$ 6,334	$ 4,137
Preferred stock dividends		(110)
Net income available to common stockholders for basic net income per share	$ 6,334	$ 4,027
Denominator:		
Weighted average shares outstanding for basic net income per share(1)	20,498	13,420
Basic net income per common share	$ 0.31	$ 0.30

(1) Basic share amounts are shown net of unvested shares subject to the Company s repurchase right, which total 39 and 285 shares at March 31, 2008 and 2007, respectively.

A reconciliation of the numerator and denominator used in the calculation of diluted net income per common share follows:

	Three Months Ended March 31,	
	2008	**2007**
Numerator:		

Net income	$	6,334	$	4,137
Denominator:				
Weighted average common shares outstanding		20,498		13,420
Plus: incremental shares from assumed conversions(1)		149		3,484
Adjusted weighted average common shares outstanding		20,647		16,904
Diluted net income per common share	$	0.31	$	0.24

(1) Fully diluted share amounts include unvested shares subject to the Company s repurchase right, which total 39 and 285 shares at March 31, 2008 and 2007, respectively. In addition, as of March 31, 2008, the Company had 849 options outstanding which are anti-dilutive and therefore not factored into the weighted average common shares amount above.

Table of Contents

4. REVENUE AND ACCOUNTS RECEIVABLE

Revenue for the three months ended March 31, 2008 and 2007, respectively, is summarized in the following tables:

	Three Months Ended March 31,			
	2008		2007	
	Revenue	% of Revenue	Revenue	% of Revenue
Medicaid	$ 47,526	41.8%	$ 42,641	43.5%
Medicare	37,918	33.3	30,130	30.8
Total Medicaid and Medicare	85,444	75.1	72,771	74.3
Managed care	15,256	13.4	12,705	13.0
Private and other payors	13,079	11.5	12,502	12.7
Revenue	$ 113,779	100.0%	$ 97,978	100.0%

Accounts receivable consisted of the following:

	March 31, 2008	December 31, 2007
Medicaid	$ 21,307	$ 20,842
Managed care	15,224	14,821
Medicare	14,381	14,521
Private and other payors	7,294	7,885
	58,206	58,069
Less allowance for doubtful accounts	(7,856)	(7,454)
Accounts receivable	$ 50,350	$ 50,615

5. PROPERTY AND EQUIPMENT

Property and equipment are initially recorded at their original historical cost. Repairs and maintenance are expensed as incurred. Depreciation is computed using the straight-line method over the estimated useful lives of the depreciable assets (ranging from 3 to 30 years). Leasehold improvements are amortized on a straight-line basis over the shorter of their estimated useful lives or the remaining lease term.

Property and equipment consist of the following:

	March 31, 2008	December 31, 2007
Land	$ 26,296	$ 26,107
Buildings and improvements	76,463	76,262
Equipment	18,659	17,801
Furniture and fixtures	7,067	6,414
Leasehold improvements	11,746	10,771
Construction in progress	6,569	4,050
Less accumulated depreciation	(18,444)	(16,544)

Property and equipment, net	$	128,356	$	124,861

6. INTANGIBLE ASSETS Net

		March 31, 2008			December 31, 2007		
Intangible Assets	Weighted Average Life (Years)	Gross Carrying Amount	Accumulated Amortization	Net	Gross Carrying Amount	Accumulated Amortization	Net
Debt issuance costs	9.3	$ 2,231	$ (730)	$ 1,501	$ 1,808	$ (687)	$ 1,121
Lease acquisition costs	15.5	1,071	(558)	513	1,071	(541)	530
Customer base	0.3	213	(213)		213	(213)	
Tradename	30.0	733	(55)	678	733	(49)	684
Total		$ 4,248	$ (1,556)	$ 2,692	$ 3,825	$ (1,490)	$ 2,335

The Company paid $423 in debt issuance costs in connection with the amendment to the Amended and Restated Loan and Security Agreement, as amended (the Revolver) to increase available borrowings. See additional discussion at Note 10. Amortization expense was $66 and $63 for the three months ended March 31, 2008 and 2007, respectively.

Goodwill

Pursuant to SFAS No. 142, the Company performed its annual goodwill impairment analysis on December 31, 2007 for each reporting unit that constitutes a business for which discrete financial information is produced and reviewed by operating segment management and provides services that are distinct from the other components of the operating segment. The Company determines impairment by comparing the net assets of each reporting unit to their respective fair values. The Company determines the estimated fair value of each reporting unit using a discounted cash flow analysis. In the event a unit s net assets exceed its fair value, an implied fair value of goodwill must be determined by assigning the unit s fair value to each asset and liability of the unit. The excess of the fair value of the reporting unit over the amounts assigned to its assets and liabilities is the implied fair value of goodwill. An impairment loss is measured by the difference between the goodwill carrying value and the implied fair value. The Company recorded no goodwill impairment for the three months ended March 31, 2008 or the year ended December 31, 2007.

