UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, DC 20549

FORM 10-Q

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

For the quarterly period ended September 30, 2007

OR

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

Commission File Number 001-16817

FIVE STAR QUALITY CARE, INC.

(Exact Name of Registrant as Specified in its Charter)

Maryland	**04-3516029**
(State or Other Jurisdiction of Incorporation or Organization)	(IRS Employer Identification No.)

400 Centre Street, Newton, Massachusetts 02458

(Address of Principal Executive Offices)

617-796-8387

(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 x No o

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

Large accelerated filer o Accelerated filer x Non-accelerated filer o

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

Number of Common Shares outstanding at November 7, 2007: 31,708,134 shares of common stock, $0.01 par value.

FIVE STAR QUALITY CARE, INC.

FORM 10-Q

September 30, 2007

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As used herein the terms we , us , our and Five Star include Five Star Quality Care, Inc. and its consolidated subsidiaries unless otherwise expressly stated or the context otherwise requires.

Part I. Financial Information

Item 1. Consolidated Financial Statements

FIVE STAR QUALITY CARE, INC.

CONSOLIDATED BALANCE SHEET

(dollars in thousands, except share amounts)

(unaudited)

	September 30, 2007	December 31, 2006
ASSETS		
Current assets:		
Cash and cash equivalents	$ 19,875	$ 46,241
Accounts receivable, net of allowance of $6,163 and $5,005 at September 30, 2007 and December 31, 2006, respectively	58,632	67,791
Prepaid expenses	9,028	16,112
Investment securities:		
Investments in trading securities	69,125	46,100
Investments in available-for-sale securities	8,347	4,334
Restricted cash	3,813	7,968
Restricted investments	4,544	2,448
Other current assets	12,306	14,766
Total current assets	185,670	205,760
Property and equipment, net	132,876	114,898
Restricted cash	1,662	8,560
Restricted investments	11,746	6,262
Goodwill and other intangible assets	22,288	22,611
Other long term assets	7,853	8,320
	$ 362,095	$ 366,411
LIABILITIES AND SHAREHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 17,781	$ 22,805
Accrued expenses	13,671	13,540
Accrued compensation and benefits	34,980	24,503
Due to Senior Housing Properties Trust (SNH)	10,973	9,988
Mortgage notes payable	158	33,317
Accrued real estate taxes	9,121	6,035
Security deposit liability	14,934	15,097
Other current liabilities	7,705	7,644
Total current liabilities	109,323	132,929
Long term liabilities:		
Mortgage notes payable	15,909	11,454
Convertible senior notes	126,500	126,500
Continuing care contracts	3,232	3,649
Other long term liabilities	24,813	24,449

Total long term liabilities		170,454		166,052
Commitments and contingencies				
Shareholders equity:				
Preferred stock, par value $0.01: 1,000,000 shares authorized, none issued				
Common stock, par value $0.01: 50,000,000 shares authorized, 31,708,134 and 31,682,134 shares issued and outstanding at September 30, 2007 and December 31, 2006, respectively		317		316
Additional paid-in capital		286,531		286,344
Accumulated deficit		(202,831)		(219,435)
Unrealized (loss) gain on investments		(1,699)		205
Total shareholders equity		82,318		67,430
	$	362,095	$	366,411

See accompanying notes.

FIVE STAR QUALITY CARE, INC.

CONSOLIDATED STATEMENTS OF OPERATIONS

(dollars in thousands, except per share amounts)

(unaudited)

	Three months ended September 30, 2007	Three months ended September 30, 2006	Nine months ended September 30, 2007	Nine months ended September 30, 2006
Revenues:				
Senior living revenue	$ 203,656	$ 186,642	$ 601,319	$ 550,079
Hospital revenue	25,361		76,711	
Pharmacy revenue	18,141	14,023	51,303	38,240
Total revenues	247,158	200,665	729,333	588,319
Operating expenses:				
Senior living wages and benefits	100,659	96,374	306,497	281,693
Other senior living operating expenses	50,988	44,881	149,399	139,163
Hospital expenses	22,588		69,585	
Pharmacy expenses	17,493	13,895	49,763	36,891
Management fee to Sunrise Senior Living Services, Inc. (SLS)		1,400		7,792
Termination expense for SLS management agreements				89,833
Rent expense	32,507	26,556	96,737	78,009
General and administrative	10,757	8,629	31,703	23,867
Depreciation and amortization	3,580	2,557	10,024	7,114
Total operating expenses	238,572	194,292	713,708	664,362
Operating income (loss)	8,586	6,373	15,625	(76,043)
Interest and other income	1,511	413	4,343	1,553
Interest expense	(1,464)	(786)	(4,919)	(2,419)
Gain on extinguishment of debt			4,491	
Income (loss) from continuing operations before income taxes	8,633	6,000	19,540	(76,909)
Provision for income taxes	277		760	
Income (loss) from continuing operations	8,356	6,000	18,780	(76,909)
Loss from discontinued operations	(595)	(2,804)	(2,176)	(5,426)
Net income (loss)	$ 7,761	$ 3,196	$ 16,604	$ (82,335)
Weighted average shares outstanding basic	31,705	31,581	31,694	27,584
Weighted average shares outstanding - diluted	41,436	31,581	41,425	27,584
Basic income (loss) per share from:				
Continuing operations	$ 0.26	$ 0.19	$ 0.59	$ (2.79)
Discontinued operations	(0.02)	(0.09)	(0.07)	(0.20)
Net income (loss) per share	$ 0.24	$ 0.10	$ 0.52	$ (2.99)
Diluted income (loss) per share from:				
Continuing operations	$ 0.23	$ 0.19	$ 0.54	$ (2.79)

Discontinued operations	(0.01)	(0.09)	(0.05)	(0.20)
Net income (loss) per share	$ 0.22	$ 0.10	$ 0.49	$ (2.99)

See accompanying notes.

FIVE STAR QUALITY CARE, INC.

CONSOLIDATED STATEMENT OF CASH FLOWS

(dollars in thousands)

(unaudited)

	Nine months ended September 30, 2007	2006
Cash flows from operating activities:		
Net income (loss)	$ 16,604	$ (82,335)
Adjustments to reconcile net income (loss) to cash provided by (used in) operating activities:		
Depreciation and amortization	10,024	7,114
Gain on extinguishment of debt	(4,491)	
Loss from discontinued operations	2,176	5,426
Provision for bad debt expense, net	1,158	2,606
Changes in assets and liabilities:		
Accounts receivable	8,001	(6,856)
Prepaid expenses and other assets	9,942	(9,709)
Investment securities	(27,038)	(882)
Accounts payable and accrued expenses	(4,893)	(1,770)
Accrued compensation and benefits	10,477	10,115
Due to/from SLS		(7,294)
Due to/from SNH	985	650
Other current and long term liabilities	2,931	3,446
Cash provided by (used in) operating activities	25,876	(79,489)
Net cash used in discontinued operations	(2,176)	(5,426)
Cash flows from investing activities:		
Withdrawals from (deposits into) restricted cash and investment accounts, net	1,757	(7,931)
Acquisition of property and equipment	(55,662)	(34,489)
Acquisition of senior living community	(5,025)	
Acquisition of pharmacy		(3,500)
Proceeds from disposition of property and equipment held for sale	33,077	16,786
Withdrawals from restricted cash for purchases of property and equipment		3,976
Cash used in investing activities	(25,853)	(25,158)
Cash flows from financing activities:		
Proceeds from issuance of common shares, net		114,215
Proceeds from borrowings on revolving credit facility		28,000
Repayments of borrowings on revolving credit facility		(28,000)
Proceeds from mortgage note payable	4,559	
Repayments of mortgage note payable	(28,772)	(417)
Cash (used in) provided by financing activities	(24,213)	113,798
Change in cash and cash equivalents	(26,366)	3,725
Cash and cash equivalents at beginning of period	46,241	16,376
Cash and cash equivalents at end of period	$ 19,875	$ 20,101

Supplemental cash flow information:				
Cash paid for interest	$	4,499	$	2,028
Non-cash investing and financing activities:				
Issuance of common stock		187		43

See accompanying notes.

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FIVE STAR QUALITY CARE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(dollars in thousands, except per share amounts)

(unaudited)

Note 1. Basis of Presentation and Organization

Certain information and disclosures required by generally accepted accounting principles for complete financial statements have been condensed or omitted. We believe the disclosures made are adequate to make the information presented not misleading. However, the accompanying financial statements should be read in conjunction with the financial statements and notes contained in our Annual Report on Form 10-K for the year ended December 31, 2006. In the opinion of our management, all adjustments, which include only normal recurring adjustments considered necessary for a fair presentation, have been included. All intercompany transactions and balances have been eliminated. Our operating results for interim periods are not necessarily indicative of the results that may be expected for the full year. Reclassifications have been made to the prior year s financial statements to conform to the current year s presentation. Material changes are limited to reclassifying accrued benefits out of other current liabilities and reclassifying available-for-sale securities out of investments in trading securities. These reclassifications had no effect on net income or shareholders equity.

