

ADCARE HEALTH SYSTEMS, INC  
Form 10-Q  
August 14, 2013  
Table of Contents

# UNITED STATES SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

## FORM 10-Q

(Mark One)

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

For the quarterly period ended June 30, 2013

- 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 001-33135

**AdCare Health Systems, Inc.**

(Exact name of registrant as specified in its charter)

Ohio

31-1332119  
(I.R.S. Employer Identification Number)

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(State or other jurisdiction  
of incorporation)

**1145 Hembree Road, Roswell, GA 30076**

(Address of principal executive offices)

**(678) 869-5116**

(Registrant's telephone number, including area code)

**Not Applicable**

(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 Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes  No

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

Large accelerated filer

Accelerated filer

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

Smaller reporting company

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

As of August 8, 2013: 14,869,499 shares of common stock with no par value were outstanding.



Table of Contents

**AdCare Health Systems, Inc.**

**Form 10-Q**

**Table of Contents**

	<b>Page Number</b>
<b><u>Part I.</u></b>	
	<b><u>FINANCIAL INFORMATION</u></b>
<u>Item 1.</u>	4
	4
	5
	6
	7
	8
<u>Item 2.</u>	28
<u>Item 3.</u>	47
<u>Item 4.</u>	48
<b><u>Part II.</u></b>	
	<b><u>OTHER INFORMATION</u></b>
<u>Item 1.</u>	49
<u>Item 1A.</u>	49
<u>Item 2.</u>	49
<u>Item 3.</u>	49
<u>Item 4.</u>	49
<u>Item 5.</u>	50
<u>Item 6.</u>	50
<b><u>Signatures</u></b>	<b>55</b>

Table of Contents

**Forward-Looking Statements**

This Quarterly Report on Form 10-Q and certain information incorporated herein by reference contain forward-looking statements and information within the “safe harbor” provisions of the Private Securities Litigation Reform Act of 1995, Section 27A of the Securities Act of 1933, and Section 21E of the Securities Exchange Act of 1934 (the “Exchange Act”). This information includes assumptions made by, and information currently available to management, including statements regarding future economic performance and financial condition, liquidity and capital resources, and management’s plans and objectives. In addition, certain statements included in this Quarterly Report and the Company’s future filings with the Securities and Exchange Commission (“SEC”), in press releases, and in oral and written statements made by us or with our approval, which are not statements of historical fact, are forward-looking statements. Words such as may, could, should, would, believe, expect, anticipate, estimate, intend, seeks, plan, project, continue, predict, will, should, and other words or expressions of similar meaning by us to identify forward-looking statements, although not all forward-looking statements contain these identifying words. These forward-looking statements are found at various places throughout this Quarterly Report. These statements are based on the Company’s current expectations about future events or results and information that is currently available to us, involve assumptions, risks, and uncertainties, and speak only as of the date on which such statements are made.

All forward-looking statements are subject to the risks and uncertainties inherent in predicting the future. The Company’s actual results may differ materially from those projected, stated or implied in these forward-looking statements as a result of many factors, including the Company’s critical accounting policies and risks and uncertainties related to, but not limited to, overall industry environment, regulatory delays, negative clinical results, and the Company’s financial condition. These and other risks and uncertainties are described in more detail in the Company’s most recent Annual Report on Form 10-K, as well as other reports that the Company files with the SEC.

Forward-looking statements speak only as of the date they are made and should not be relied upon as representing the Company’s views as of any subsequent date. The Company undertakes no obligation to update or revise such statements to reflect new circumstances or unanticipated events as they occur, except as required by applicable laws, and you are urged to review and consider disclosures that the Company makes in this Quarterly Report and other reports that the Company files with the SEC that discuss factors germane to the Company’s business.

Table of Contents**Part I. Financial Information**

## Item 1. Financial Statements

**ADCARE HEALTH SYSTEMS, INC. AND SUBSIDIARIES**

## CONSOLIDATED BALANCE SHEETS

*(Amounts in 000 s)*

	June 30, 2013 (Unaudited)	December 31, 2012
<b><u>ASSETS</u></b>		
Current assets:		
Cash and cash equivalents	\$ 10,222	\$ 15,937
Restricted cash and investments	706	1,742
Accounts receivable, net of allowance of \$4,619 and \$3,729	27,991	26,037
Prepaid expenses and other	1,872	489
Assets of disposal group held for sale	400	6,159
Total current assets	41,191	50,364
Restricted cash and investments	10,808	7,215
Property and equipment, net	150,440	151,064
Intangible assets - bed licenses	2,471	2,471
Intangible assets - lease rights, net	5,672	6,844
Goodwill	5,023	5,023
Escrow deposits for acquisitions	400	
Lease deposits	1,695	1,720
Deferred loan costs, net	5,193	6,137
Other assets	11	3,611
Total assets	\$ 222,904	\$ 234,449
<b><u>LIABILITIES AND EQUITY</u></b>		
Current liabilities:		
Current portion of notes payable and other debt	\$ 13,199	\$ 6,941
Revolving credit facilities and lines of credit	2,355	1,498
Current portion of convertible debt, net of discount	15,536	10,948
Accounts payable	23,490	19,503
Accrued expenses	15,077	13,730
Liabilities of disposal group held for sale	60	3,662
Total current liabilities	69,717	56,282
Notes payable and other debt, net of current portion:		
Senior debt	103,102	112,160
Bonds, net of discounts	15,960	16,088
Revolving credit facilities	6,524	7,706
Convertible debt	7,500	12,009

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Other debt	234	864
Derivative liability	3,284	3,630
Other liabilities	1,444	1,394
Deferred tax liability	104	104
Total liabilities	207,869	210,237
Commitments and contingency (Note 16)		
Preferred stock, no par value; 1,000 shares authorized; 450 shares issued and outstanding	9,159	9,159
Stockholders' equity:		
Common stock and additional paid-in capital, no par value; 29,000 shares authorized; 14,788 and 14,659 issued and outstanding	42,774	41,644
Accumulated deficit	(35,627)	(25,753)
Total stockholders' equity	7,147	15,891
Noncontrolling interest in subsidiaries	(1,271)	(838)
Total equity	5,876	15,053
Total liabilities and equity	\$ 222,904	\$ 234,449

See accompanying notes to unaudited consolidated financial statements

Table of Contents**ADCARE HEALTH SYSTEMS, INC. AND SUBSIDIARIES**

## CONSOLIDATED STATEMENTS OF OPERATIONS

*(Amounts in 000 s, except per share data)*

(Unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2013	2012	2013	2012
<b>Revenues:</b>				
Patient care revenues	\$ 55,923	\$ 46,390	\$ 111,642	\$ 87,889
Management revenues	498	525	1,008	1,049
Total revenues	56,421	46,915	112,650	88,938
<b>Expenses:</b>				
Cost of services (exclusive of facility rent, depreciation and amortization)	47,495	36,476	95,117	71,170
General and administrative expenses	4,505	4,295	9,433	8,248
Audit committee investigation expense	848		1,982	
Facility rent expense	1,758	1,745	3,495	3,503
Depreciation and amortization	1,867	1,426	3,670	2,970
Salary retirement and continuation costs	149		149	
Total expense	56,622	43,942	113,846	85,891
(Loss) Income from Operations	(201)	2,973	(1,196)	3,047
<b>Other Income (Expense):</b>				
Interest expense, net	(3,355)	(3,280)	(6,791)	(5,780)
Acquisition costs, net of gains	(477)	(524)	(574)	(817)
Derivative (loss) gain	(1,947)	352	189	763
Loss on extinguishment of debt	(25)		(27)	
(Loss) gain on disposal of assets	(4)		(4)	2
Other expense		(13)		(29)
Total other expense, net	(5,808)	(3,465)	(7,207)	(5,861)
Loss from Continuing Operations Before Income Taxes	(6,009)	(492)	(8,403)	(2,814)
Income tax expense		(18)	(78)	(19)
Loss from Continuing Operations	(6,009)	(510)	(8,481)	(2,833)
(Loss) Income from Discontinued Operations, net of tax	(936)	163	(1,214)	77
Net Loss	(6,945)	(347)	(9,695)	(2,756)
Net Loss Attributable to Noncontrolling Interests	241	142	433	286
Net Loss Attributable to AdCare Health Systems, Inc.	(6,704)	(205)	(9,262)	(2,470)
Preferred stock dividend	(306)		(612)	
Net Loss Attributable to AdCare Health Systems, Inc. Common Stockholders	\$ (7,010)	\$ (205)	\$ (9,874)	\$ (2,470)



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Net (loss) income per Common Share attributable to  
AdCare Health Systems, Inc.