7. RESTRICTED AND OTHER ASSETS

Restricted and other assets consist primarily of capital reserves and deposits. Capital reserves are maintained as part of the mortgage agreements of the Company and certain of its landlords with the U.S. Department of Housing and Urban Development. These capital reserves are restricted for capital improvements and repairs to the related facilities. Restricted and other assets consist of the following:

	March 31, 2008	December 31, 2007
Deposits with landlords	$ 1,001	$ 1,001
Capital improvement reserves with landlords and lenders	2,425	2,244
Other	27	28
	$ 3,453	$ 3,273

8. OTHER ACCRUED LIABILITIES

Other accrued liabilities consist of the following:

	March 31, 2008	December 31, 2007
Quality assurance fee	$ 1,891	$ 1,853
Resident refunds payable	1,663	1,767

Deferred resident revenue		1,682		1,745
Cash held in trust for residents		1,012		1,152
Dividends payable		821		819
Property taxes		731		838
Other		3,116		2,963
Other accrued liabilities	$	10,916	$	11,137

Table of Contents

Quality assurance fee represents amounts payable to the State of California in respect of a mandated fee based on resident days. Resident refunds payable includes amounts due to residents for overpayments and duplicate payments. Deferred resident revenue occurs when the Company receives payments in advance of services provided. Cash held in trust for residents reflects monies received from, or on behalf of, residents. Maintaining a trust account for residents is a regulatory requirement and, while the trust assets offset the liability, the Company assumes a fiduciary responsibility for these funds. The cash balance related to this liability is included in other current assets in the accompanying condensed consolidated balance sheets.

9. INCOME TAXES

The provision for income taxes for the three months ended March 31, 2008 and 2007 is summarized as follows:

	Three Months Ended March 31, 2008	Three Months Ended March 31, 2007
Current:		
Federal	$ 3,611	$ 2,814
State	723	706
	4,334	3,520
Deferred:		
Federal	(182)	(515)
State	(44)	(260)
	(226)	(775)
Tax benefit from exercise of stock options	89	
Interest income, gross of related tax effects	(20)	(18)
Interest expense, gross of related tax effects	35	57
Total	$ 4,212	$ 2,784

The Company s deferred tax assets and liabilities as of March 31, 2008 and December 31, 2007 are summarized as follows:

	March 31, 2008	December 31, 2007
Deferred tax assets (liabilities):		
Accrued expenses	$ 9,745	$ 9,243
Allowance for doubtful accounts	3,331	3,161
Tax credits	1,139	1,103
Total deferred tax assets	14,215	13,507
State taxes	(588)	(199)
Depreciation and amortization	(607)	(563)
Prepaid expenses	(1,066)	(1,018)

Total deferred tax liabilities	(2,261)	(1,780)
Net deferred tax assets	$ 11,954	$ 11,727

The Company adopted FIN 48 effective January 1, 2007 and, as of the date of adoption, had a net amount of unrecognized tax detriments of $36, exclusive of accrued interest. This total consisted of $234 of unrecognized tax benefits for permanent differences (as defined by SFAS 109) and other items, net of $270 of unrecognized tax detriments from temporary differences (as defined by SFAS 109), which resulted in additional deferred tax liability. The ending unrecognized tax benefit as of December 31, 2007 was $120.

As of January 1, 2007, the Company recorded $340 as an adjustment, net of the associated tax impact on interest amounts, to opening retained earnings as a result of the adoption of FIN 48. Of this total, $188 related to unrecognized tax benefits and $152 related to accrued interest.

As of March 31, 2008 and December 31, 2007, the unrecognized tax benefits, net of their state tax benefits that would affect the Company s effective tax rate were $44.

The Company closed examinations by the Internal Revenue Service (IRS) for the 2004 and 2005 income tax years and by a major state tax jurisdiction for the 2003, 2004, and 2005 income tax years. As of December 31, 2007, the Company had settled with both the IRS and the major tax jurisdiction on all outstanding requests for a net refund of tax. Because the Company contemplated certain of the favorable examination adjustments in its beginning unrecognized tax detriment, the settlement of these items resulted in the recognition of the tax detriments and an increase to the Company s unrecognized tax benefits.

The Federal statute of limitations on the Company s 2003 income tax year lapsed in the third quarter of 2007, which resulted in a reduction in unrecognized tax benefits of $38 for uncertain tax positions. In 2008, the statute of limitations will lapse on the Company s 2003 and 2004 income tax years for state and Federal purposes in the third quarter, respectively; however, the Company does not believe this lapse will significantly impact unrecognized tax benefits for any uncertain tax position. The Company is not aware of any other event that might significantly impact the balance of unrecognized tax benefits.