As of September 30, 2007, we operated 161 senior living communities containing 17,911 living units, including 112 primarily independent and assisted living communities containing 13,507 living units and 49 nursing homes containing 4,404 living units. Of our 112 primarily independent and assisted living communities, we leased 95 communities containing 12,244 living units from Senior Housing Properties Trust, or Senior Housing, our former parent, and we owned or leased from parties other than Senior Housing 17 communities containing 1,263 living units. We leased 47 of our 49 nursing homes from Senior Housing. Our 161 communities include 5,627 independent living apartments, 6,235 assisted living suites and 6,049 skilled nursing units. We also operated six institutional pharmacies, one of which provided mail order pharmaceuticals to the general public, and we operated two rehabilitation hospitals that we leased from Senior Housing. Our two rehabilitation hospitals have 341 beds available for inpatient services, three satellite locations and 20 outpatient clinics.

Note 2. Property and Equipment

Property and equipment, at cost, consists of:

	September 30, 2007	December 31, 2006
Land	$ 7,195	$ 6,685
Buildings and improvements	100,187	82,293
Furniture, fixtures and equipment	54,006	46,685
	161,388	135,663
Accumulated depreciation	(28,512)	(20,765)
	$ 132,876	$ 114,898

As of September 30, 2007 and December 31, 2006, we had assets classified as held for sale of $26,108 and $15,478, respectively, included in our property and equipment, that we intend to sell to Senior Housing as permitted by our leases.

Note 3. Comprehensive Income (Loss)

Comprehensive income (loss) for the three and nine months ended September 30, 2007 and 2006 is summarized below:

	Three months ended September 30, 2007	Three months ended September 30, 2006	Nine months ended September 30, 2007	Nine months ended September 30, 2006
Net income (loss)	$ 7,761	$ 3,196	$ 16,604	$ (82,335)
Unrealized (loss) gain on investments in available for sale securities	(1,011)	521	(1,904)	163
Comprehensive income (loss)	$ 6,750	$ 3,717	$ 14,700	$ (82,172)

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Note 4. Financial Data By Segment

Our reportable segments consist of our senior living community business and our rehabilitation hospital business that we began to operate in October 2006.   In the senior living community segment, we operate independent living and congregate care communities, assisted living communities and nursing homes. Our rehabilitation hospital segment provides inpatient health rehabilitation services at our two hospital locations and three satellite locations and outpatient health rehabilitation services at 20 locations. We do not consider our pharmacy operations to be a material, separately reportable segment of our business but we report our pharmacy revenues and expense as separate items within our corporate and other activities. All of our operations and assets are located in the United States.

We use segment operating profit as an important measure to evaluate our performance and for decision making purposes. Segment operating profit excludes interest and other income, interest expense and certain corporate expenses.

Our revenues by segment and a reconciliation of segment operating profit to income from continuing operations before income taxes for the three and nine months ended September 30, 2007 and 2006 are as follows:

	Senior Living Communities	Rehabilitation Hospitals	Corporate and other (1)	Total
Three months ended September 30, 2007				
Revenues	$ 203,656	$ 25,361	$ 18,141	$ 247,158
Segment expenses:				
Operating expenses	151,647	22,588	17,493	191,728
Rent expense	29,943	2,564		32,507
Depreciation and amortization	2,405	294	881	3,580
Total segment expenses	183,995	25,446	18,374	227,815
Segment operating profit (loss)	19,661	(85)	(233)	19,343
General and administrative expenses (2)			(10,757)	(10,757)
Operating income (loss)	19,661	(85)	(10,990)	8,586
Interest and other income			1,511	1,511
Interest expense	(226)		(1,238)	(1,464)
Provision for income taxes			(277)	(277)
Income (loss) from continuing operations	$ 19,435	$ (85)	$ (10,994)	$ 8,356
Total Assets as of September 30, 2007	$ 231,384	$ 21,845	$ 108,866	$ 362,095
Three months ended September 30, 2006				
Revenues	$ 186,642	$	$ 14,023	$ 200,665
Segment expenses:				
Operating expenses	141,255		13,895	155,150
Management fee to SLS	1,400			1,400
Rent expense	26,556			26,556
Depreciation and amortization	1,979		578	2,557
Total segment expenses	171,190		14,473	185,663
Segment operating profit (loss)	15,452		(450)	15,002
General and administrative expenses (2)			(8,629)	(8,629)

Operating income (loss)	15,452		(9,079)	6,373
Interest and other income			413	413
Interest expense	(667)		(119)	(786)
Income (loss) from continuing operations	$ 14,785	$	$ (8,785)	$ 6,000
Total Assets as of September 30, 2006	$ 235,481	$	$ 30,069	$ 265,550

Nine months ended September 30, 2007				
Revenues	$ 601,319	$ 76,711	$ 51,303	$ 729,333
Segment expenses:				
Operating expenses	455,896	69,585	49,763	575,244
Rent expense	89,042	7,695		96,737
Depreciation and amortization	6,926	787	2,311	10,024
Total segment expenses	551,864	78,067	52,074	682,005
Segment operating profit (loss)	49,455	(1,356)	(771)	47,328
General and administrative expenses (2)			(31,703)	(31,703)
Operating income (loss)	49,455	(1,356)	(32,474)	15,625
Interest and other income			4,343	4,343
Interest expense	(882)		(4,037)	(4,919)
Gain on extinguishment of debt	4,491			4,491
Provision for income taxes			(760)	(760)
Income (loss) from continuing operations	$ 53,064	$ (1,356)	$ (32,928)	$ 18,780
Nine months ended September 30, 2006				
Revenues	$ 550,079	$	$ 38,240	$ 588,319
Segment expenses:				
Operating expenses	420,856		36,891	457,747
Management fee to SLS	7,792			7,792
Termination expense for SLS management agreements	89,833			89,833
Rent expense	78,009			78,009
Depreciation and amortization	5,595		1,519	7,114
Total segment expenses	602,085		38,410	640,495
Segment operating loss	(52,006)		(170)	(52,176)
General and administrative expenses (2)			(23,867)	(23,867)
Operating loss	(52,006)		(24,037)	(76,043)
Interest and other income			1,553	1,553
Interest expense	(2,031)		(388)	(2,419)
Loss from continuing operations	$ (54,037)	$	$ (22,872)	$ (76,909)

(1) Corporate and Other includes operations that we do not consider significant, separately reportable segments of our business and income and expenses that are not attributable to a specific segment.

(2) General and administrative expenses are not attributable to a specific segment and include items such as corporate payroll and benefits and outside service expenses.

Note 5. Income Taxes

In June 2006, the Financial Accounting Standards Board issued Interpretation No. 48 Accounting for Uncertainty in Income Taxes , or FIN 48. FIN 48 prescribes how we should recognize, measure and present in our financial statements uncertain tax positions that have been taken or are expected to be taken in a tax return. Pursuant to FIN 48, we can recognize a tax benefit only if it is more likely than not that a particular tax position will be sustained upon examination or audit. To the extent the more likely than not standard has been satisfied, the benefit associated with a tax position is measured as the largest amount that has a greater than 50% likelihood of being realized upon settlement.

As required, we adopted FIN 48 effective January 1, 2007 and have concluded the effect is not material to our consolidated financial statements. Accordingly, we did not record a cumulative effect adjustment related to the adoption of FIN 48. At the date of adoption, we had $785 in unrecognized tax benefits related to FIN 48 plus significant tax loss carry forwards totaling approximately $201,000 which, if recognized, would favorably affect our effective tax rate. We do not believe that our unrecognized tax benefits related to FIN 48 will change significantly in the next 12 months.

Because we have historically reported losses, we do not currently recognize the benefit of all of our deferred tax assets, including tax loss carry forwards that may be used to offset future taxable income. We will, however, continue to assess our ability to generate sufficient taxable income during future periods in which our deferred tax assets may be realized. When we believe that we will more likely than not recover our deferred tax assets, we will record deferred tax assets as an income tax benefit in the consolidated statement of operations, which will affect our results of operations. Our net operating loss carry forwards begin to expire in 2023, if unused. Our tax loss carry forwards and tax returns filed for the 2002 through 2006 tax years are subject to examination by taxing authorities.

For the nine months ended September 30, 2007, we recognized tax expense of $760, which includes $593 of alternative minimum taxes and certain state taxes that are payable without regard to our tax loss carry forwards and $167 of a non cash deferred tax liability arising from the amortization of goodwill for tax purposes but not for book purposes. We may recognize this deferred tax liability as a reduction in the income tax provision if, in some future period, we expense the related items of goodwill for book purposes as the result of its sale, other disposition or its impairment.