Common Stockholders -

Basic:

Continuing Operations	\$	(0.41)	\$	(0.03)	\$	(0.59)	\$	(0.20)
Discontinued Operations		(0.06)		0.01		(0.08)		0.01
	\$	(0.47)	\$	(0.02)	\$	(0.67)	\$	(0.19)

Net (loss) income per Common Share attributable to  
AdCare Health Systems, Inc.

Common Stockholders -

Diluted:

Continuing Operations	\$	(0.41)	\$	(0.03)	\$	(0.59)	\$	(0.20)
Discontinued Operations		(0.06)		0.01		(0.08)		0.01
	\$	(0.47)	\$	(0.02)	\$	(0.67)	\$	(0.19)

Weighted Average Common Shares Outstanding:

Basic	14,733	13,463	14,725	12,844
Diluted	14,733	13,463	14,725	12,844

See accompanying notes to unaudited consolidated financial statements

Table of Contents**ADCARE HEALTH SYSTEMS, INC. AND SUBSIDIARIES****CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY***(Amounts in 000 \$)**(Unaudited)*

	<b>Common Stock Shares</b>		<b>Common Stock and Additional Paid-in Capital</b>		<b>Accumulated Deficit</b>		<b>Noncontrolling Interests</b>		<b>Total</b>
Balances, December 31, 2012	14,659	\$	41,644	\$	(25,753)	\$	(838)	\$	15,053
Stock-based compensation expense			551						551
Exercises of options and warrants	38		67						67
Issuance of stock for converted debt	91		512						512
Preferred stock dividend					(612)				(612)
Net loss					(9,262)		(433)		(9,695)
Balances, June 30, 2013	14,788	\$	42,774	\$	(35,627)	\$	(1,271)	\$	5,876

See accompanying notes to unaudited consolidated financial statements

Table of Contents

## ADCARE HEALTH SYSTEMS, INC. AND SUBSIDIARIES

## CONSOLIDATED STATEMENTS OF CASH FLOWS

*(Amounts in 000 s)*

(Unaudited)

	Six Months Ended June 30,	
	2013	2012
Cash flows from operating activities:		
Net loss	\$ (9,695)	\$ (2,756)
Loss (Income) from discontinued operations, net of tax	1,214	(77)
Loss from continuing operations	(8,481)	(2,833)
Adjustments to reconcile net loss from continuing operations to net cash provided by (used in) operating activities:		
Depreciation and amortization	3,670	2,970
Stock-based compensation expense	551	371
Lease expense in excess of cash	49	291
Amortization of deferred financing costs	1,062	971
Amortization of debt discounts	377	427
Derivative gain	(189)	(763)
Loss on debt extinguishment	27	
Deferred tax expense		33
Loss (gain) on disposal of assets	4	(2)
Provision for bad debts	2,178	1,371
Changes in certain assets and liabilities, net of acquisitions:		
Accounts receivable	(4,742)	(7,102)
Prepaid expenses and other	(1,319)	227
Other assets	579	(99)
Accounts payable and accrued expenses	5,466	4,145
Net cash (used in) provided by operating activities - continuing operations	(768)	7
Net cash provided by operating activities - discontinued operations	415	64
Net cash (used in) provided by operating activities	(353)	71
Cash flows from investing activities:		
Proceeds from sale of property and equipment		3
Change in restricted cash and investments and escrow deposits for acquisitions	(3,067)	(2,734)
Acquisitions		(36,655)
Purchase of property and equipment	(2,414)	(1,526)
Net cash used in investing activities - continuing operations	(5,481)	(40,912)
Net cash provided by (used in) investing activities - discontinued operations	1,645	(61)
Net cash used in investing activities	(3,836)	(40,973)
Cash flows from financing activities:		
Proceeds from debt	2,372	47,001
Proceeds from notes receivable	3,240	
Repayment on notes payable	(4,037)	(3,374)
Change in lines of credit	(321)	(3,100)
Debt issuance costs	(345)	(1,502)
Exercise of warrants and options	67	95
Proceeds from stock issuances, net		3,768
Dividends paid on preferred stock	(612)	

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Net cash flows provided by financing activities - continuing operations	364	42,888
Net cash flows used in financing activities - discontinued operations	(1,890)	(97)
Net cash flows (used in) provided by provided by financing activities	(1,526)	42,791
Net Change in Cash	(5,715)	1,889
Cash, Beginning	15,937	7,364
Cash decrease due to deconsolidation of variable interest entities		(180)
Cash, Ending	\$ 10,222	\$ 9,073

Supplemental disclosure of cash flow information:

Cash paid during the year for:

Interest	\$ 5,381	\$ 4,430
Conversions of debt to equity	\$ 349	\$
Acquisitions in exchange for debt and equity instruments	\$	\$ 5,000
Warrants issued for financing costs	\$	\$ 565

See accompanying notes to unaudited consolidated financial statements

Table of Contents

**ADCARE HEALTH SYSTEMS, INC. AND SUBSIDIARIES**

Notes to Unaudited Consolidated Financial Statements

For the Three and Six Months Ended June 30, 2013 and 2012

**NOTE 1. DESCRIPTION OF BUSINESS**

AdCare Health Systems, Inc. ( AdCare ) and its controlled subsidiaries (collectively with AdCare, the Company or we ), owns and operates skilled nursing and assisted living facilities in the states of Alabama, Arkansas, Georgia, Missouri, North Carolina, Ohio, Oklahoma and South Carolina. The Company, through wholly owned separate operating subsidiaries, as of June 30, 2013, operates 47 facilities comprised of 43 skilled nursing facilities, three assisted living facilities and one independent living/senior housing facility totaling approximately 4,800 beds. The Company's facilities provide a range of health care services to their patients and residents including, but not limited to, skilled nursing and assisted living services, social services, various therapy services, and other rehabilitative and healthcare services for both long-term residents and short-stay patients. As of June 30, 2013, of the total 47 facilities, the Company owned and operated 26 facilities, leased and operated nine facilities, and managed 12 facilities, one of which is a consolidated variable interest entity. As part of the Company's strategy to focus on the growth of skilled nursing facilities, the Company decided in the fourth quarter of 2011 to exit the home health business; therefore, this business is reported as discontinued operations (see *Note 11 Discontinued Operations*). The Company sold the assets of the home health business in 2012. Additionally, in the fourth quarter of 2012, the Company entered into an agreement to sell six assisted living facilities located in Ohio and executed a sublease arrangement to exit the skilled nursing business in Jeffersonville, Georgia. The six Ohio assisted living facilities and the Jeffersonville, Georgia skilled nursing facility had an aggregate of 313 units in service. These seven facilities are also reported as discontinued operations (see *Note 11 Discontinued Operations*). The Company sold the assets of four of the six Ohio assisted living facilities in December 2012, one in February 2013, and one in May 2013. On June 12, 2013, the Company executed two sublease arrangements effective as of June 30, 2013 to exit the skilled nursing business in Tybee Island, Georgia. The two skilled nursing facilities had an aggregate of 135 units in service. These two facilities are also reported as discontinued operations (see *Note 11 Discontinued Operations*).

***Basis of Presentation***

The accompanying unaudited consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America ( GAAP ) for interim financial information and with the instructions to Form 10-Q and Rule 8-03 of Article 8 of Regulations S-X. Accordingly, they do not include all of the information and footnotes required by GAAP for complete financial statements. Changes to GAAP are established by the Financial Accounting Standards Board ( FASB ) in the form of Accounting Standards Updates ( ASUs ) to the FASB's Accounting Standards Codification ( ASC ). In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation of the results of operations for the periods presented have been included. Operating results for the three and six months ended June 30, 2013 and 2012, are not necessarily indicative of the results that may be expected for the fiscal year. The balance sheet at December 31, 2012, has been derived from the audited consolidated financial statements at that date, but does not include all of the information and footnotes required by GAAP for complete financial statements.

You should read these consolidated financial statements together with the historical consolidated financial statements of the Company for the year ended December 31, 2012 included in our Annual Report on Form 10-K for the year ended December 31, 2012, filed with the SEC on July 8, 2013.