The Company has historically classified interest and/or penalties on income tax liabilities or refunds as additional income tax expense or income and will continue to do so with the adoption of FIN 48. As of the adoption date of FIN 48, the Company recorded total accrued interest and penalties, gross of related tax benefit, of $253. For 2007, the Company reported $123 of interest income and $150 of interest expense, gross of related tax benefit, in the statement of income. As of December 31, 2007, the total amount of accrued interest and penalties in the Company s consolidated balance sheet was $298. As of March 31, 2008, the total amount of accrued interest and penalties in the Company s consolidated balance sheet was $314.

10. Debt

The Company has an Amended and Restated Loan and Security Agreement, as amended (the Revolver) with General Electric Capital Corporation (the Lender) under which the Company may borrow up to the lesser of $50,000 or 85% of the eligible accounts receivable. The Company may elect from time to time to change the interest rate for all or any portion of the outstanding indebtedness thereunder to any of three options: (i) the one, two, three or six month LIBOR (at the Company s option) plus 2.5%, or (ii) the greater of (a) prime plus 1.0% or (b) the federal funds rate plus 1.5% or (iii) a floating LIBOR rate. The Revolver will expire on February 21, 2013. The Revolver contains typical representations and financial and non-financial covenants for a loan of this type, a violation of which could result in a default under the Revolver and could possibly cause the entire amount outstanding, under the Revolver and all amounts owed by the Company, including amounts due under the Third Amended and Restated Loan Agreement (the Term Loan), to be declared immediately due and payable. The Company was in compliance with all covenants as of March 31, 2008. At March 31, 2008 and December 31, 2007, there were no outstanding borrowings under the Revolver and $8,449 of borrowing capacity was pledged to secure outstanding letters of credit in the same periods.

Long-term debt consists of the following:

	March 31, 2008	December 31, 2007
Term Loan with the Lender, multiple-advance term loan, principal and interest payable monthly; interest is fixed at time of draw at 10-year Treasury Note rate plus 2.25% (rates in effect at December 31, 2007 range from 6.95% to 7.50%), balance due June 2016, collateralized by deeds of trust on real property, assignments of rents, security agreements and fixture financing statements	$ 54,722	$ 54,929
Mortgage note, principal, and interest of $54 payable monthly and continuing through February 2027, interest at fixed rate of 7.5%, collateralized by deed of trust on real property, assignment of rents and security agreement	6,572	6,612
Mortgage note, principal, and interest of $18 payable monthly and continuing through September 2008, interest at fixed rate of 7.49%, collateralized by a deed of trust and security agreement and an assignment of rents	2,013	2,029

		63,307		63,570
Less current maturities		(3,017)		(2,993)
	$	60,290	$	60,577

13

Under the Term Loan, the Company is subject to standard reporting requirements and other typical covenants for a loan of this type. On a quarterly basis, the Company is subject to restrictive financial covenants, including average occupancy, Debt Service (as defined in the agreement) and Project Yield (as defined in the agreement). As of March 31, 2008 and December 31, 2007, the Company was in compliance with such loan covenants.

The carrying value of the Company s long-term debt is considered to approximate the fair value of such debt for all periods presented based upon the interest rates that the Company believes it can currently obtain for similar debt.

11. OPTIONS AND WARRANTS

Stock-based compensation expense recognized under SFAS 123(R) consists of share-based payment awards made to employees and directors including employee stock options based on estimated fair values. Stock-based compensation expense recognized in the Company s condensed consolidated statements of income for the three months ended March 31, 2008 and 2007 does not include compensation expense for share-based payment awards granted prior to, but not yet vested as of January 1, 2006, in accordance with the provisions of SFAS 123 but does include compensation expense for the share-based payment awards granted on or subsequent to January 1, 2006 based on the grant date fair value estimated in accordance with the adoption provisions of SFAS 123(R). As stock-based compensation expense recognized in the Company s condensed consolidated statements of income for the three month periods ended March 31, 2008 and 2007 was based on awards ultimately expected to vest, it has been reduced for estimated forfeitures. SFAS 123(R) requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates.

The Company has three option plans, all of which have been approved by the stockholders. In the 2001 Stock Option, Deferred Stock and Restricted Stock Plan (2001Plan) and the 2005 Stock Incentive Plan (2005 Plan), options may be exercised for unvested shares of common stock, which have full stockholder rights including voting, dividend and liquidation rights. The Company retains the right to repurchase any or all unvested shares at the exercise price paid per share of any or all unvested shares should the optionee cease to remain in service while holding such unvested shares.