Note 6. Earnings Per Share

Basic earnings per share for the periods ended September 30, 2007 and 2006 is computed using the weighted average number of shares outstanding during the periods. Diluted earnings per share for the period ended September 30, 2007 reflects additional common shares that would have been outstanding if dilutive potential common shares had been issued, as well as any adjustment to income applicable to common shareholders that would result from their assumed issuance. The effect our convertible senior notes have on loss from discontinued operations per share is anti-dilutive for the three and nine months ended September 30, 2007, respectively.

The following table provides a reconciliation of net income and the number of common shares used in the computations of diluted earnings per share, or EPS:

	Three Months Ended September 30,									
	2007					2006				
	Income (loss)	Shares		Per Share		Income (loss)	Shares		Per Share	
Income from continuing operations	$	8,356	31,705	$	0.26	$	6,000	31,581	$	0.19
Effect of convertible senior notes		1,238	9,731							
Diluted earnings from continuing operations		9,594	41,436	$	0.23		6,000	31,581	$	0.19
Diluted loss from discontinued operations	$	(595)	41,436	$	(0.01)	$	(2,804)	31,581	$	(0.09)

	Nine Months Ended September 30,									
	2007					2006				
	Income (loss)	Shares		Per Share		Income (loss)	Shares		Per Share	
Income from continuing operations	$	18,780	31,694	$	0.59	$	(76,909)	27,584	$	(2.79)
Effect of convertible senior notes		3,719	9,731							
Diluted earnings (loss) from continuing operations		22,499	41,425	$	0.54	$	(76,909)	27,584	$	(2.79)
Diluted loss from discontinued operations	$	(2,176)	41,425	$	(0.05)	$	(5,426)	27,584	$	(0.20)

Note 7. Acquisitions

In April 2007, we acquired a 48 unit assisted living community located in Tennessee for $5,025. We financed the acquisition by assuming a $4,559 non recourse United States Department of Housing, or HUD, insured mortgage and paying the balance of the purchase price with cash on hand. The interest rate on the assumed HUD insured mortgage is 7.65%. We included the results of this community s operations in our consolidated financial statements from the date of acquisition. All of the community s revenues come from residents private resources. We acquired this community to expand our business in high quality senior living operations where residents pay for our services with private resources.

Note 8. Line of Credit

In June 2007, we amended our revolving line of credit. The amendment increased the line from $25,000 to $40,000, extended the termination date to May 8, 2009 and reduced the interest rate by 25 basis points. Our revolving line of credit is available for acquisitions, working capital and general business purposes. The amount we are able to borrow at any time is subject to limitation based upon qualifying collateral. We are the borrower under this revolving credit facility and certain of our subsidiaries guarantee our obligations under the facility, which is secured by our and our guarantor subsidiaries accounts receivable, deposit accounts and related assets. The facility contains covenants requiring us to maintain collateral, minimum net worth and certain other financial ratios, limits our ability to incur or assume debt or create liens with respect to certain of our properties and has other customary provisions. In certain circumstances and subject to available collateral and lender approvals, the maximum amounts which we may draw under this credit facility may be increased to $80,000. The termination date may be extended twice, in each case by twelve months, subject to lender approval, our payment of extension fees and other conditions. As of September 30, 2007 and November 7, 2007, no amounts were outstanding under this credit facility. As of September 30, 2007 and November 7, 2007 we believe we are in compliance with all applicable covenants under this credit facility. Interest expense and other associated costs related to this facility were $0 and $119 for the three months ended September 30, 2007 and 2006, respectively, and $318 and $388 for the nine months ended September 30, 2007 and 2006, respectively.

Note 9. Mortgages Payable

At September 30, 2007, four of our communities were encumbered by five HUD insured mortgages totaling $16,067. The weighted average interest rate on these loans was 6.6 %. Payments of principal and interest are due monthly until maturities at varying dates ranging from June 2035 to July 2043. These mortgages contain standard HUD mortgage covenants. We recorded mortgage premiums in connection with some of these HUD mortgages in order to record assumed mortgages at their estimated fair value. The mortgage premiums are being amortized as a reduction of interest expense until the maturity of the mortgages. The mortgage premium balance included in mortgage notes payable as of September 30, 2007 was $797.

In February 2007, we prepaid six mortgages that were secured by five of our senior living communities. We paid $22,923 to retire these six mortgages, which consisted of approximately $22,198 in principal and interest and $725 in prepayment penalties. Because we had carried these mortgages at a premium to their face value, we recognized a net gain of $3,557 in connection with the early extinguishment of debt. In April 2007, we prepaid one mortgage that was secured by one of our communities. We paid $5,944 to retire this mortgage, which consisted of approximately $5,828 in principal and interest and $115 in prepayment penalties. Because we had carried this mortgage at a premium to its face value, we recognized a net gain of approximately $934 in connection with the early extinguishment of debt. Mortgage interest expense, including premium amortization, was $226 and $667 for the three months ended September 30, 2007 and 2006, respectively, and $882 and $2,031 for the nine months ended September 30, 2007 and 2006, respectively.

As discussed in Note 7, in April 2007 we acquired a 48 unit assisted living community located in Tennessee for $5,025. We financed the acquisition by assuming a $4,559 non recourse HUD insured mortgage and paying the balance of the purchase price with cash on hand. The interest rate on the assumed HUD insured mortgage is 7.65%.

Note 10. Convertible Senior Notes due 2026

In October 2006, we issued $126,500 principal amount of 3.75% convertible senior notes. Our net proceeds from this offering were approximately $122,600. These notes are convertible into our common shares at any time. The initial conversion rate, which is subject to adjustment, is 76.9231 common shares per $1 principal amount of notes, which represents an initial conversion price of $13.00 per share. Interest expense and other associated costs on the notes were $1,238 and $3,719 for the three and nine months ended September 30, 2007, respectively. The notes are guaranteed by certain of our domestic wholly owned subsidiaries (see Note 13). These notes mature on October 15, 2026; we may prepay them at anytime after October 20, 2011 and the note holders may require that we purchase all or a portion of these notes on each October 15 of 2013, 2016 and 2021. We issued these notes pursuant to an indenture which contains various customary covenants. We believe we are in compliance with all applicable covenants of the indenture.

Note 11. Related Party Transactions

We lease 142 of the 161 senior living communities and the two rehabilitation hospitals that we operated on September 30, 2007 from Senior Housing for total annual minimum rent of $127,594. In addition to the minimum rent, we paid $690 and $244 in percentage rent to Senior Housing for the three months ended September 30, 2007 and 2006, respectively and $1,857 and $876 for the nine months ended September 30, 2007 and 2006, respectively.

During the nine months ended September 30, 2007, as permitted by our leases with Senior Housing, we sold to Senior Housing, at cost, $33,077 of improvements made to properties leased from Senior Housing, and the annual rent payable to Senior Housing increased by $3,194.

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Note 12. Discontinued Operations

In March 2007, we agreed with Senior Housing that it should sell two assisted living communities in Pennsylvania, which we lease from Senior Housing. We and Senior Housing are in the process of selling these assisted living communities and, upon their sale, our annual minimum rent payable to Senior Housing will decrease by 9.5% of the net proceeds of the sale to Senior Housing. As of September 30, 2007, we have disposed of substantially all of our assets and settled all liabilities related to these two communities. We have reclassified the statement of operations for all periods presented to show the results of operations of the communities which have been sold or are expected to be sold as discontinued. A summary of the operating results of these discontinued operations included in the financial statements for the three and nine months ended September 30, 2007 and 2006 is:

	Three months ended September 30, 2007	Three months ended September 30, 2006	Nine months ended September 30, 2007	Nine months ended September 30, 2006
Revenues	$ 715	$ 5,874	$ 2,246	$ 20,088
Expenses	(1,310)	(8,678)	(4,422)	(25,514)
Net loss	$ (595)	$ (2,804)	$ (2,176)	$ (5,426)

Note 13. Guarantor Financial Information

Our convertible notes are guaranteed by certain of our domestic wholly owned subsidiaries. Such guarantees are full, unconditional and joint and several. Condensed consolidating financial information related to the Company, its guarantor subsidiaries and non-guarantor subsidiaries for all periods presented are as follows:

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Consolidating Statement of Operations