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The Company operates in one business segment. These statements include the accounts of AdCare Health Systems, Inc. and its controlled subsidiaries. Controlled subsidiaries include AdCare's majority owned subsidiaries and variable interest entity (the "VIE") in which AdCare has control as primary beneficiary. All inter-company accounts and transactions were eliminated in the consolidation.

### **NOTE 2. SIGNIFICANT ACCOUNTING POLICIES**

See Note 1 to our Consolidated Financial Statements included in the Company's Annual Report on Form 10-K for the year ended December 31, 2012, for a description of all significant accounting policies.

#### ***Reclassifications***

Certain items previously reported in the consolidated financial statement captions have been reclassified to conform to the current financial statement presentation with no effect on the Company's consolidated financial position or results of operations. These

Table of Contents

reclassifications did not affect total assets, total liabilities, or stockholders' equity. These reclassifications in the December 31, 2012 Consolidated Balance Sheets included separating Bonds, net of discounts, within Notes payable and other debt within the Total liabilities to define the Company's debt instruments in further detail. Reclassifications were made to June 30, 2012 Consolidated Statements of Operations to reflect the same facilities in discontinued operations for both periods presented.

*Use of Estimates*

The preparation of financial statements in conformity with 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 period. Actual results could differ from those estimates.

*Patient Care Receivables and Revenues*

Patient care accounts receivable and revenues for the Company are recorded in the month in which the services are provided.

The Company provides services to certain patients under contractual arrangements with third-party payors, primarily under Federal Medicare and state Medicaid programs. Amounts paid under these contractual arrangements are subject to review and final determination by the appropriate government authority or its agent. In the opinion of management, adequate provision was made in the consolidated financial statements for any adjustments resulting from the respective government authorities' review.

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.

Potentially uncollectible patient accounts are provided for on the allowance method based upon management's evaluation of outstanding accounts receivable at period-end and historical experience. Uncollected accounts that are written off are charged against the allowance. As of June 30, 2013 and December 31, 2012, management recorded an allowance for uncollectible accounts of \$4.6 million and \$3.7 million, respectively.

*Management Fee Receivables and Revenues*

Management fee receivables and revenue are recorded in the month that services are provided. As of June 30, 2013 and December 31, 2012, there was no allowance for uncollectible management fee receivables.

*Fair Value Measurements and Financial Instruments*

Accounting guidance establishes a three-level valuation hierarchy for disclosure of fair value measurements. The valuation hierarchy is based upon the transparency of inputs to the valuation of an asset or liability as of the measurement date. The categorization within the valuation hierarchy is based upon the lowest level of input that is significant to the fair value measurement. The three levels are defined as follows:

Level 1 Quoted market prices in active markets for identical assets or liabilities

Level 2 Other observable market-based inputs or unobservable inputs that are corroborated by market data

Level 3 Significant unobservable inputs

The respective carrying value of certain financial instruments of the Company approximates their fair value. These instruments include cash and cash equivalents, restricted cash and investments, accounts receivable, notes receivable, notes payable and other debt, and accounts payable. Fair values were assumed to approximate carrying values for these financial instruments since they are short-term in nature and their carrying amounts approximate fair values, they are receivable or payable on demand, or the interest rates earned and/or paid approximate current market rates.

*Recent Accounting Pronouncements*

The Company considers the applicability and impact of all ASUs. For the three months ended June 30, 2013 and through the date of this Quarterly Report, all ASUs issued, effective and not yet effective, were assessed and determined to be either not applicable or are expected to have minimal impact on our consolidated financial position and results of operations.



Table of Contents**NOTE 3. EARNINGS PER SHARE**

Basic earnings per common share is computed using the weighted-average number of common shares outstanding during the period. Diluted net loss per common share is computed using the weighted-average number of common and dilutive common equivalent shares from stock options, warrants and convertible promissory notes using the treasury stock method. For all periods presented, diluted net loss per share is the same as basic net loss per share, as the inclusion of equivalent shares from outstanding common stock options, warrants and convertible promissory notes would be anti-dilutive.

(Amounts in 000 s, except per share data)	Three Months Ended June 30,					
	2013 Income (loss)	2013 Shares	Per Share	2012 Income (loss)	2012 Shares	Per Share
<b>Continuing Operations:</b>						
Loss from continuing operations	\$ (6,009)			\$ (510)		
Net loss attributable to noncontrolling interests	241			142		
Basic loss from continuing operations	\$ (5,768)	14,733	\$ (0.39)	\$ (368)	13,463	\$ (0.03)
Preferred stock dividend	(306)	14,733	\$ (0.02)			\$
Effect of dilutive securities: Stock options, warrants outstanding and convertible debt (a)						
Diluted loss from continuing operations	\$ (6,074)	14,733	\$ (0.41)	\$ (368)	13,463	\$ (0.03)
<b>Discontinued Operations:</b>						
Basic (loss) income from discontinued operations	(936)	14,733	\$ (0.06)	163	13,463	\$ 0.01
Diluted (loss) income from discontinued operations	(936)	14,733	\$ (0.06)	163	13,463	\$ 0.01
<b>Net Loss Attributable to AdCare:</b>						
Basic loss	(7,010)	14,733	\$ (0.47)	(205)	13,463	\$ (0.02)
Diluted loss	(7,010)	14,733	\$ (0.47)	(205)	13,463	\$ (0.02)
(Amounts in 000 s, except per share data)	Six Months Ended June 30,					
	2013 Income (loss)	2013 Shares	Per Share	2012 Income (loss)	2012 Shares	Per Share
<b>Continuing Operations:</b>						
Loss from continuing operations	\$ (8,481)			\$ (2,833)		
Net loss attributable to noncontrolling interests	433			286		
Basic loss from continuing operations	\$ (8,048)	14,725	\$ (0.55)	\$ (2,547)	12,844	\$ (0.20)
Preferred stock dividend	(612)	14,725	\$ (0.04)			\$
Effect of dilutive securities: Stock options, warrants outstanding and convertible debt (a)						
Diluted loss from continuing operations	\$ (8,660)	14,725	\$ (0.59)	\$ (2,547)	12,844	\$ (0.20)
<b>Discontinued Operations:</b>						
Basic (loss) income from discontinued operations	(1,214)	14,725	\$ (0.08)	77	12,844	\$ 0.01
Diluted (loss) income from discontinued operations	(1,214)	14,725	\$ (0.08)	77	12,844	\$ 0.01
<b>Net Loss Attributable to AdCare:</b>						
Basic loss	(9,874)	14,725	\$ (0.67)	(2,470)	12,844	\$ (0.19)
Diluted loss	(9,874)	14,725	\$ (0.67)	(2,470)	12,844	\$ (0.19)

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(a) Securities outstanding that were excluded from the computation, prior to the use of the treasury stock method, because they would have been anti-dilutive are as follows:

Table of Contents

(Amounts in 000 s)	June 30, 2013	December 31, 2012
Outstanding Stock Options	1,480	1,351
Outstanding Warrants - employee	1,876	1,806
Outstanding Warrants - nonemployee	1,904	1,961
Convertible Debt shares issuable(a)	7,031	7,140
Total anti-dilutive securities	12,291	12,258

(a) The number of shares issuable upon conversion of convertible promissory notes is 120% of the aggregate principal amount of the convertible promissory notes divided by the current conversion price, which is the number required to be reserved for issuance by the Company under the applicable registration rights agreement.

**NOTE 4. LIQUIDITY AND PROFITABILITY**

For the six months ended and as of June 30, 2013, we had a net loss of \$9.7 million and negative working capital of \$28.4 million. At June 30, 2013, we had \$10.2 million in cash and cash equivalents and \$164.4 million in indebtedness, including current maturities and discontinued operations, of which \$31.0 million is current debt (including the Company's outstanding subordinated convertible promissory notes with a principal amount in the aggregate of \$11.4 million and \$4.5 million that mature in October 2013 and March 2014, respectively). Our ability to achieve profitable operations is dependent on continued growth in revenue and controlling costs.