2001 Stock Option, Deferred Stock and Restricted Stock Plan The 2001 Stock Option, Deferred Stock and Restricted Stock Plan (2001 Plan) authorizes the sale of up to 1,980 shares of common stock to officers, employees, directors, and consultants of the Company. Granted non-employee director options vest and become exercisable immediately. Generally, all other granted options and restricted stock vest over five years at 20% per year on the anniversary of the grant date. Options expire ten years from the date of grant. The exercise price of the stock is determined by the Board of Directors, but shall not be less than 100% of the fair value on the date of grant. Shares issued upon early exercise of options granted prior to 2006 vested in full upon the consummation of the Company s initial public offering (IPO) or if such options had not been exercised before the consummation of the Company s IPO, such shares will vest in full upon exercise. At March 31, 2008 and December 31, 2007, there were 257 and 247, respectively, unissued shares of common stock available for issuance under this plan, including shares that have been forfeited and are available for reissue.

2005 Stock Incentive Plan The 2005 Stock Incentive Plan (2005 Plan) authorizes the sale of up to 1,000 shares of treasury stock of which only 800 shares were repurchased and therefore eligible for reissuance as of March 31, 2008 and December 31, 2007, to officers, employees, directors, and consultants of the Company. Options granted to non-employee directors vest and become exercisable immediately. All other granted options vest over five years at 20% per year on the anniversary of the grant date. Options expire ten years from the date of grant. At March 31, 2008 and December 31, 2007, there were 114 and 112, respectively, unissued shares of common stock available for issuance under this plan, including shares that have been forfeited and are available for reissue.

2007 Omnibus Incentive Plan The 2007 Omnibus Incentive Plan (2007 Plan) authorizes the sale of up to 1,000 shares of common stock to officers, employees, directors and consultants of the Company. In addition, the number of shares of common stock reserved under the 2007 Plan will automatically increase on the first day of each fiscal year, beginning on January 1, 2008, in an amount equal to the lesser of (i) 1,000 shares of common stock, or (ii) 2% of the number of shares outstanding as of the last day of the immediately preceding fiscal year, or (iii) such lesser number as determined by the Company s board of directors. Granted non-employee director options vest and become exercisable in three equal annual installments, or the length of the term if less than three years, on the completion of each year of service measured from the grant date. All other granted options vest over five years at 20% per year on the anniversary of the grant date. Options expire ten years from the date of grant. At March 31, 2008, there were 1,035 unissued shares of common stock available for issuance under this plan.

Table of Contents

The Company uses the Black-Scholes option-pricing model to recognize the value of stock-based compensation expense for all share-based payment awards. Determining the appropriate fair-value model and calculating the fair value of stock-based awards at the grant date requires considerable judgment, including estimating stock price volatility, expected option life and forfeiture rates. The Company develops estimates based on historical data and market information, which can change significantly over time. The Black-Scholes model required the Company to make several key judgments including:

The expected option term reflects the application of the simplified method set out in SAB No. 107 *Share-Based Payment* (SAB 107), which was issued in March 2006. In December 2007, the SEC released SAB No. 110 (SAB 110), which extends the use of the simplified method, under certain circumstances, in developing an estimate of expected term of plain vanilla share options. Accordingly, the Company has utilized the average of the contractual term of the options and the weighted average vesting period for all options to calculate the expected option term.

Estimated volatility also reflects the application of SAB 107 interpretive guidance and, accordingly, incorporates historical volatility of similar public entities until sufficient information regarding the volatility of the Company s share price becomes available.

The dividend yield is based on the Company s historical pattern of dividends as well as expected dividend patterns.

The risk-free rate is based on the implied yield of U.S. Treasury notes as of the grant date with a remaining term approximately equal to the expected term.

Estimated forfeiture rate of approximately 8% per year is based on its historical forfeiture activity of unvested stock options.

Approximately 375 options were granted during the three month period ended March 31, 2008. The Company used the following assumptions for stock options granted during the three months ended March 31, 2008:

Plan	Options Granted	Weighted Average Risk-Free Rate	Expected Life	Weighted Average Volatility	Weighted Average Dividend Yield
2007	375	2.9%	6.5 years	45%	1.45%

For the three months ended March 31, 2008, the following represents the Company s weighted average exercise price, grant date intrinsic value and fair value displayed at grant date:

Plan	Grant Date	Options Granted	Weighted Average Exercise Price	Weighted Average Grant Date Intrinsic Value	Weighted Average Fair Value of Options	Weighted Average Fair Value of Common Stock
2007	1/22/2008	375	$ 11.03	$ 0.00	$ 4.62	$ 11.03

As of December 31, 2004, 2005 and 2006, the Company valued its common stock using a combination of weighted income and market valuation approaches. The income approach was based on discounted cash flows. The market approach employed both a guideline company method and merger and acquisition method.