For the three months ended September 30, 2007

	Parent	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Eliminations	Consolidated
Revenues:					
Senior living revenue	$	$ 85,678	$ 117,978	$	$ 203,656
Hospital revenue			25,361		25,361
Pharmacy revenue			18,141		18,141
Total revenues		85,678	161,480		247,158
Operating expenses:					
Senior living wages and benefits		36,402	64,257		100,659
Other senior living operating expenses		25,119	25,869		50,988
Hospital expenses			22,588		22,588
Pharmacy expenses			17,493		17,493
Rent expense		16,802	15,705		32,507
General and administrative expenses			10,757		10,757
Depreciation and amortization		1,200	2,380		3,580
Total operating expenses		79,523	159,049		238,572
Operating income		6,155	2,431		8,586
Interest and other income		3	1,508		1,511
Interest expense			(1,464)		(1,464)
Gain on extinguishment of debt					
Equity in earnings of subsidiaries	7,761			(7,761)	
Income from continuing operations before income taxes	7,761	6,158	2,475	(7,761)	8,633
Provision for income taxes			277		277
Income from continuing operations	7,761	6,158	2,198	(7,761)	8,356
Loss from discontinued operations			(595)		(595)
Net income	$ 7,761	$ 6,158	$ 1,603	$ (7,761)	$ 7,761

Consolidating Statement of Operations

For the three months ended September 30, 2006

	Parent	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Eliminations	Consolidated
Revenues:					
Senior living revenue	$	$ 82,097	$ 104,545	$	$ 186,642
Pharmacy revenue			14,023		14,023
Total revenues		82,097	118,568		200,665
Operating expenses:					
Senior living wages and benefits		37,116	59,258		96,374
Other senior living operating expenses		23,568	21,313		44,881

Pharmacy expenses			13,895		13,895
Management fee to SLS		1,400			1,400
Termination expense for SLS management agreements					
Rent expense		16,317	10,239		26,556
General and administrative expenses			8,629		8,629
Depreciation and amortization		1,076	1,481		2,557
Total operating expenses		79,477	114,815		194,292
Operating income		2,620	3,753		6,373
Interest and other income		105	308		413
Interest expense		(11)	(775)		(786)
Equity in earnings of subsidiaries	3,196			(3,196)	
Income from continuing operations before income taxes	3,196	2,714	3,286	(3,196)	6,000
Provision for income taxes					
Income from continuing operations	3,196	2,714	3,286	(3,196)	6,000
Loss from discontinuing operations			(2,804)		(2,804)
Net income	$ 3,196	$ 2,714	$ 482	$ (3,196)	$ 3,196

Consolidating Statement of Operations

For the nine months ended September 30, 2007

	Parent	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Eliminations	Consolidated
Revenues:					
Senior living revenue	$	$ 254,704	$ 346,615	$	$ 601,319
Hospital revenue			76,711		76,711
Pharmacy revenue			51,303		51,303
Total revenues		254,704	474,629		729,333
Operating expenses:					
Senior living wages and benefits		113,373	193,124		306,497
Other senior living operating expenses		75,605	73,794		149,399
Hospital expenses			69,585		69,585
Pharmacy expenses			49,763		49,763
Rent expense		50,039	46,698		96,737
General and administrative expenses			31,703		31,703
Depreciation and amortization		3,572	6,452		10,024
Total operating expenses		242,589	471,119		713,708
Operating income		12,115	3,510		15,625
Interest and other income		(5)	4,348		4,343
Interest expense			(4,919)		(4,919)
Gain on extinguishment of debt			4,491		4,491
Equity in earnings of subsidiaries	16,604			(16,604)	
Income from continuing operations before income taxes	16,604	12,110	7,430	(16,604)	19,540
Provision for income taxes			760		760
Income from continuing operations	16,604	12,110	6,670	(16,604)	18,780
Loss from discontinued operations			(2,176)		(2,176)
Net income	$ 16,604	$ 12,110	$ 4,494	$ (16,604)	$ 16,604

Consolidating Statement of Operations

For the nine months ended September 30, 2006

	Parent	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Eliminations	Consolidated
Revenues:					
Senior living revenue	$	$ 245,249	$ 304,830	$	$ 550,079
Pharmacy revenue			38,240		38,240
Total revenues		245,249	343,070		588,319
Operating expenses:					
Senior living wages and benefits		107,222	174,471		281,693
Other senior living operating expenses		74,344	64,819		139,163

Pharmacy expenses			36,891		36,891
Management fee to SLS		7,792			7,792
Termination expense for SLS management agreements		89,833			89,833
Rent expense		48,554	29,455		78,009
General and administrative expenses			23,867		23,867
Depreciation and amortization		3,040	4,074		7,114
Total operating expenses		330,785	333,577		664,362
Operating (loss) income		(85,536)	9,493		(76,043)
Interest and other income		247	1,306		1,553
Interest expense		(15)	(2,404)		(2,419)
Equity in earnings of subsidiaries	(82,335)			82,335	
(Loss) income from continuing operations before income taxes	(82,335)	(85,304)	8,395	82,335	(76,909)
Provision for income taxes					
(Loss) income from continuing operations	(82,335)	(85,304)	8,395	82,335	(76,909)
Loss from discontinued operations		(95)	(5,331)		(5,426)
Net (loss) income	$ (82,335)	$ (85,399)	$ 3,064	$ 82,335	$ (82,335)

Condensed Consolidating Balance Sheet

As of September 30, 2007

	Parent	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Eliminations	Consolidated
ASSETS					
Current assets:					
Cash and cash equivalents	$	$ 3,667	$ 16,208	$	$ 19,875
Accounts receivable, net		11,559	47,073		58,632
Prepaid expenses		155	8,873		9,028
Investments in trading securities			77,472		77,472
Restricted cash and other current assets		7,195	13,468		20,663
Total current assets		22,576	163,094		185,670
Property and equipment, net		29,415	103,461		132,876
Investment in subsidiary and long term receivable from (to) subsidiaries	200		200	(400)	
Intercompany	228,527			(228,527)	
Restricted cash and investments, goodwill and other long term assets			43,549		43,549
	$ 228,727	$ 51,991	$ 310,304	$ (228,927)	$ 362,095
LIABILITIES AND SHAREHOLDERS EQUITY					
Current liabilities:					
Accounts payable and other current liabilities	$	$ 22,216	$ 51,969	$	$ 74,185
Accrued compensation		7,942	27,038		34,980
Mortgage notes payable			158		158
Total current liabilities		30,158	79,165		109,323
Long term liabilities:					
Mortgage notes payable			15,909		15,909
Convertible senior notes			126,500		126,500
Notes payable to related parties	200			(200)	
Other long term liabilities		5,949	22,096		28,045
Total long term liabilities	200	5,949	164,505	(200)	170,454
Total shareholders equity	228,527	15,884	66,634	(228,727)	82,318
	$ 228,727	$ 51,991	$ 310,304	$ (228,927)	$ 362,095

Condensed Consolidating Balance Sheet

As of December 31, 2006

	Parent	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Eliminations	Consolidated
ASSETS					
Current assets:					
Cash and cash equivalents	$	$ 8,065	$ 38,176	$	$ 46,241
Accounts receivable, net		13,209	54,582		67,791
Investments in trading securities			50,434		50,434
Prepaid expenses and other currentassets		8,353	32,941		41,294
Total current assets		29,627	176,133		205,760
Property and equipment, net		23,061	91,837		114,898
Investment in subsidiary and long term receivable from (to) subsidiaries	200		200	(400)	
Restricted cash and investments		3,072	11,750		14,822
Intercompany	228,656			(228,656)	
Other long term assets			30,931		30,931
	$ 228,856	$ 55,760	$ 310,851	$ (229,056)	$ 366,411
LIABILITIES AND SHAREHOLDERS EQUITY					
Current liabilities:					
Accounts payable and other current liabilities	$	$ 41,852	$ 57,760	$	$ 99,612
Mortgage notes payable			33,317		33,317
Total current liabilities		41,852	91,077		132,929
Long term liabilities:					
Mortgage notes payable			11,454		11,454
Convertible senior notes			126,500		126,500
Notes payable to related parties	200			(200)	
Other long term liabilities		6,431	21,667		28,098
Total long term liabilities	200	6,431	159,621	(200)	166,052
Total shareholders equity	228,656	7,477	60,153	(228,856)	67,430
	$ 228,856	$ 55,760	$ 310,851	$ (229,056)	$ 366,411

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Condensed Consolidating Cash Flow Statement

For the nine months ended September 30, 2007

	Parent	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Eliminations	Consolidated
Cash Flows from operating activities:					
Net income	$ 16,604	$ 12,005	$ 4,599	$ (16,604)	$ 16,604
Undistributed equity in earnings of subsidiaries	(16,604)			16,604	
Adjustments to reconcile net income to cash provided by (used in) operating activities, net		(9,889)	16,985		7,096
Net cash provided by (used in) operating activities		2,116	21,584		23,700
Cash Flows from investing activities:					
Capital expenditures		(20,365)	(40,322)		(60,687)
Proceeds from the sale of property and equipment		10,354	22,723		33,077
Other, net		3,497	(1,740)		1,757
Net cash used in investing activities		(6,514)	(19,339)		(25,853)
Cash Flows from financing activities:					
Change in borrowings, net			(24,213)		(24,213)
Net cash used in financing activities			(24,213)		(24,213)
Change in cash and cash equivalents		(4,398)	(21,968)		(26,366)
Cash and cash equivalents at beginning of period		8,065	38,176		46,241
Cash and cash equivalents at end of period	$	$ 3,667	$ 16,208	$	$ 19,875