We anticipate that scheduled debt service (excluding outstanding subordinated convertible promissory notes and approximately \$7.0 million of bullet maturities due February 2014 that the Company believes will be refinanced on a longer term basis but including principal, interest, collateral and capital improvement fund or other escrow deposits) will total approximately \$16.3 million and cash outlays for acquisition costs, maintenance capital expenditures, dividends on our Series A Preferred Stock and income taxes will total approximately \$4.7 million for the 12 months ending June 30, 2014. We routinely have ongoing discussions with existing and potential new lenders to refinance current debt on a longer term basis and, in recent periods, have refinanced shorter term acquisition debt, including seller notes, with traditional longer term mortgage notes, some of which have been executed under government guaranteed lending programs. Although, we anticipate the conversion to common stock of the Company's outstanding subordinated convertible promissory notes with a principal amount in the aggregate of \$11.4 million and \$4.5 million that mature in October 2013 and March 2014, respectively, we believe that our anticipated cash flow and committed funding sources would allow us to pay these notes in cash. These promissory notes are convertible at the option of the holder into shares of common stock of the Company at \$3.73 per share and \$4.80 per share, respectively. The closing price of the common stock exceeded \$4.00 per share from January 1, 2013 through August 8, 2013, except for the last three trading days in March 2013. We have been successful in recent years in raising new equity capital and believe, based on recent discussions that these markets will continue to be available to us for raising capital in 2013. As discussed further below, if we were required to pay these subordinated convertible promissory notes in cash and were unable to refinance the \$7.0 million of bullet maturities due February 2014, then the Company may be required to restructure its outstanding indebtedness, implement further cost reduction initiatives, sell assets, or delay, modify, or abandon its expansion plans due to our limited liquidity in such an event.

Based on existing cash balances, anticipated cash flows for the 12 months ending June 30, 2014, the anticipated refinancing of the \$7.0 million of bullet maturities due February 2014, and anticipated new sources of capital, we believe there will be sufficient funds for our operations, scheduled debt service, and capital expenditures at least through the next 12 months. On a longer term basis, we have approximately \$73.9 million of debt payments and maturities due between 2015 and 2017, excluding subordinated convertible promissory notes which are convertible into shares of common stock. We believe our long-term liquidity needs will be satisfied by these same sources, as well as borrowings as required to refinance indebtedness.

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In order to satisfy these capital needs, we intend to: (i) improve our operating results by increasing facility occupancy, optimizing our payor mix by increasing the proportion of sub-acute patients within our skilled nursing facilities, continuing our cost optimization and efficiency strategies and acquiring additional long-term care facilities with existing operating cash flow; (ii) expand our borrowing arrangements with certain existing lenders; (iii) refinance current debt where possible to obtain more favorable terms; and (iv) raise capital through the issuance of debt or equity securities. We anticipate that these actions, if successful, will provide the opportunity for us to maintain liquidity on a short and long term basis, thereby permitting us to meet our operating and financing obligations for the next 12 months and provide for the continuance of our acquisition strategy. However, there is no guarantee that such actions will be successful or that anticipated operating results will be achieved. We currently have limited borrowing availability under our existing revolving credit facilities. If the Company is unable to improve operating results, expand existing borrowing agreements, refinance current debt (including the \$7.0 million of bullet maturities due February 2014), raise capital through the issuance of securities, or the subordinated convertible promissory notes due October 2013 and March 2014 are not converted into common stock and are required

Table of Contents

to be repaid by us in cash, then the Company may be required to restructure its outstanding indebtedness, implement further cost reduction initiatives, sell assets, or delay, modify, or abandon its expansion plans.

**NOTE 5. RESTRICTED CASH AND INVESTMENTS**

The following table sets forth the Company's various restricted cash, escrow deposits and investments:

(Amounts in 000 s)	June 30, 2013		December 31, 2012	
HUD escrow deposits	\$	61	\$	279
Principal and interest escrow		379		106
Collateral certificates of deposit		266		1,357
Total current portion		706		1,742
HUD reserve replacement		341		372
Reserves for capital improvements		1,685		1,602
Restricted investments for other debt obligations		8,782		5,241
Total noncurrent portion		10,808		7,215
Total restricted cash and investments	\$	11,514	\$	8,957

**NOTE 6. PROPERTY AND EQUIPMENT**

The following table sets forth the Company's property and equipment:

(Amounts in 000 s)	Estimated Useful Lives (Years)	June 30, 2013		December 31, 2012	
Buildings and improvements	5-40	\$	138,735	\$	137,842
Equipment	2-10		11,117		10,448
Land			8,469		8,469
Computer related	2-10		3,014		2,670
Construction in process			1,185		510
			162,520		159,939
Less: Accumulated depreciation and amortization expense			12,080		8,875
Property and equipment, net		\$	150,440	\$	151,064

Depreciation and amortization expense was approximately \$1.9 million and \$3.7 million for the three and six months ended June 30, 2013, respectively, and \$1.4 million and \$3.0 million for the three and six months ended June 30, 2012, respectively.

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During the quarter ended March 31, 2012, the Company recognized a \$0.4 million impairment charge to write down the carrying value of an office building located in Rogers, Arkansas. The office building was acquired in 2011. The purchase price allocation for that acquisition was deemed to be final as of December 31, 2011. Subsequent to December 31, 2011, it was determined that the acquired office building would not be utilized and the building was not in use as of March 31, 2012. The impairment charge represents a change in fair value from value recognized in the purchase price allocation. The impairment charge is classified as depreciation expense in the consolidated statement of operations.

Table of Contents**NOTE 7. INTANGIBLE ASSETS AND GOODWILL**

There have been no impairment adjustments goodwill during the three and six months ended June 30, 2013. The Company recognized an impairment loss of \$0.7 million related to two facilities in Tybee Island, Georgia during the three months ended June 30, 2013 (see *Note 11 Discontinued Operations*).

Intangible assets consist of the following:

(Amounts in 000 s)	Bed Licenses (included in property and equipment)	Bed Licenses - Separable	Lease Rights	Total
Balances, December 31, 2012:				
Gross	\$ 38,478	\$ 2,471	\$ 9,545	\$ 50,494
Accumulated amortization	(1,438)		(2,701)	(4,139)
Net carrying amount	\$ 37,040	\$ 2,471	\$ 6,844	\$ 46,355
Acquisitions				
Disposals				
Impairment losses			(721)	(721)
Amortization expense	(611)		(451)	(1,062)
Balances, June 30, 2013:				
Gross	38,478	2,471	9,545	50,494
Impairment losses			(721)	(721)
Accumulated amortization	(2,049)		(3,152)	(5,201)
Net carrying amount	\$ 36,429	\$ 2,471	\$ 5,672	\$ 44,572

Amortization expense for bed licenses included in property and equipment was approximately \$0.3 million and \$0.6 million for the three and six months ended June 30, 2013, respectively, and \$ 0.2 million and \$0.4 million for the three and six months ended June 30, 2012, respectively. Amortization expense for lease rights was approximately \$0.2 million and \$0.5 million for the three and six months ended June 30, 2013, respectively, and \$0.1 million and \$0.5 million for the three and six months ended June 30, 2012, respectively. For the three and six months months ended June 30, 2013, the Company recognized an impairment loss of \$0.7 million related to two facilities in Tybee Island, Georgia (see *Note 11 Discontinued Operations*).

Expected amortization expense for all definite lived intangibles for each of the years ended December 31 is as follows:

(Amounts in 000 s)	Bed Licenses	Lease Rights
2013 (a)	\$ 641	\$ 451
2014	1,283	844
2015	1,283	719
2016	1,283	719
2017	1,283	719

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Thereafter		30,656		2,220
Total expected amortization expense	\$	36,429	\$	5,672

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(a) Estimated amortization expense for the year ending December 31, 2013 includes only amortization to be recorded after June 30, 2013.



Table of Contents

The following table summarizes the carrying amount of goodwill at June 30, 2013 as compared with December 31, 2012:

	(Amounts in 000 s)	
Balances, December 31, 2012:		
Gross	\$	5,023
Accumulated impairment losses		
Total	\$	5,023
Goodwill acquired in acquisitions		
Disposed in sale of business, net		
Impairment losses		
Balances, June 30, 2013:		
Gross	\$	5,023
Accumulated impairment losses		
Total	\$	5,023

The Company does not amortize goodwill or indefinite lived intangibles, which consist of separable bed licenses.