The following table represents the employee stock option activity during the three months ended March 31, 2008:

	Weighted	Weighted

	Number of Options Outstanding	Average Exercise Price	Number of Options Vested	Average Exercise Price
December 31, 2007	1,023	$ 6.19	316	$ 5.25
Granted	375	$ 11.03		
Forfeitures	(7)	$ 5.09		
Exercised	(56)	$ 4.82		
March 31, 2008	1,335	$ 7.61	256	$ 5.37

Table of Contents

The following summary information reflects stock options outstanding, vesting and related details as of March 31, 2008:

	Options Outstanding				Options Vested	
Year of Grant	Number Outstanding	Exercise Price	Black-Scholes Fair Value	Remaining Contractual Life (Years)	Number Vested and Exercisable	Exercise Price
2003	43	$ 0.67-0.81	$ 34	6	30	$ 0.67-0.81
2004	72	$ 1.96-2.46	165	7	37	$ 1.96-2.46
2005	273	$ 4.99-5.75	1,552	8	78	$ 4.99-5.75
2006	572	$ 7.05-7.50	5,440	8	111	$ 7.05-7.50
2008	375	$ 11.03	1,731	10		$ 11.03
Total	1,335		8,922		256	

The Company recognized $462 and $249 in compensation expense during the three months ended March 31, 2008 and 2007, respectively. In future periods, the Company expects to recognize approximately $5,521 in stock-based compensation expense over the next 3.0 weighted average years for unvested options that were outstanding as of March 31, 2008. There were 1,079 unvested and outstanding options at March 31, 2008, of which 919 are expected to vest. The weighted average contractual life for options vested at March 31, 2008 was 7.8 years.

The aggregate intrinsic value of options outstanding, vested, expected to vest and exercised as of March 31, 2008 was approximately $2,871, $839, $1,827 and $279, respectively. The aggregate intrinsic value of options outstanding, vested, expected to vest and exercised as of December 31, 2007 was approximately $8,392, $2,890, $4,509 and $404, respectively. The intrinsic value is calculated as the difference between the market value and the exercise price of the options.

12. COMMITMENTS AND CONTINGENCIES

Leases The Company leases certain facilities and its Service Center offices under non-cancelable operating leases, most of which have initial lease terms ranging from 5 to 20 years. The Company also leases certain of its equipment under non-cancelable operating leases with initial terms ranging from three to five years. Most of these leases contain renewal options, certain of which involve rent increases. Total rent expense, inclusive of straight-line rent adjustments, was $4,087 and $4,229 for the three months ended March 31, 2008 and 2007, respectively.

Six of the Company s facilities are operated under master lease arrangements and a breach at a single facility could subject multiple facilities covered by the same master lease to the same default risk. Under a master lease, the Company may lease a large number of geographically dispersed properties through an indivisible lease. Failure to comply with Medicare or Medicaid provider requirements is a default under several of the Company s master lease and debt financing instruments. In addition, other potential defaults related to an individual facility may cause a default of an entire master lease portfolio and could trigger cross-default provisions in the Company s outstanding debt arrangements and other leases. With an indivisible lease, it is difficult to restructure the composition of the portfolio or economic terms of the lease without the consent of the landlord. In addition, a number of the Company s individual facility leases are held by the same or related landlords, and some of these leases include cross-default provisions that could cause a default at one facility to trigger a technical default with respect to others, potentially subjecting certain leases and facilities to the various remedies available to the landlords under separate but cross-defaulted leases.

Regulatory Matters Laws and regulations governing Medicare and Medicaid programs are complex and subject to interpretation. Compliance with such laws and regulations can be subject to future governmental review and interpretation, as well as significant regulatory action including fines, penalties, and exclusion from certain governmental programs. The Company believes that it is in material compliance with all applicable laws and regulations.

A significant portion of the Company s revenue is derived from Medicaid and Medicare, for which reimbursement rates are subject to regulatory changes and government funding restrictions. Although the Company is not aware of any significant future rate changes currently passed into law, significant changes to the reimbursement rates could have a material effect on the Company s operations.

Cost-Containment Measures Both government and private payor sources have instituted cost-containment measures designed to limit payments made to providers of healthcare services, and there can be no assurance that future measures designed to limit payments made to providers will not adversely affect the Company.

Table of Contents

Indemnities From time to time, the Company enters into certain types of contracts that contingently require the Company to indemnify parties against third-party claims. These contracts primarily include (i) certain real estate leases, under which the Company may be required to indemnify property owners or prior facility operators for post-transfer environmental or other liabilities and other claims arising from the Company s use of the applicable premises, (ii) operations transfer agreements, in which the Company agrees to indemnify past operators of facilities the Company acquires against certain liabilities arising from the transfer of the operation and/or the operation thereof after the transfer, (iii) certain lending agreements, under which the Company may be required to indemnify the lender against various claims and liabilities, (iv) agreements with certain lenders under which the Company may be required to indemnify such lenders against various claims and liabilities, and (v) certain agreements with the Company s officers, directors and employees, under which the Company may be required to indemnify such persons for liabilities arising in the course of their duties for the Company. The terms of such obligations vary by contract and, in most instances, a specific or maximum dollar amount is not explicitly stated therein. Generally, amounts under these contracts cannot be reasonably estimated until a specific claim is asserted. Consequently, because no claims have been asserted, no liabilities have been recorded for these obligations on the Company s balance sheets for any of the periods presented.