Condensed Consolidating Cash Flow Statement

For the nine months ended September 30, 2006

	Parent	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Eliminations	Consolidated
Cash Flows from operating activities:					
Net (loss) income	$ (82,335)	$ (85,399)	$ 3,064	$ 82,335	$ (82,335)
Undistributed equity in earnings of subsidiaries	82,335			(82,335)	
Adjustments to reconcile net income to cash provided by (used in) operating activities, net		83,315	(85,895)		(2,580)
Net cash used in operating activities		(2,084)	(82,831)		(84,915)
Cash Flows from investing activities:					
Capital expenditures		(9,665)	(28,324)		(37,989)
Proceeds from the sale of property and equipment		6,182	10,604		16,786
Other, net		990	(4,945)		(3,955)
Net cash used in investing activities		(2,493)	(22,665)		(25,158)
Cash Flows from financing activities:					
Change in borrowings, net			114,215		114,215
Proceeds from issuance of common shares, net			(417)		(417)

Net cash provided by financing activities			113,798		113,798
Change in cash and cash equivalents		(4,577)	8,302		3,725
Cash and cash equivalents at beginning of period		7,076	9,300		16,376
Cash and cash equivalents at end of period	$	$ 2,499	$ 17,602	$	$ 20,101

Item 2. Management s discussion and Analysis of Financial Conditions and Results of Operations

RESULTS OF OPERATIONS

Our reportable segments consist of our senior living community business and our rehabilitation hospital business that we began to operate in October 2006. In the senior living community segment, we operate independent living and congregate care communities, assisted living communities and nursing homes. Our rehabilitation hospital segment provides inpatient health rehabilitation services at our two hospital locations and three satellite locations and outpatient health rehabilitation services at 20 outpatient clinics. We did not report our rehabilitation hospital business as a separate segment in 2006 since we only began to operate these hospitals in October 2006. We do not consider our pharmacy operations to be a significant, separately reportable segment of our business but we report our pharmacy revenues and expense as separate items within our corporate and other activities. All of our operations and assets are located in the United States.

We use segment operating profit as an important measure to evaluate our performance and for decision making purposes. Segment operating profit excludes interest and other income, interest expense and certain corporate expenses.

Key Statistical Data (for the three months ended September 30, 2007 and 2006):

The following tables present a summary of our operations for the three months ended September 30, 2007 and 2006:

Senior living communities:

	Three months ended September 30,			
(dollars in thousands, except per day amounts)	2007	2006	$ Variance	Change
Senior living revenue	$ 203,656	$ 186,642	$ 17,014	9%
Senior living wages and benefits	100,659	96,374	4,285	4%
Other senior living operating expenses	50,988	44,881	6,107	14%
Management fee to SLS		1,400	(1,400)	-100%
Rent expense	29,943	26,556	3,387	13%
Depreciation and amortization	2,405	1,979	426	22%
Interest expense	226	667	(441)	-66%
Senior living income from continuing operations	19,435	14,785	4,650	31%
No. of communities (end of period)	161	154	7	5%
No. of living units (end of period)	17,911	17,401	510	3%
Occupancy	90.4%	91.0%		-0.6%
Average daily rate	$ 137	$ 128	$ 9	7%
Percent of senior living revenue from Medicare	15%	15%		
Percent of senior living revenue from Medicaid	18%	19%		-1%
Percent of senior living revenue from private and other sources	67%	66%		1%

Comparable communities (communities that we operated continuously since July 1, 2006):

	Three months ended September 30,			
(dollars in thousands, except per day amounts)	2007	2006	$ Variance	Change
Senior living revenue	$ 194,116	$ 185,021	$ 9,095	5%
Senior living community expenses	143,787	140,277	3,510	3%
No. of communities (end of period)	149	149		
No. of living units (end of period)	16,618	16,618		
Occupancy	90.8%	91.2%		-0.4%

Average daily rate	$	140	$	133	7	5%
Percent of senior living revenue from Medicare		15%		15%		
Percent of senior living revenue from Medicaid		19%		19%		
Percent of senior living revenue from private and other sources		66%		66%		

Rehabilitation hospitals:

(dollars in thousands)	Three months ended September 30, 2007	2006	$ Variance	Change
Hospital revenues	$ 25,361	$	$ 25,361	$
Hospital expenses	22,588		22,588	
Rent expense	2,564		2,564	
Depreciation and amortization	294		294	
Hospital loss from continuing operations	(85)		(85)	

Corporate and Other (1):

(dollars in thousands)	Three months ended September 30, 2007	2006	$ Variance	Change
Pharmacy revenue	$ 18,141	$ 14,023	$ 4,118	29%
Pharmacy expenses	17,493	13,895	3,598	26%
Depreciation and amortization	881	578	303	52%
General and administrative (2)	10,757	8,629	2,128	25%
Interest and other income	1,511	413	1,098	266%
Interest expense	1,238	119	1,119	940%
Provision for income taxes	277		277	
Corporate and Other loss from continuing operations	(10,994)	(8,785)	(2,209)	25%

(1) Corporate and Other includes operations that we do not consider significant, separately reportable segments of our business and income and expenses that are not attributable to a specific segment.

(2) General and administrative expenses are not attributable to a specific segment and include items such as corporate payroll and benefits and outside service expenses.

Consolidated:

(dollars in thousands)	Three months ended September 30, 2007	2006	$ Variance	Change
Summary of revenue:	$ 203,656	$ 186,642	$ 17,014	9%
Senior living revenue	25,361		25,361	
Hospital revenue	18,141	14,023	4,118	29%
Corporate and Other	247,158	200,665	46,493	23%
Total revenue				
Summary of income (loss) from continuing operations:				
Senior living communities	19,435	14,785	4,650	31%
Rehabilitation hospitals	(85)		(85)	
Corporate and Other	(10,994)	(8,785)	(2,209)	25%
Income from continuing operations	8,356	6,000	2,356	39%

Three Months Ended September 30, 2007, Compared to Three Months Ended September 30, 2006

Senior living communities:

The 9% increase in senior living revenue is due primarily to revenues from the 11 communities we acquired in the third and fourth quarters of 2006, the one community we acquired in April 2007 and higher per diem charges to residents, partially offset by a decrease in occupancy. The 5% increase in senior living revenue at the communities that we have operated continuously since July 1, 2006 is due primarily to higher per diem charges to residents, partially offset by a decrease in occupancy.

Our 4% increase in senior living wages and benefits costs is primarily due to wages and benefits at the 11 communities we acquired in the third and fourth quarters of 2006, the one community we acquired in April 2007 and wage increases. The 14% increase in other senior living operating expenses, which include utilities, housekeeping, dietary, maintenance, insurance and community level administrative costs, primarily results from the other operating expenses at the 11 communities we acquired in the third and fourth quarters of 2006, the one community we acquired in April 2007, and increased charges from third parties. The senior living community expenses for the senior living communities that we have operated continuously since July 1, 2006 have increased by 3%, principally due to wage and benefit increases. Management fees to SLS were eliminated due to our termination of the last of our management agreements with SLS in 2006. The 13% rent expense increase is due to the communities that we began to lease in 2006 and our payment of additional rent for senior living community capital improvements purchased by Senior Housing since January 1, 2006.

The 22% increase in depreciation and amortization expense for the three months ended September 30, 2007 is primarily attributable to our purchase of furniture and fixtures for our communities as well as the one community we acquired in April 2007.

Our interest expense decreased by 66% because in February 2007 we prepaid six HUD insured mortgages that were secured by five of our communities. We recognized a net gain of $3.6 million on extinguishments of these mortgages that consisted of the elimination of $4.3 million of debt premium offset by $725,000 in prepayment penalties. In April 2007, we prepaid an additional HUD insured mortgage that was secured by one of our communities. We recognized a net gain of $934,000 on extinguishment of this mortgage that consisted of the elimination of $1,049,000 of debt premium offset by $115,000 in prepayment penalties. This decrease was partially offset by interest we incurred on a $4.6 million HUD insured mortgage that we assumed in connection with the community we acquired in April 2007.