**NOTE 8. ACCRUED EXPENSES**

Accrued expenses consist of the following:

(Amounts in 000 s)	June 30, 2013		December 31, 2012	
Accrued payroll related	\$	4,796	\$	5,626
Accrued employee benefits		5,500		3,790
Real estate and other taxes		1,784		1,245
Other accrued expenses		2,997		3,069
Total accrued expenses	\$	15,077	\$	13,730

Table of Contents**NOTE 9. NOTES PAYABLE AND OTHER DEBT**

Notes payable and other debt consist of the following:

(Amounts in 000 s)	June 30, 2013	December 31, 2012
Senior debt - guaranteed by HUD (a)	\$ 4,121	\$ 9,699
Senior debt - guaranteed by USDA	28,068	28,370
Senior debt - guaranteed by SBA	6,072	6,189
Senior debt - bonds, net of discount	16,151	16,265
Senior debt - other mortgage indebtedness	73,551	75,188
Revolving credit facilities and lines of credit	8,879	9,204
Convertible debt issued in 2010, net of discount	11,077	10,948
Convertible debt issued in 2011	4,459	4,509
Convertible debt issued in 2012	7,500	7,500
Other debt	4,532	4,004
<b>Total</b>	<b>\$ 164,410</b>	<b>\$ 171,876</b>
Less: current portion	31,090	19,387
Less: portion included in liabilities of disposal group held for sale		3,662
Notes payable and other debt, net of current portion	\$ 133,320	\$ 148,827

(a) The senior debt - guaranteed by the U.S. Department of Housing and Urban Development ( HUD ) includes \$3.6 million related to the Vandalia HUD mortgage note classified as liabilities of disposal group held for sale at December 31, 2012, that was assumed by the buyer of the Hearth & Home of Vandalia assisted living facility that the Company sold in a transaction that closed in May 2013.

***Scheduled Maturities***

The schedule below summarizes the scheduled maturities as of June 30, 2013 for each of the next five years and thereafter.

	(Amounts in 000 s)
2014	\$ 31,271
2015	24,915
2016	14,475
2017	39,653
2018	3,738
Thereafter	50,736
Subtotal	164,788
Less: unamortized discounts (\$274 classified as current)	(692)
Plus: unamortized premiums (\$93 classified as current)	314
Total notes and other debt	\$ 164,410

***Debt Covenant Compliance***

As of June 30, 2013, the Company (including its consolidated VIE) has over twenty different credit facilities (credit facilities, mortgage notes, bonds and other credit obligations) outstanding that include various financial and administrative covenant requirements. Covenant requirements include, but are not limited to, fixed charge coverage ratios, debt service coverage ratios, minimum EBITDA or EBITDAR, current ratios and tangible net worth requirements. Certain financial covenant requirements are based on consolidated financial measurements whereas others are based on subsidiary level (i.e., facility, multiple facilities or a combination of subsidiaries comprising less than the Company's consolidated financial measurements). Some covenants are based on annual financial metric measurements whereas others are based on monthly or quarterly financial metric measurements. The Company routinely tracks and monitors its compliance with its covenant requirements. In recent periods, including as of June 30, 2013, the

Table of Contents

Company has not been in compliance with certain financial and administrative covenants. For each instance of such non-compliance, the Company has obtained waivers or amendments to such requirements including as necessary modifications to future covenant requirements or the elimination of certain requirements in future periods.

***Senior Debt Guaranteed by HUD***

*Hearth and Home of Vandalia*

In connection with the Company's January 2012 refinancing of the assisted living facility known as Hearth and Home of Vandalia ( Vandalia ), owned by a wholly owned subsidiary of AdCare, the Company issued a note, insured by HUD, to a financial institution for a total amount of \$3.7 million that matures in 2041. The HUD note requires monthly principal and interest payments with a fixed interest rate of 3.74%. The Company incurred deferred financing costs on the note of approximately \$0.2 million, which are being amortized to interest expense over the life of the note. The HUD note has a prepayment penalty of 8% starting in 2014 declining by 1% each year through 2022. This note was assumed by the buyer in the closing of the sale of this facility that occurred in May 2013 pursuant to the terms of the sale agreement related to the sale of six of the Company's assisted living facilities located in Ohio.

***Revolving Credit Facilities and Lines of Credit***

*PrivateBank Credit Facility*

On January 25, 2013, the Company entered into a Memorandum of Agreement with The PrivateBank and Trust Company ( PrivateBank ). Pursuant to the memorandum, three of the Company's subsidiaries and their collateral, which comprise the three skilled nursing facilities located in Arkansas known as the Aviv facilities, were released from liability under that certain Loan and Security Agreement, dated October 26, 2012 and as so amended, between PrivateBank and the Company (the PrivateBank Credit Facility ). In exchange for the release from liability under the loan agreement, the Company made a payment in the amount of \$0.7 million on December 28, 2012. The memorandum did not change the maximum amount that may be borrowed under the loan agreement by the Company, which remains \$10.6 million.

On June 27, 2013, certain wholly-owned subsidiaries of the Company entered into a Third Modification Agreement with PrivateBank, dated as of June 26, 2013, which modified that certain Loan Agreement, dated March 30, 2012, between such subsidiaries and PrivateBank. Pursuant to the modification, PrivateBank waives certain financial covenants under the credit facility regarding the minimum fixed charge coverage ratio and minimum EBITDAR of one of the subsidiaries that is the operator of the Company's skilled nursing facility located in Little Rock, Arkansas.

As of June 30, 2013, \$6.5 million was outstanding of the maximum borrowing amount of \$10.6 million under the PrivateBank Credit Facility. There were also \$1.9 million of outstanding letters of credit that are pledged as collateral of borrowing capacity on this revolver.

Gemino Northwest Credit Facility

On May 30, 2013, NW 61st Nursing, LLC ( Northwest ), a wholly-owned subsidiary of the Company, entered into a Credit Agreement (the Northwest Credit Facility ) with Gemino Healthcare Finance, LLC ( Gemino ). The Northwest Credit Facility provides for a \$1.0 million principal amount senior-secured revolving credit facility.

The Northwest Credit Facility matures on January 31, 2015 and interest accrues on the principal balance thereof at an annual rate of 4.75% plus the current LIBOR rate. Northwest shall also pay to Gemino: (i) a collateral monitoring fee equal to 1.0% per annum of the daily outstanding balance of the Northwest Credit Facility; and (ii) a fee equal to 0.5% per annum of the unused portion of the Northwest Credit Facility. In the event the Northwest Credit Facility is terminated prior to January 31, 2015, Northwest shall also be required to pay a fee to Gemino in an amount equal to 1.0% of the Northwest Credit Facility. The Northwest Credit Facility is secured by a security interest in, without limitation, the accounts receivable and the collections and proceeds thereof relating to the Company s skilled nursing facility located in Oklahoma City, Oklahoma known as the Northwest Nursing Center. The Company has unconditionally guaranteed all amounts owing under the Northwest Credit Facility.

The Northwest Credit Facility contains customary events of default, including material breach of representations and warranties, failure to make required payments, failure to comply with certain agreements or covenants and certain events of bankruptcy and insolvency. Upon the occurrence of an event of default, Gemino may terminate the Northwest Credit Facility.

In connection with entering into the Northwest Credit Facility, certain affiliates of the Company and Northwest, as applicable, also entered into an intercreditor and subordination agreement, governmental depository agreement and subordination of management fee agreement, each containing customary terms and conditions.

Table of Contents

On June 25, 2013, Northwest entered into a First Amendment to the Credit Agreement which amended the Northwest Credit Facility. The amendment, among other things: (i) amends certain financial covenants regarding fixed charge coverage ratio and minimum EBITDA; and (ii) amends the credit facility to include the Bonterra Credit Facility (discussed below) as an affiliated credit agreement in determining whether certain financial covenants are being met.

On June 28, 2013, Georgetown HC&R Nursing, LLC and Sumter N&R, LLC, both wholly-owned subsidiaries of the Company, entered into a Joinder Agreement, Second Amendment and Supplement to Credit Agreement with Northwest and Gemino pursuant to which such subsidiaries became additional borrowers under the Northwest Credit Facility. Pursuant to the joinder, the borrowers granted a continuing security interest in, among other things, their accounts receivables, payment intangibles, chattel paper, general intangibles, collateral relating to any accounts or payment intangibles, commercial lockboxes and cash, as additional collateral under the Northwest Credit Facility. In connection with the execution of the joinder, the borrowers issued an amended and restated revolving promissory note in favor of Gemino in the amount of \$1.5 million.

As of June 30, 2013, \$0.9 million was outstanding of the maximum borrowing amount of \$1.5 million under the Northwest Credit Facility.