Litigation The skilled nursing business involves a significant risk of liability given the age and health of the Company s patients and residents and the services the Company provides. The Company and others in the industry are subject to an increasing number of claims and lawsuits, including professional liability claims, alleging that services have resulted in personal injury, elder abuse, wrongful death or other related claims. The defense of these lawsuits may result in significant legal costs, regardless of the outcome, and can result in large settlement amounts or damage awards.

In addition to the lawsuits and claims described above, the Company is also subject to potential lawsuits under the Federal False Claims Act and comparable state laws alleging submission of fraudulent claims for services to any healthcare program (such as Medicare) or payor. A violation may provide the basis for exclusion from federally-funded healthcare programs. Such exclusions could have a correlative negative impact on the Company s financial performance. Some states, including California, Arizona and Texas, have enacted similar whistleblower and false claims laws and regulations. In addition, the Deficit Reduction Act of 2005 created incentives for states to enact anti-fraud legislation modeled on the Federal False Claims Act. As such, the Company could face increased scrutiny, potential liability and legal expenses and costs based on claims under state false claims acts in the markets in which it does business.

On June 5, 2006, a complaint was filed against the Company in the Superior Court of the State of California for the County of Los Angeles, purportedly on behalf of the United States, claiming that the Company violated the Medicare Secondary Payer Act. In the complaint, the plaintiff alleged that the Company inappropriately received and retained reimbursement from Medicare for treatment given to certain unidentified patients and residents of its facilities whose injuries were caused by the Company as a result of unidentified and unadjudicated incidents of medical malpractice. The plaintiff in this action is seeking damages of twice the amount that the Company was allegedly obligated to pay or reimburse to Medicare in connection with the treatment in question under the Medicare Secondary Payer Act, plus interest, together with plaintiff s costs and fees, including attorneys fees. The plaintiff s case was dismissed in the Company s favor by the trial court, and the dismissal is currently on appeal. At this time the loss or possible range of loss is not estimable or probable; accordingly, we have not recorded an accrual for this matter.

The Company has been, and continues to be, subject to claims and legal actions that arise in the ordinary course of business including potential claims related to care and treatment provided at its facilities, as well as employment related claims. The Company does not believe that the ultimate resolution of these actions will have a material adverse effect on the Company s financial business, financial condition or results of operations. A significant increase in the number of these claims or an increase in amounts owing under successful claims could materially adversely affect the Company s business, financial condition, results of operations and cash flows.

Medicare Revenue Recoupments We are subject to reviews relating to Medicare services, billings and potential overpayments. One facility was subject to probe review during the three months ended March 31, 2008, which was subsequently concluded with a Medicare revenue recoupment, net of appeal recoveries, to the federal government and related resident copayments of approximately $4, which was paid subsequent to quarter end. We anticipate that these probe reviews will increase in frequency in the future. In addition, two of our facilities are currently on prepayment review, and others may be placed on prepayment review in the future. If a facility fails prepayment review, the facility could then be subject to undergo targeted review, which is a review that targets perceived claims deficiencies. We have no facilities that are currently undergoing targeted review.

Other Matters In March 2007, the Company and certain of its officers received a series of notices from the Company s bank indicating that the United States Attorney (U.S. Attorney) for the Central District of California had issued an authorized investigative demand, a request for records similar to a subpoena, to the Company s bank and then rescinded that demand. This rescinded demand originally requested documents from the Company s bank related to financial transactions involving the Company, ten of its operating subsidiaries, an outside investor group, and certain of its current and former officers. Subsequently, in June 2007, the U.S. Attorney sent a letter to one of the Company s current employees requesting a meeting. The letter indicated that the U.S. Attorney and the U.S. Department of Health and Human Services Office of Inspector General were conducting an investigation of claims submitted to the Medicare program for rehabilitation services provided at the Company s facilities. Although both the Company and the employee offered to cooperate, the U.S. Attorney later withdrew its meeting request. From these contacts, the Company believes that an investigation was underway, but to date the Company has been unable to determine the exact cause or nature of the U.S. Attorney s interest in the Company or its subsidiaries.

On December 17, 2007, the Company was informed by Deloitte & Touche LLP, the Company s independent registered public accounting firm that the U.S. Attorney served a grand jury subpoena on Deloitte & Touche LLP, relating to the Company and several of its operating subsidiaries. The subpoena confirmed the Company s previously reported belief that the U.S. Attorney is conducting an investigation involving certain of the Company s operating subsidiaries. Based on these most recent events, the Company believes that the United States Government may be conducting parallel criminal, civil and administrative investigations involving The Ensign Group and one or more of its skilled nursing facilities. To the Company s knowledge, however, neither The Ensign Group, Inc. nor any of its operating subsidiaries or employees has been formally charged with any wrongdoing, served with any related subpoenas or requests, or been directly notified of any concerns or related investigations by the U.S. Attorney or any government agency.