Rehabilitation hospitals:

The increase in hospital revenues, hospital expenses, rent expense and depreciation and amortization expense from our hospitals is a result of our beginning operations at our hospitals in October 2006. We are currently experiencing losses from our operation of our two rehabilitation hospitals, and we may be unable to operate these hospitals profitably. Also, the percentage of patients at one of our hospitals who are required to meet certain Medicare requirements has recently increased and this percentage requirement will increase at both of our hospitals in the future. We believe that we are in compliance with these current Medicare requirements. Although we expect to be in compliance with future requirements, the actual percentage of patients at these hospitals who meet these Medicare requirements may not remain as high as we currently anticipate or may decline and, as a result, we may not remain in compliance. Failure to remain in compliance will result in these hospitals receiving lower Medicare reimbursement rates than we currently anticipate. We cannot estimate the impact this may have but it may be material to our operations and may adversely affect our future results of operations.

Corporate and other:

The 29% and 26% increase in revenues and expenses, respectively from our pharmacies is primarily the result of our acquiring one pharmacy in November 2006.

The 25% increase in general and administrative expenses for the three months ended September 30, 2007 over the same period in 2006 results from our acquisition of 11 communities in the third and fourth quarters of 2006, from the communities we began to operate in 2006 that were previously managed for us by SLS and from the rehabilitation hospitals we began to operate in October 2006.

The 52% increase in depreciation and amortization expense for the three months ended September 30, 2007 is primarily attributable to increases in assets associated with our pharmacy acquisitions.

Our interest and other income increased by $1.1 million or 266%, for the three months ended September 30, 2007, compared to the three months ended September 30, 2006, primarily as a result of higher levels of investable cash proceeds from our convertible senior notes offering.

Our interest expense increased by $1.1 million, due to the issuance of our convertible senior notes in October 2006.

For the quarter ended September 30, 2007, we recognized taxes of $277,000, which includes $224,000 of alternative minimum taxes and certain state taxes that are payable without regard to our tax loss carry forwards and $53,000 of a deferred tax liability arising from the amortization of goodwill for tax purposes but not for book purposes.

Key Statistical Data (for the nine months ended September 30, 2007 and 2006):

The following tables present a summary of our operations for the nine months ended September 30, 2007 and 2006:

Senior living communities:

	Nine months ended September 30,			
	2007	**2006**	**$ Variance**	**Change**
(dollars in thousands, except per day amounts)				
Senior living revenue	$ 601,319	$ 550,079	$ 51,240	9%
Senior living wages and benefits	306,497	281,693	24,804	9%
Other senior living operating expenses	149,399	139,163	10,236	7%
Management fee to SLS		7,792	(7,792)	-100%
Termination expense for certain SLS management agreements		89,833	(89,833)	-100%
Rent expense	89,042	78,009	11,033	14%
Depreciation and amortization	6,926	5,593	1,333	24%
Interest expense	882	2,031	(1,149)	-57%
Gain on extinguishment of debt	4,491		4,491	
Senior living income from continuing operations	53,064	(54,037)	107,101	-198%
No. of communities (end of period)	161	154	7	5%
No. of living units (end of period)	17,911	17,401	510	3%
Occupancy	90.4%	91.2%		-0.8%
Average daily rate	$ 136	$ 127	$ 9	7%
Percent of net revenues from residents from Medicare	15%	16%		-1%
Percent of net revenues from residents from Medicaid	18%	19%		-1%
Percent of net revenues from residents from private and other sources	67%	65%		2%

Comparable communities (communities that we operated continuously since January 1, 2006):

	Nine months ended September 30,			
	2007	**2006**	**$ Variance**	**Change**
(dollars in thousands, except per day amounts)				
Net revenues from residents	$ 573,969	$ 548,458	$ 25,511	5%
Community expenses	433,213	419,880	13,333	3%
No. of communities (end of period)	149	149		
No. of living units (end of period)	16,618	16,618		
Occupancy	90.7%	91.3%		-0.6%
Average daily rate	$ 139	$ 132	$ 7	5%
Percent of net revenues from residents from Medicare	16%	16%		
Percent of net revenues from residents from Medicaid	19%	19%		
Percent of net revenues from residents from private and other sources	65%	65%		

Rehabilitation hospitals:

	Nine months ended September 30, 2007	2006	$ Variance	Change
(dollars in thousands)				
Hospital revenues	$ 76,711	$	$ 76,711	
Hospital expenses	69,585		69,585	
Rent expense	7,695		7,695	
Depreciation and amortization	787		787	
Hospital loss from continuing operations	(1,356)		(1,356)	

Corporate and Other (1):

	Nine months ended September 30,			
	2007	2006	$ Variance	Change
(dollars in thousands)				
Pharmacy revenue	$ 51,303	$ 38,240	$ 13,063	34%
Pharmacy expenses	49,763	36,891	12,872	35%
Depreciation and amortization	2,311	1,519	792	52%
General and administrative (2)	31,703	23,867	7,836	33%
Interest and other income	4,343	1,555	2,788	179%
Interest expense	4,037	388	3,649	940%
Provision for income taxes	760		760	
Corporate and Other loss from continuing operations	(32,928)	(22,872)	(10,056)	44%

(1) Corporate and Other includes operations that we do not consider significant, separately reportable segments of our business and income and expenses that are not attributable to a specific segment.

(2) General and administrative expenses are not attributable to a specific segment and include items such as corporate payroll and benefits and outside service expenses.

Consolidated:

	Nine months ended September 30,			
	2007	2006	$ Variance	Change
(dollars in thousands)				
Summary of revenue:	$ 601,319	$ 550,079	$ 51,240	9%
Senior living revenue	76,711		76,711	
Hospital revenue	51,303	38,240	13,063	34%
Corporate and Other	729,333	588,319	141,014	24%
Total revenue				
Summary of income (loss) from continuing operations:				
Senior living communities	53,064	(54,037)	107,101	-198%
Rehabilitation hospitals	(1,356)		(1,356)	
Corporate and Other	(32,928)	(22,872)	(10,056)	44%
Income from continuing operations	18,780	(76,909)	95,689	-124%

Nine Months Ended September 30, 2007, Compared to Nine Months Ended September 30, 2006

Senior living communities:

The 9% increase in senior living revenue is due primarily to revenues from the 11 communities we acquired in the third and fourth quarters of 2006, the one community we acquired in April 2007, and higher per diem charges to residents, partially offset by a decrease in occupancy. The 5% increase in senior living revenue at the communities that we have operated continuously since January 1, 2006 is due primarily to higher per diem charges to residents, partially offset by a decrease in occupancy.

Our 9% increase in senior living wages and benefits costs is primarily due to wages and benefits at the 11 communities we acquired in the third and fourth quarters of 2006, the one community we acquired in April 2007, and wage increases. The 7% increase in other senior living operating expenses, which include utilities, housekeeping, dietary, maintenance, insurance and community level administrative costs, primarily results from the other operating expenses at the 11 communities we acquired in the third and fourth quarters of 2006, the one community we acquired in April 2007, and increased charges from third parties. The senior living community expenses for the senior living communities that we have operated continuously since January 1, 2006 have increased by 3%, principally due to wage and benefit increases. Management fees to SLS were eliminated due to our termination of the last of our management agreements with SLS in 2006. The 14% rent expense increase is due to the communities that we began to lease in 2006 and our payment of additional rent for senior living community capital improvements purchased by Senior Housing since January 1, 2006.

The 24% increase in depreciation and amortization expense for the nine months ended September 30, 2007 is primarily attributable to our purchase of furniture and fixtures for our communities as well as the one community we acquired in April 2007.

Our interest expense decreased by 57% because in February 2007 we prepaid six HUD insured mortgages that were secured by five of our communities. We recognized a net gain of $3.6 million on extinguishments of these mortgages that consists of the elimination of $4.3 million of debt premium offset by $725,000 in prepayment penalties. In addition, In April 2007, we prepaid one HUD insured mortgage that was secured by one of our communities. We recognized a net gain of $934,000 on extinguishment of this mortgage that consisted of the elimination of $1,049,000 million of debt premium offset by $115,000 in prepayment penalties. This decrease was partially offset by interest we incurred on a $4.6 million HUD insured mortgage that we assumed in connection with one community we acquired in April 2007.

<u>Rehabilitation hospitals:</u>

The increase in hospital revenues, hospital expenses, rent expense and depreciation and amortization expense from our hospitals is a result of our beginning operations at our hospitals in October 2006. We are currently experiencing losses from our operation of our two rehabilitation hospitals, and we may be unable to operate these hospitals profitably. Also, the percentage of patients at one of our hospitals who are required to meet certain Medicare requirements has recently increased and this percentage requirement will increase at both of our hospitals in the future. We believe that we are in compliance with these current Medicare requirements. Although we expect to be in compliance with future requirements, the actual percentage of patients at these hospitals who meet these Medicare requirements may not remain as high as we currently anticipate or may decline and, as a result, we may not remain in compliance. Failure to remain in compliance will result in these hospitals receiving lower Medicare reimbursement rates than we currently anticipate. We cannot estimate the impact this may have but it may be material to our operations and may adversely affect our future results of operations.