Gemino Bonterra Credit Facility

On May 30, 2013, the ADK Bonterra/Parkview, LLC, a wholly-owned subsidiary of the Company ( Bonterra ), entered into a Fourth Amendment to Credit Agreement with Gemino, which amended that certain Credit Agreement dated April 27, 2011 between Bonterra and Gemino (as amended, the Bonterra Credit Facility ). The amendment, among other things: (i) extends the term of the Bonterra Credit Facility from January 31, 2014 to January 31, 2015; (ii) amends certain financial covenants regarding Bonterra s fixed charge coverage ratio and maximum loan turn days; and (iii) amends the Gemino-Bonterra credit facility to include the Northwest Credit Facility as an affiliated credit agreement in determining whether certain financial covenants are being met.

As of June 30, 2013, \$1.2 million was outstanding of the maximum borrowing amount of \$2.0 million under the Bonterra Credit Facility.

KeyBank Credit Facility

On May 31, 2013, certain subsidiaries of the Company entered into a First Amendment to Secured Loan Agreement and Payment Guaranty (the KeyBank Amendment ) with KeyBank National Association ( KeyBank ) which amended that certain Secured Loan Agreement, dated December 28, 2012, between the Company and KeyBank (the KeyBank Credit Facility ). Pursuant to the KeyBank Amendment, KeyBank waives any default or events of default that may exist relating to the Company s: (i) failure to timely file with the SEC its Annual Report on Form 10-K for the year ended December 31, 2012; (ii) process of restating its previously issued financial statements for the quarters ended March 31, 2012, June 30, 2012 and September 30, 2012; and (iii) non-compliance with the continued listing standards of the NYSE MKT LLC, as well as certain other events. The KeyBank Amendment, among other things: (1) establishes a special account under the sole dominion and control of KeyBank pursuant to which certain subsidiaries of the Company shall deposit certain funds, on a monthly basis, to be held as collateral; (2) amends certain financial covenants regarding such subsidiaries implied debt service coverage and furnishing of certain financial information; and (3) amends certain financial covenants provided for in a guaranty made by the Company for the benefit of KeyBank relating to the KeyBank Credit Facility. In addition, as a condition precedent for KeyBank to enter into the KeyBank Amendment, the Company granted a

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first-priority security interest in the real property and improvements, leases and rents, revenues and accounts receivables relating to the 32 unit assisted-living facility located in Mountain View, Arkansas known as the Stone County Residential Care Center. The KeyBank Amendment also requires the Company to pledge to KeyBank, as additional collateral, that certain secured promissory note dated December 28, 2012, issued by CHP Acquisition Company, LLC ( CHP ) to the Company in the amount of \$3.6 million (as amended, the CHP Note ); provided, however, that the Company shall be entitled to any excess payments of principal or prepayments over \$2.0 million made by CHP on the CHP Note (see *Note 11 Discontinued Operations* ).

On June 27, 2013, the Company entered into a Second Amendment to Secured Loan Agreement and Payment Guaranty with KeyBank, which amended the KeyBank Credit Facility. Pursuant to the amendment: (i) KeyBank waives the failure of certain financial covenants of such subsidiaries regarding fixed charge coverage ratio and implied debt service coverage such that no default or events of default under the KeyBank Credit Facility occurred due to such failure; and (ii) KeyBank and the Company agreed to amend certain financial covenants regarding the Company s fixed charge ratio.

As of June 30, 2013, \$15.4 million was outstanding under the KeyBank Credit Facility.

Table of Contents

*Convertible Debt*

*Subordinated Convertible Promissory Notes Issued in 2010*

In February 2013, there was a conversion of a \$0.02 million convertible promissory note, which was part of the October 26, 2010 note offering, at a price of \$3.73 per share and resulted in the issuance of 6,635 shares of common stock. In March 2013, another conversion of a \$0.02 million convertible promissory note, which was also a part of the October 26, 2010 offering, at a price of \$3.73 per share, resulted in the issuance of 6,635 shares of common stock. In April 2013, another conversion of a \$0.3 million convertible promissory note, which was part of the October 26, 2010 offering, at a price of \$3.73 per share, resulted in the issuance of 67,024 shares of common stock.

*Subordinated Convertible Promissory Notes Issued in 2011*

In April 2013, there was a conversion of a \$0.05 million convertible promissory note, which was part of the March 31, 2011 note offering, at a price of \$4.80 per share and resulted in the issuance of 10,438 shares of common stock.

*Other Debt*

During March 2013, the Company obtained financing from AON Premium Finance, LLC and entered into Commercial Insurance Premium Finance Security Agreements for the insurance programs, including general and professional liability, property, casualty, crime, and employment practices liability effective January 1, 2013 and matures on December 31, 2013. The total amount financed was approximately \$2.4 million requiring monthly payments of \$0.2 million with interest ranging from 2.87% to 4.79%. The outstanding amount was approximately \$1.3 million at June 30, 2013.

On June 11, 2013, the Company completed the sale of its former Springfield, Ohio corporate office building which was sold for the approximate net book value. The Company used the proceeds to pay the principal balance of the mortgage note with respect to the building of approximately \$0.1 million.

**NOTE 10. ACQUISITIONS**

On February 15, 2013, the Company entered into a Purchase and Sale Agreement with Avalon Health Care, LLC to acquire certain land, buildings, improvements, furniture, vehicles, contracts, fixtures and equipment comprising: (i) a 180-bed skilled nursing facility known as Bethany Health and Rehab; and (ii) a 240-bed skilled nursing facility known as Trevecca Health and Rehab, both located in Nashville, Tennessee. The Company deposited \$0.4 million of earnest money escrow deposits in February 2013. On June 1, 2013, the Purchase and Sale Agreement was terminated due to the failure of the transaction to close by May 31, 2013. In connection with the termination of the Purchase and



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Sale Agreement, the Company is seeking the return of \$0.4 million previously deposited earnest money escrow deposits. On August 1, 2013, the Company entered into a settlement agreement regarding the return of the \$0.4 million previously deposited earnest money escrow deposits (see *Note 18-Subsequent Events*).

The Company incurred acquisition costs of approximately \$0.5 million and \$0.6 million during the three and six months ended June 30, 2013, and \$0.5 million and \$0.8 million during the three and six months ended June 30, 2012, respectively. Acquisition costs are recorded in Other Income (Expense) section of the Consolidated Statements of Operations.

During the six months ended June 30, 2012, the Company acquired a total of five skilled nursing facilities and one assisted living facility.

### *Unaudited Pro forma Financial Information*

Acquisitions have been included in the consolidated financial statements since the dates of the acquisition. The following table represents pro forma results of consolidated operations as if all of the 2012 acquisitions had occurred at the beginning of the earliest fiscal year being presented, after giving effect to certain adjustments.

<b>(Amounts in 000s)</b>	<b>Three Months Ended June 30, 2012</b>	
Pro forma revenue	\$	48,127
Pro forma operating expenses	\$	44,678
Pro forma (loss) income from operations	\$	3,449

Table of Contents

(Amounts in 000s)	Six Months Ended June 30, 2012	
Pro forma revenue	\$	103,968
Pro forma operating expenses	\$	100,169
Pro forma (loss) income from operations	\$	3,799

The forgoing pro forma information is not indicative of what the results of operations would have been if the acquisitions had actually occurred at the beginning of the periods presented and is not intended as a projection of future results or trends.

**NOTE 11. DISCONTINUED OPERATIONS**

As part of the Company's strategy to focus on the growth of its skilled nursing segment, the Company decided in the fourth quarter of 2011 to exit the home health segment of the business. In the fourth quarter of 2012, the Company continued this strategy and entered into an agreement to sell six assisted living facilities located in Ohio. The Company also entered into a sublease arrangement in the fourth quarter of 2012 to exit the operations of a skilled nursing facility in Jeffersonville, Georgia. On June 12, 2013, the Company executed two sublease agreements to exit the skilled nursing business in Tybee Island, Georgia effective June 30, 2013 relating to two facilities. The results of operations and cash flows for the home health business, the six Ohio assisted living facilities, the Jeffersonville, Georgia skilled nursing facility, and the two facilities in Tybee Island, Georgia are reported as discontinued operations in 2013 and 2012.