Subsequently, in February 2008, the U.S. Attorney contacted two additional current employees. Both the Company and all three of the employees contacted have offered to cooperate and meet with the U.S. Attorney. While the Company has no reason to believe that the assertion of criminal charges, civil claims, administrative sanctions or whistleblower actions would be warranted, to date the U.S. Attorney s office has declined to provide the Company with any specific information with respect to this matter, other than to confirm that an investigation is ongoing. The Company continued to request a meeting with the U.S. Attorney to discuss the grand jury subpoena, the Company s completed internal investigation and any specific allegations or concerns they may have. The Company cannot predict or provide any assurance as to the possible outcome of the investigation or any possible related proceedings, or as to the possible outcome of any *qui tam* litigation that may follow, nor can the Company estimate the possible loss or range of loss that may result from any such proceedings and, therefore, the Company has not recorded any related accruals. To the extent the U.S. Attorney s office elects to pursue this matter, or if the investigation has been instigated by a *qui tam* relator who elects to pursue the matter, the Company s business, financial condition and results of operations could be materially and adversely affected.

In November 2006, the Company became aware of an allegation of possible reimbursement irregularities at one or more of its facilities. That same month, the Company retained outside counsel and initiated an internal investigation into these matters. The Company and its outside counsel concluded this investigation without identifying any systemic patterns or practices of fraudulent or intentional misconduct. The Company made observations at certain facilities regarding areas of potential improvement in some of its recordkeeping and billing practices and has implemented measures, some of which were already underway before the investigation began, that it believes will strengthen recordkeeping and billing processes. None of these additional findings or observations appears to be rooted in fraudulent or intentional misconduct. The Company continues to evaluate the measures implemented for effectiveness, and is continuing to seek ways to improve these processes.

As a byproduct of its investigation, the Company identified a limited number of selected Medicare claims for which adequate back-up documentation could not be located or for which other billing deficiencies existed. The Company, with the assistance of independent consultants experienced in Medicare billing, completed a billing review on these claims. To the extent missing documentation was not located, the Company treated these claims as overpayments. Consistent with healthcare industry accounting practices, the Company records any charge for refunded payments against revenue in the period in which the claim adjustment becomes known. During the year ended December 31, 2007, the Company accrued a liability of approximately $224, plus interest, for selected Medicare claims for which documentation had not been located or for other billing deficiencies identified to date. The remittance of these claims started with the Company s filing of its regular January 2008 Quarterly Credit Balance Reports, which were submitted to the Medicare Fiscal Intermediary on or before January 31, 2008, and were completed with the regular April 2008 Quarterly Credit Balance Reports which were submitted on or before April 30, 2008. If additional reviews result in identification and quantification of additional amounts to be refunded, the Company would accrue additional liabilities for claim costs and interest and repay any amounts due in normal course. If future investigations ultimately result in findings of significant billing and reimbursement noncompliance which could require the Company to record significant additional provisions or remit payments, the Company s business, financial condition and results of operations could be materially and adversely affected.

Table of Contents

Concentrations

Credit Risk The Company has significant accounts receivable balances, the collectibility of which is dependent on the availability of funds from certain governmental programs, primarily Medicare and Medicaid. These receivables represent the only significant concentration of credit risk for the Company. The Company does not believe there is significant credit risks associated with these governmental programs. The Company believes that an adequate allowance has been recorded for the possibility of these receivables proving uncollectible, and continually monitors and adjusts these allowances as necessary. The Company s receivables from Medicare and Medicaid payor programs accounted for approximately 61% of its total accounts receivable as of March 31, 2008 and December 31, 2007, respectively. Revenue from reimbursements under the Medicare and Medicaid programs accounted for approximately 75% and 74% of the Company s revenue for the three months ended March 31, 2008 and 2007.

Cash in Excess of FDIC Limits The Company currently has bank deposits with a financial institution that exceed FDIC insurance limits. FDIC insurance provides protection for bank deposits up to $100.

13. DEFINED CONTRIBUTION PLAN

The Company has a 401(k) defined contribution plan (the 401(k) Plan), whereby eligible employees may contribute up to 15% of their annual basic earnings. Additionally, the 401(k) Plan provides for discretionary matching contributions (as defined in the 401(k) Plan) by the Company. The Company contributed $77 and $63 to the 401(k) Plan during the three months ended March 31, 2008 and 2007, respectively. Beginning in 2007, the Company s 401(k) plan allowed eligible employees to contribute up to 90% of their eligible compensation, subject to applicable annual Internal Revenue Code limits.