<u>Corporate and other:</u>

The 34% and 35% increase in revenues and expenses, respectively, from our pharmacies is primarily the result of our acquiring one pharmacy in November 2006.

The 33% increase in general and administrative expenses for the nine months ended September 30, 2007 over the same period in 2006 results from our acquisition of 11 communities in the third and fourth quarters of 2006, from the communities we began to operate in 2006 that were previously managed for us by SLS and from the rehabilitation hospitals we began to operate in October 2006.

The 52% increase in depreciation and amortization expense for the nine months ended September 30, 2007 is primarily attributable to increases in assets associated with our pharmacy acquisitions.

Our interest and other income increased by $2.8 million, or 179%, for the nine months ended September 30, 2007, compared to the nine months ended September 30, 2006, primarily as a result of higher levels of investable cash proceeds from our convertible senior notes offering.

Our interest expense increased by $3.6 million, due to the issuance of our convertible senior notes in October 2006.

For the nine months ended September 30, 2007, we recognized taxes of $760,000 which includes $593,000 of alternative minimum taxes and certain state taxes that are payable without regard to our tax loss carry forwards and $167,000 of a deferred tax liability arising from the amortization of goodwill for tax purposes but not for book purposes.

LIQUIDITY AND CAPITAL RESOURCES

Assets and Liabilities

Our total current assets at September 30, 2007 were $185.7 million, compared to $205.8 million at December 31, 2006. At September 30, 2007 and December 31, 2006, we had cash and cash equivalents of $19.9 million and $46.2 million, respectively. Our current liabilities were $109.3 million at September 30, 2007, compared to $132.9 million at December 31, 2006. The decrease in both current assets and current liabilities is primarily the result of our prepayment of seven mortgages in 2007.

Our Leases with Senior Housing

As of November 7, 2007, we lease 142 senior living communities and two rehabilitation hospitals that we operate from Senior Housing under six leases. Our leases with Senior Housing require us to pay minimum rent of $127.6 million annually and percentage rent for most senior living communities. In addition to the minimum rent, we paid approximately $690,000 and $244,000 in percentage rent to Senior Housing for the three months ended September 30, 2007 and 2006, respectively, and $1.9 million and $876,000 for the nine months ended September 30, 2007 and 2006, respectively.

Upon our request, Senior Housing reimburses our capital expenditures made at the communities we lease from Senior Housing and increases our rent expense pursuant to contractual formulas. Senior Housing reimbursed us $33.1 million during the nine months ended September 30, 2007 for capital expenditures made at these leased communities and increased our annual rent by $3.2 million.

Our Revenues

Our revenues from services to residents at our senior living communities are our primary source of cash to fund our operating expenses, including rent, principal and interest payments on our debt and our capital expenditures. At some of our communities, operating revenues for nursing home services are received from the Medicare and Medicaid programs. Medicare and Medicaid revenues from senior living services were earned primarily at our 49 nursing homes. We derived 34% of our senior living revenue from these programs in each of the three and nine month periods ended September 30, 2007 and 2006.

Our net Medicare revenues from senior living community residents totaled $91.8 million and $85.0 million for the nine months ended September 30, 2007 and 2006, respectively. In October 2007 and 2006 our senior living community Medicare rates increased by approximately 3.6% and 3.3%, respectively. Our net Medicaid revenues from senior living community residents totaled $108.5 million and $106.0 million for the nine months ended September 30, 2007 and 2006, respectively. The Bush administration and certain members of the Senate and the House of Representatives have proposed Medicare and Medicaid policy changes and rate reductions to be phased in during the next several years. In addition, some of the states in which we operate either have not raised Medicaid rates by amounts sufficient to offset increasing costs or are expected to reduce Medicaid funding. The magnitude of the potential Medicare and Medicaid rate reductions and the impact of the failure of these programs to increase rates to match increasing expenses, as well as the magnitude of the potential Medicare and Medicaid policy changes, cannot currently be estimated, but they may be material to our operations and may affect our future results of operations.

We began to operate two rehabilitation hospitals in October 2006. Approximately 68% and 69% of our revenues from these hospitals came from the Medicare and Medicaid programs for the three and nine months ended September 30, 2007, respectively. In October 2007 our rehabilitation hospital Medicare rates increased by approximately 3.5% over the prior period. In May 2004, the Federal Centers for Medicare and Medicaid Services, or CMS, issued a rule known as the 75% Rule , establishing revised Medicare standards that rehabilitation hospitals are required to meet in order to participate as inpatient rehabilitation facilities, or IRFs, in the Medicare program. The 75% Rule is being phased in over a four year period that began on July 1, 2004. For cost reporting periods starting on and after July 1, 2006, 60% of a facility s inpatient population must require intensive rehabilitation services for one of the CMS designated medical conditions. For cost reporting periods starting on and after July 1, 2007, the requirement is 65% and for cost reporting periods starting on and after July 1, 2008, the requirement is 75%. An IRF that fails to meet the requirements of the 75% Rule is subject to reclassification as a different type of healthcare provider and the effect of such reclassification would be to lower Medicare payment rates. As of September 30, 2007 and November 7, 2007, we believe we are in compliance with the requirements of this rule necessary for our hospitals to remain classified as IFRs. However, the actual percentage of patients at these hospitals who meet these Medicare requirements may not remain as high as we currently anticipate or may decline and, as a result, we may not remain in compliance. Failure to remain in compliance will result in these hospitals receiving lower Medicare rates than we currently anticipate.

Debt Instruments and Covenants

In June 2007, we amended of our revolving line of credit. The amendment increased the line from $25.0 million to $40.0 million, extended the termination date to May 8, 2009 and reduced the interest rate by 25 basis points. Our revolving line of credit is available for acquisitions, working capital and general business purposes. The amount we are able to borrow at any time is subject to limitations based upon qualifying collateral. We are the borrower under this revolving credit facility and certain of our subsidiaries guarantee our obligations under the facility, which is secured by our and our guarantor subsidiaries accounts receivable, deposit accounts and related assets.

The facility contains covenants requiring us to maintain collateral, minimum net worth and certain other financial ratios, limits our ability to incur or assume debt or create liens with respect to certain of our properties and has other customary provisions. In certain circumstances and subject to available collateral and lender approvals, the maximum amounts which we may draw under this credit facility may be increased to $80.0 million. The termination date may be extended twice, in each case by twelve months, subject to lender approval, our payment of extension fees and other conditions. As of September 30, 2007 and November 7, 2007, no amounts were outstanding under this credit facility. As of September 30, 2007 and November 7, 2007 we believe we are in compliance with all applicable covenants under this credit facility.

In October 2006, we issued $126.5 million principal amount of 3.75% convertible senior notes. Our net proceeds from this offering were approximately $122.6 million. These notes are convertible into our common shares at any time. The initial conversion rate, which is subject to adjustment, is 76.9231 common shares per $1,000 principal amount of notes, which represents an initial conversion price of $13.00 per share. The notes are guaranteed by certain of our wholly owned subsidiaries. These notes mature on October 15, 2026; we may prepay them at anytime after October 20, 2011 and the note holders may require that we purchase all or a portion of these notes on each October 15 of 2013, 2016 and 2021. We issued these notes pursuant to an indenture which contains various customary covenants. As of September 30, 2007 and November 7, 2007, we believe we are in compliance with all applicable covenants of the indenture.

At September 30, 2007, we had five HUD insured mortgage loans totaling $16.1 million that were secured by four properties. The weighted average interest rate on these loans was 6.6 %. Payments of principal and interest are due monthly until maturities at varying dates ranging from June 2035 to July 2043. These mortgages contain standard HUD mortgage covenants. We recorded mortgage premiums in connection with some of these HUD mortgages in order to record assumed mortgages at their estimated fair value. The mortgage premiums are being amortized as a reduction of interest expense until the maturity of the mortgages. The mortgage premium balance included in mortgage notes payable as of September 30, 2007 was $797,000.

In February 2007, we prepaid six mortgages that were secured by five of our senior living communities. We paid $22.9 million to retire these six mortgages, which consisted of approximately $22.2 million in principal and interest and $725,000 in prepayment penalties. Because we had carried these mortgages at a premium to their face value, we recognized a net gain of $3.6 million in connection with the early extinguishment of debt. In April 2007, we prepaid one mortgage that was secured by one of our communities. We paid $5.9 million to retire this mortgage, which consisted of approximately $5.8 million in principal and interest and $115,000 in prepayment penalties. Because we had carried this mortgage at a premium to its face value, we recognized a net gain of $934,000 in connection with the early extinguishment of debt.