Total revenues from discontinued operations were \$1.7 million and \$3.9 million for the three and six months ended June 30, 2013, respectively, and \$3.8 million and \$7.4 million for the three and six months ended June 30, 2012, respectively. Net loss from discontinued operations was \$0.9 million and \$1.2 million for the three months and six months ended June 30, 2013, respectively, and a net income of \$0.2 million and \$0.01 million for the three and six months ended June 30, 2012, respectively. Interest expense included in discontinued operations was approximately \$0.01 million and \$0.07 million for the three and six months ended June 30, 2013, respectively, and \$0.2 million and \$0.5 million for the three and six months ended June 30, 2012, respectively. In the quarter ended June 30, 2013, the Company recognized an impairment loss of \$0.7 million related to two facilities in Tybee Island, Georgia.

On February 28, 2013, the Company completed the sale of the facility known as Lincoln Lodge Retirement Residence and used the proceeds to pay the principal balance of the HUD mortgage note with respect to the facility of \$1.9 million. The Company recognized a gain on the sale of \$0.1 million and cash proceeds, net of costs and debt payoff, of \$0.7 million.

On May 6, 2013, Hearth & Home of Vandalia, Inc. (the "Vandalia Seller"), a wholly owned subsidiary of the Company, sold to H & H of Vandalia LLC (the "Vandalia Purchaser"), pursuant to that certain Agreement of Sale, dated October 11, 2012 and amended December 28, 2012 (as amended, the "Ohio Sale Agreement"), between the Company and certain of its subsidiaries, including the Vandalia Seller (together, the "Ohio ALF Sellers"), on the one hand, and CHP Acquisition Company, LLC ("CHP") on the other hand, certain land, buildings, improvements, furniture, fixtures and equipment comprising the Vandalia facility located in Vandalia, Ohio. CHP had previously assigned its rights in the Ohio Sale Agreement with respect to the Vandalia facility to the Vandalia Purchaser.

The sale price for the Vandalia facility consisted of, among other items: (i) an assumption, by the Vandalia Purchaser, of a mortgage in an aggregate amount of \$3.6 million (the "Vandalia Mortgage") that secures the Vandalia facility; and (ii) a release of the Vandalia Seller from its obligations to Red Mortgage Capital, LLC (the "Vandalia Mortgagee") and HUD with respect to the Vandalia Mortgage, pursuant to a release and

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assumption agreement entered into among the Vandalia Purchaser, the Vandalia Seller, HUD and the Vandalia Mortgagee. In connection with the sale of the Vandalia facility, the Vandalia Seller and Vandalia Purchaser also entered into an assignment and assumption agreement of trust funds and service contracts, containing customary terms and conditions.

In June 2013, the Company entered into a Release Agreement with CHP amending the terms of the \$3.6 million Seller Note issued in the connection with the sale of four of the six Ohio assisted living facilities sold to CHP in the fourth quarter of 2012. In exchange for a reduction in the Vandalia purchase price by \$0.4 million, CHP agreed to immediately payoff the Seller Note resulting in a net payment of \$3.2 million.

Proceeds from the \$3.2 million payment were used to fund a \$2.0 million increase in collateralized restricted cash required by one of the Company's lenders and \$1.2 million was received by the Company for working capital purposes. The Company recognized a loss on the sale of Vandalia of \$0.4 million.

Table of Contents

On June 11, 2013, the Company completed the sale of its former Springfield, Ohio corporate office building which was sold for the approximate net book value. The Company used the proceeds to pay the principal balance of the mortgage note with respect to the building of approximately \$0.1 million.

Assets and liabilities of the disposal groups held for sale at June 30, 2013 and December 31, 2012 are as follows:

(Amounts in 000 \$)	June 30, 2013	December 31, 2012
Property and equipment, net	\$ 400	\$ 5,840
Other assets		319
Assets of disposal group held for sale	\$ 400	\$ 6,159
Other liabilities	\$ 60	
Notes payable		3,662
Liabilities of disposal group held for sale	\$ 60	\$ 3,662

**NOTE 12. PREFERRED STOCK AND STOCKHOLDERS EQUITY**Preferred Stock

On November 7, 2012, the Company announced a best efforts public offering of 450,000 shares of its newly designated Series A Preferred Stock. The Series A Preferred Stock was offered at \$23 per share. In November 2012, the Company issued 450,000 shares of Series A Preferred Stock at \$23 per share, receiving proceeds of \$9.2 million after deducting underwriting discounts and other offering-related expenses of \$1.2 million. The liquidation preference per share is \$25. Cumulative dividends accrue and are paid in the amount of \$2.72 per share each year, which is equivalent to 10.875% of the \$25.00 liquidation preference per share. The dividend rate may increase under certain circumstances.

Holders of the Series A Preferred Stock generally have limited voting rights under certain circumstances. The Company may not redeem the Series A Preferred Stock before December 1, 2017, however the Company is required to redeem the Series A Preferred Stock following a Change of Control, as defined. On and after December 1, 2017, the Company may, at its option, redeem the Series A Preferred Stock, in whole or in part, by paying \$25.00 per share, plus any accrued and unpaid dividends to the redemption date.

The change-in-control provision requires the Series A Preferred Stock to be classified as temporary equity because, although deemed a remote possibility, a purchaser could acquire a majority of the voting power of the outstanding common stock without company approval, thereby triggering redemption. FASB ASC Topic 480-10-S99-3A, *SEC Staff Announcement: Classification and Measurement of Redeemable Securities*, requires classification outside of permanent equity for redeemable instruments for which the redemption triggers are outside of the issuer's control. The assessment of whether the redemption of an equity security could occur outside of the issuer's control is required to be made without regard to the probability of the event or events that may result in the instrument becoming redeemable.

Preferred Stock Dividends

On June 7, 2013, the Company declared a quarterly dividend out of capital surplus of \$0.68 per share on the Series A Preferred Stock. The dividend payment is equivalent to an annualized 10.875% per share, based on the \$25.00 per share stated liquidation preference, accruing from April 1, 2013. The dividend was paid on July 1, 2013 to holders of the Series A Preferred Stock of record on June 20, 2013.

On March 8, 2013, the Company declared a quarterly dividend out of capital surplus of \$0.68 per share on the Series A Preferred Stock. The dividend payment is equivalent to an annualized 10.875% per share, based on the \$25.00 per share stated liquidation preference, accruing from January 1, 2013. The dividend was paid on April 1, 2013 to holders of the Series A Preferred Stock of record on March 21, 2013.

Table of Contents

Stock Dividend

On September 6, 2012, the Company's Board of Directors declared a 5% stock dividend issued on October 22, 2012 to holders of the common stock as of October 8, 2012. As a result of the stock dividend, the number of outstanding shares of common stock increased by 0.7 million shares in 2012.

2012 Public Common Stock Offering

In March 2012, the Company closed a firm commitment underwritten public offering of 1.1 million shares of common stock at an offering price to the public of \$3.75 per share. The Company also granted the underwriter in the offering an option for 45 days to purchase up to an additional 165,000 shares of common stock to cover over-allotments, if any. In connection with the underwriter's partial exercise of this option, the Company issued an additional 65,000 shares of common stock at an offering price to the public of \$3.75 per share on May 22, 2012. The Company received net proceeds of \$3.8 million after deducting underwriting discounts and other offering-related expenses of \$0.6 million.

**NOTE 13. STOCK BASED COMPENSATION**

Stock Incentive Plans

The Company has three share-based compensation plans: the AdCare Health Systems, Inc. 2011 Stock Incentive Plan (the 2011 Plan), the 2005 Stock Option Plan of AdCare Health Systems, Inc. (the 2005 Plan) and the 2004 Stock Option Plan of AdCare Health Systems, Inc. (the 2004 Plan) which provide for the granting of qualified incentive and non-qualified stock options to employees, directors, consultants and advisors. The 2011 Plan also permits the granting of restricted stock to employees, directors, consultants and advisors. The awards are subject to a vesting schedule as set forth in each individual agreement. The Company intends to use only the 2011 Plan to make future grants. The number of options under the 2004 Plan and 2005 Plan outstanding at June 30, 2013 totaled 31,528. The maximum number of shares of common stock which can be issued under the 2011 Plan is 2,100,000 at June 30, 2013.

The fair value of options granted by the Company is estimated on the date of grant using the Black-Scholes-Merton option-pricing model that uses assumptions for expected volatility, expected dividends, expected term, and the risk-free interest rate. Expected volatilities are based on historical volatility of the Company's common stock. The term of employee options and warrants granted is based on historical exercises of employee options and warrants. The term of non-employee warrants is based on the term of the associated contract. The risk-free rate is based on the U.S. Treasury yield curve in effect at the time of grant for the period of the expected term as described.