14. SUBSEQUENT EVENTS

On May 1, 2008, the Company assumed an existing lease for a 120-bed skilled nursing facility in Orem, Utah. The Company purchased the tenant s rights under the lease agreement from the prior tenant and operator for approximately $2.0 million. The Company did not acquire any material assets or assume any liabilities other than the prior tenant s post-assumption rights and obligations under the lease. The Company also entered into a separate operations transfer agreement with the prior tenant as a part of this transaction, which is common. The Company paid for the prior tenant s lease rights in cash from its IPO proceeds.

Also on May 1, 2008, under the terms of a purchase option contained in the original lease agreement, the Company purchased the underlying assets of one of its leased long-term care facilities in Scottsdale, Arizona. This facility was purchased for approximately $5.2 million, which was paid in cash from the Company s IPO proceeds.

As of May 1, 2008, the Company owns 27 of its facilities and operates 35 under long-term lease arrangements with options to purchase or purchase agreements for nine of those 35 facilities.

Item 2. *Management s Discussion and Analysis of Financial Condition and Results of Operations*

You should read the following discussion and analysis in conjunction with our unaudited condensed consolidated financial statements and the related notes thereto contained in Part I, Item 1 of this Report. The information contained in this Quarterly Report on Form 10-Q is not a complete description of our business or the risks associated with an investment in our common stock. We urge you to carefully review and consider the various disclosures made by us in this Report and in our other reports filed with the Securities and Exchange Commission (SEC), including our Annual Report on Form 10-K (Annual Report), which discusses our business and related risks in greater detail, as well as subsequent reports we may file from time to time on Forms 10-Q and 8-K, for additional information. The section entitled Risk Factors contained in Part II, Item 1A of this Report, and similar discussions in our other SEC filings, also describe some of the important risk factors that may affect our business, financial condition, results of operations and/or liquidity. You should carefully consider those risks, in addition to the other information in this Report and in our other filings with the SEC, before deciding to purchase, hold or sell our common stock.

This Report contains forward-looking statements, which include, but are not limited to the Company s expected future financial position, results of operations, cash flows, financing plans, business strategy, budgets, capital expenditures, competitive positions, growth opportunities and plans and objectives of management. Forward-looking statements can often be identified by words such as anticipates, expects, intends, plans, predicts, believes, seeks, estimat should, would, could, potential, continue, ongoing, similar expressions, and variations or negatives of these w These statements are not guarantees of future performance and are subject to risks, uncertainties and assumptions that are difficult to predict. Therefore, our actual results could differ materially and adversely from those expressed in any forward-looking statements as a result of various factors, some of which are listed under the section Risk Factors contained in Part II, Item 1A of this Report. These forward-looking statements speak only as of the date of this Report, and are based on our current expectations, estimates and projections about our industry and business, management s beliefs, and certain assumptions made by us, all of which are subject to change. We undertake no obligation to revise or update publicly any forward-looking statement for any reason, except as otherwise required by law. As used in this Management s Discussion and Analysis of Financial Condition and Results of Operations, the words, we, our and us refer to The Ensign Group, Inc. and its consolidated subsidiaries. All of our facilities, the Service Center and the Captive are operated by separate, wholly-owned, independent subsidiaries that have their own management, employees and assets. The use of we , us , our and similar verbiage in this quarterly report is not meant to imply that any of our facilities or the Service Center are operated by the same entity. This Management s Discussion and Analysis of Financial Condition and Results of Operations should be read in conjunction with our consolidated financial statements and related notes included in the Annual Report.

Table of Contents

Overview

We are a provider of skilled nursing and rehabilitative care services through the operation of 61 facilities located in California, Arizona, Texas, Washington, Utah and Idaho. All of these facilities are skilled nursing facilities, other than three stand-alone assisted living facilities in Arizona and Texas and four campuses that offer both skilled nursing and assisted living services in California, Arizona and Utah. Our facilities provide a broad spectrum of skilled nursing and assisted living services, physical, occupational and speech therapies, and other rehabilitative and healthcare services, for both long-term residents and short-stay rehabilitation patients. We encourage and empower our facility leaders and staff to make their facility the facility of choice in the community it serves. This means that our facility leaders and staff are generally free to discern and address the unique needs and priorities of healthcare professionals, customers and other stakeholders in the local community or market, and then work to create a superior service offering and reputation for that particular community or market to encourage prospective customers and referral sources to choose or recommend the facility. As of March 31, 2008, we owned 26 of our facilities and operated an additional 35 facilities under long-term lease arrangements, and had options to purchase, or purchase agreements in place, for 10 of those 35 facilities. The following table summarizes our facilities and licensed and independent living beds by ownership status as of March 31, 2008:

	Owned	Leased (with a Purchase Option)	Leased (without a Purchase Option)	Total
Number of facilities	26	10	25	61
Percent of total	42.6%	16.4%	41.0%	100%
Skilled nursing, assisted living and independent living beds(1)	3,251	1,227	2,970	7,448