In April 2007, we acquired a 48 unit assisted living community located in Tennessee for $5.0 million. We financed the acquisition by assuming a $4.6 million non recourse HUD insured mortgage and paying the balance of the purchase price with cash on hand. The interest rate on the assumed HUD insured mortgage is 7.65%.

As of September 30, 2007 and November 7, 2007, we believe we are in compliance with all covenants of our mortgages.

Seasonality

Our business is subject to modest effects of seasonality. During the calendar fourth quarter holiday periods, nursing home and assisted living residents are sometimes discharged to join family celebrations and admission decisions are often deferred. The first quarter of each calendar year usually coincides with increased illness among nursing home and assisted living residents that can result in increased costs or discharges to hospitals. As a result of these factors, nursing home and assisted living operations sometimes produce greater earnings in the second and third quarters of a calendar year and lesser earnings in the first and fourth quarters. We do not believe that this seasonality will cause fluctuations in our revenues or operating cash flow to such an extent that we will have difficulty paying our expenses, including rent, which do not fluctuate seasonally.

Related Party Transactions

We lease 142 of the 161 senior living communities and the two rehabilitation hospitals that we operate from Senior Housing for total annual minimum rent of $127.6 million. In addition to the minimum rent, we paid approximately $690,000 and $244,000 in percentage rent to Senior Housing for the three months ended September 30, 2007 and 2006, respectively, and approximately $1.9 million and $876,000 for the nine months ended September 30, 2007 and 2006, respectively.

During the nine months ended September 30, 2007, as permitted by our leases with Senior Housing, we sold to Senior Housing, at cost, $33.1 million of improvements made to properties leased from Senior Housing, and the annual rent payable to Senior Housing increased by approximately $3.2 million.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

We are exposed to risks associated with market changes in interest rates. We manage our exposure to this market risk by monitoring available financing alternatives. Our strategy to manage exposure to changes in interest rates remains unchanged since December 31, 2006. Other than as described below, we do not now anticipate any significant changes in our exposure to fluctuations in interest rates or in how we manage this risk in the future. Changes in market interest rates also affect the fair value of our debt obligations; increases in market interest rates decrease the fair value of our fixed rate debt, while decreases in market interest rates increase the fair value of our fixed rate debt. For example: based upon discounted cash flow analysis, if prevailing interest rates were to decline by 10% of existing interest rates and other credit market considerations remained unchanged, the market value of our $142.6 million mortgage debt and convertible notes outstanding on September 30, 2007, would increase by about $5.7 million; and, similarly, if prevailing interest rates were to increase by 10% of existing interest rates, the market value of our $142.6 million mortgage debt and convertible notes would decline by about $5.3 million.

Our revolving credit facility bears interest at floating rates and matures in May 2009. As of September 30, 2007 and November 7, 2007, no amounts were outstanding under this credit facility. We borrow in U.S. dollars and borrowings under our revolving credit facility bear interest at LIBOR plus a premium. Accordingly, we are vulnerable to changes in U.S. dollar based short term interest rates, specifically LIBOR. A change in interest rates would not affect the value of any outstanding floating rate debt but could affect our operating results. For example, if the maximum amount of $40.0 million were drawn under our credit facility and interest rates decreased or increased by 1% per annum, our interest expense would decrease or increase by $400,000 per year, or $0.01 per share, based on our currently outstanding common shares. If interest rates were to change gradually over time, the impact would occur over time.

Our exposure to fluctuations in interest rates may increase in the future if we incur debt to fund acquisitions or otherwise.

Item 4. Controls and Procedures

As of the end of the period covered by this report, our management carried out an evaluation, under the supervision and with the participation of our President and Chief Executive Officer and our Treasurer and Chief Financial Officer, of the effectiveness of our disclosure controls and procedures pursuant to Rules 13a-15(e) and 15d-15(e). Based upon that evaluation, our President and Chief Executive Officer and our Treasurer and Chief Financial Officer concluded that our disclosure controls and procedures are effective.

There have been no changes in our internal control over financial reporting during the quarter ended September 30, 2007, that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

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There have been no changes in our internal control over financial reporting during the quarter ended September 30

WARNING CONCERNING FORWARD LOOKING STATEMENTS

THIS QUARTERLY REPORT CONTAINS STATEMENTS WHICH CONSTITUTE FORWARD LOOKING STATEMENTS WITHIN THE MEANING OF THE PRIVATE SECURITIES LITIGATION REFORM ACT OF 1995 AND OTHER FEDERAL SECURITIES LAWS. ALSO, WHENEVER WE USE WORDS SUCH AS BELIEVE , EXPECT , ANTICIPATE , INTEND , PLAN , ESTIMATE OR SIMILAR EXPRESSIONS, WE ARE MAKING FORWARD LOOKING STATEMENTS. THESE FORWARD LOOKING STATEMENTS ARE BASED UPON OUR PRESENT INTENT, BELIEFS OR EXPECTATIONS, BUT FORWARD LOOKING STATEMENTS ARE NOT GUARANTEED TO OCCUR AND MAY NOT OCCUR. ACTUAL REULTS MAY DIFFER MATERIALLY FROM THOSE CONTAINED IN OR IMPLIED BY OUR FORWARD LOOKING STATEMENTS AS A RESULT OF VARIOUS FACTORS.

IMPORTANT FACTORS THAT COULD CAUSE ACTUAL RESULTS TO DIFFER MATERIALLY FROM THOSE IN OUR FORWARD LOOKING STATEMENTS INCLUDE, WITHOUT LIMITATION:

WE ARE CURRENTLY EXPERIENCING LOSSES FROM OUR OPERATION OF OUR TWO REHABILITATION HOSPITALS, AND WE MAY BE UNABLE TO OPERATE THESE HOSPITALS PROFITABLY. ALSO, THE PERCENTAGE OF PATIENTS AT ONE OF OUR HOSPITALS WHO ARE REQUIRED TO MEET CERTAIN MEDICARE REQUIREMENTS HAS RECENTLY INCREASED AND THIS PERCENTAGE REQUIREMENT WILL INCREASE AT BOTH OF THESE HOSPITALS IN THE FUTURE. WE BELIEVE THAT WE ARE IN COMPLIANCE WITH THESE CURRENT MEDICARE REQUIREMENTS. ALTHOUGH WE EXPECT TO BE IN COMPLIANCE WITH FUTURE REQUIREMENTS, THE ACTUAL PERCENTAGE OF PATIENTS AT THESE HOSPITALS WHO MEET THESE MEDICARE REQUIREMENTS MAY NOT REMAIN AS HIGH AS WE CURRENTLY ANTICIPATE OR MAY DECLINE; AND, AS A RESULT, WE MAY NOT REMAIN IN COMPLIANCE. FAILURE TO REMAIN IN COMPLIANCE WILL RESULT IN THESE HOSPITALS RECEIVING LOWER MEDICARE REIMBURSEMENT RATES THAN WE CURRENTLY ANTICIPATE. WE CANNOT ESTIMATE THE IMPACT THIS MAY HAVE BUT IT MAY BE MATERIAL TO OUR OPERATIONS AND MAY ADVERSELY AFFECT OUR FUTURE RESULTS OF OPERATIONS.

OTHER RISKS MAY ADVERSELY IMPACT US, AS DESCRIBED MORE FULLY UNDER ITEM 1A. RISK FACTORS IN OUR ANNUAL REPORT ON FORM 10-K FOR THE YEAR ENDED DECEMBER 31, 2006.

YOU SHOULD NOT PLACE UNDUE RELIANCE UPON FORWARD LOOKING STATEMENTS.

EXCEPT AS REQUIRED BY LAW, WE UNDERTAKE NO OBLIGATION TO UPDATE OR REVISE ANY FORWARD LOOKING STATEMENTS AS A RESULT OF NEW INFORMATION, FUTURE EVENTS OR OTHERWISE.

Part II. Other Information

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

On September 18, 2007, we granted 4,000 shares of common stock, par value $0.01 per share, valued at $8.52 per share, the closing price of our common shares on the American Stock Exchange on that day, to our Director of Internal Audit. We made these grants pursuant to the exemption from registration contained in Section 4(2) of the Securities Act of 1933, as amended.

Item 6. Exhibits

31.1 Rule 13a-14(a) Certification of Chief Executive Officer. (*Filed herewith.*)

31.2 Rule 13a-14(a) Certification of Chief Financial Officer. (*Filed herewith.*)

32.1 Section 1350 Certification of Chief Executive Officer and Chief Financial Officer. (*Furnished herewith.*)

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.

FIVE STAR QUALITY CARE, INC.

/s/ Evrett W. Benton
Evrett W. Benton
President and Chief Executive Officer
Dated: November 8, 2007

/s/ Bruce J. Mackey Jr.
Bruce J. Mackey Jr.
Treasurer and Chief Financial Officer
(Principal Financial Officer)
Dated: November 8, 2007