The assumptions used in calculating the fair value of employee common stock options granted during the six months ended June 30, 2013, using the Black-Scholes-Merton option-pricing model are set forth in the following table:

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	Six Months Ended June 30, 2013
Expected volatility	60.0 - 63.2%
Expected life (in years)	5.2
Expected dividend yield	
Risk-free interest rate	0.71% - 0.75%

The weighted-average grant date fair value for options granted during the six months ended June 30, 2013 was approximately \$2.41.

The assumptions used in calculating the fair value of employee common stock warrants granted during the six months ended June 30, 2013, using the Black-Scholes-Merton option-pricing model are set forth in the following table:

	Six Months Ended June 30, 2013
Expected volatility	60.1%
Expected life (in years)	5.2
Expected dividend yield	
Risk-free interest rate	0.88%

Table of Contents

The weighted-average grant date fair value for options granted during the six months ended June 30, 2013 was approximately \$3.06.

Employee Common Stock Options

Activity with respect to employee stock options is summarized as follows:

	Number of Shares	Weighted- Average Exercise Price	Weighted- Average Remaining Contractual Term (in years)	Aggregate Intrinsic Value (in 000 s)
Outstanding at December 31, 2012	1,350,861	\$ 4.57		
Granted	258,000	\$ 4.59		
Exercised	(10,370)	\$ 3.52		
Unvested options forfeited or cancelled	(88,151)	\$ 3.95		
Vested options expired	(30,562)	\$ 1.30		
Outstanding at June 30, 2013	1,479,778	\$ 4.68	6.8	\$ 818
Vested at June 30, 2013	402,852	\$ 4.45	4.6	\$ 268

Total unrecognized compensation expense related to non-vested stock options at June 30, 2013, was approximately \$1.4 million and is expected to be recognized over a weighted-average period of 2.2 years.

Employee Common Stock Warrants

Activity with respect to employee common stock warrants is summarized as follows:

	Number of Shares	Weighted- Average Exercise Price	Weighted- Average Remaining Contractual Term (in years)	Aggregate Intrinsic Value (in 000 s)
Outstanding at December 31, 2012	1,806,024	\$ 2.99		
Granted	70,000	\$ 5.90		
Exercised		\$		
Unvested warrants forfeited or cancelled		\$		
Vested warrants expired		\$		
Outstanding at June 30, 2013	1,876,024	\$ 3.10	5.3	\$ 3,272
Vested at June 30, 2013	1,631,020	\$ 2.85	4.8	\$ 3,188



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Total unrecognized compensation expense related to non-vested employee stock warrants at June 30, 2013, was approximately \$0.4 million and is expected to be recognized over a weighted-average period of 2.5 years.

### Restricted Stock

In June 2012, the Company approved issuing, pursuant to the 2011 Plan, 270,000 shares of common stock with a three-year restriction on transfer to its nine directors. The restricted stock has all the rights of a shareholder from the date of grant, including, without limitation the right to receive dividends and the right to vote. The Company calculated the fair value of the restricted stock to be equal to the closing stock price of \$3.20 on the date of grant. The related compensation expense is being recognized over the three-year restricted period.

Table of Contents

On July 2, 2012, in connection with the issuance of the \$7.5 million principal amount of 8% subordinated convertible notes, the Company granted 50,000 shares of restricted common stock with a one year restriction on transferability to the placement agent as partial consideration for its service on the offering. The Company calculated the fair value of the restricted stock to be equal to the closing stock price of \$3.50 on the date of grant date. The related compensation expense is included in deferred loan costs and is being amortized as interest expense over the term of the 8% subordinated convertible notes. The expense for the three and six months ended June 30, 2013 was less than \$0.01 million and \$0.02 million with unrecognized expense of approximately \$0.03 million remaining at June 30, 2013.

Activity with respect to restricted stock is summarized as follows:

	Number of Shares	Weighted Avg. Grant Date Fair Value
Unvested at December 31, 2012	283,500	\$ 3.20
Granted		\$
Vested		\$
Forfeited		\$
Unvested at June 30, 2013	283,500	\$ 3.20

Total unrecognized compensation expense related to non-vested restricted stock at June 30, 2013, was approximately \$0.6 million and is expected to be recognized over a weighted-average period of 1.9 years.

Nonemployee Common Stock Warrants

The Company grants common stock warrants in connection with equity share purchases by investors as an additional incentive for providing long-term equity capital to the Company and as additional compensation to consultants and advisors. The warrants are granted at negotiated prices in connection with the equity share purchases and at the market price of the common stock in other instances. The warrants have been issued for terms between two and ten years.

Activity with respect to nonemployee common stock warrants is summarized as follows:

	Number of Shares	Weighted- Average Exercise Price	Weighted- Average Remaining Contractual Term (in years)	Aggregate Intrinsic Value
Outstanding at December 31, 2012	1,961,457	\$ 3.78		
Granted		\$		
Exercised	(28,825)	\$ 1.05		
Unvested warrants forfeited or cancelled		\$		
Vested warrants expired	(28,941)	\$ 2.27		

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Outstanding at June 30, 2013	1,903,691	\$	3.84	1.3	\$	1,838
Vested at June 30, 2013	1,903,691	\$	3.84	1.3	\$	1,838

Table of Contents

For the three and six months ended June 30, 2013 and 2012, the Company recognized stock-based compensation as follows:

(Amounts in 000 \$)	Three Months Ended June 30,		Six Months Ended June 30,	
	2013	2012	2013	2012
<b>Employee compensation:</b>				
Stock options	\$ 154	\$ 114	\$ 341	\$ 222
Employee warrants	35	57	60	115
Total option and warrants compensation	\$ 189	\$ 171	\$ 401	\$ 337
Board restricted stock	75	11	150	11
Total Employee Compensation Expense	\$ 264	\$ 182	\$ 551	\$ 348
<b>Non-employee compensation:</b>				
Warrants	\$	\$ 1,052	\$	\$ 1,354
Less: Deferred financing and prepaid services		(750)		(1,027)
Amortization of prepaid services	4		8	
Total Nonemployee Compensation Expense	\$ 4	\$ 302	\$ 8	\$ 327

**NOTE 14. VARIABLE INTEREST ENTITIES**

As further described in Note 20 to our Consolidated Financial Statements in the Company's Annual Report on Form 10-K for the year ended December 31, 2012, the Company has certain variable interest entities that are required to be consolidated because AdCare has control as primary beneficiary. A primary beneficiary is the party in a VIE that has both of the following characteristics: (a) the power to direct the activities of the VIE that most significantly impact the VIE's economic performance and (b) the obligation to absorb losses of the VIE that could potentially be significant to the VIE or the right to receive benefits from the VIE that could potentially be significant to the VIE.

On June 22, 2013, the Company and Riverchase Village ADK, LLC (Riverchase), an entity owned and controlled by Christopher Brogdon (the Company's Vice Chairman and a greater than 10% beneficial owner of the common stock), agreed to mutually terminate the five-year year management agreement, dated June 22, 2010. Riverchase owns Riverchase Village, a 105-bed assisted living facility located in Hoover, Alabama. Pursuant to the management agreement, a subsidiary of the Company supervised the management of the Riverchase Village facility for a monthly fee equal to 5% of the monthly gross revenues of the Riverchase Village facility.

On June 22, 2013, a wholly owned subsidiary of the Company and Mr. Brogdon amended the Option Agreement, dated June 22, 2010, pursuant to which the Company has the exclusive and irrevocable right to acquire from Mr. Brogdon all of the issued and outstanding membership interests in Riverchase, which owns the Riverchase Village facility. The amendment extended the option provided for thereby from June 22, 2013 to June 22, 2014.

The following summarizes the assets and liabilities of the variable interest entity included in the consolidated balance sheets:

(Amounts in 000 \$)	June 30, 2013	December 31, 2012
Cash	\$ (1)	\$ (38)

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Accounts receivable		81		
Restricted investments		302		343
Property and equipment, net		5,981		5,974
Other assets		401		391
Total assets	\$	6,764	\$	6,670
Accounts payable	\$	1,802	\$	1,316
Accrued expenses		190		67
Current portion of notes payable		92		92
Notes payable, net of current portion		5,951		6,033
Non-controlling interest		(1,271)		(838)
Total liabilities	\$	6,764	\$	6,670

Table of Contents**NOTE 15. FAIR VALUE MEASUREMENTS**

The following are the major categories of assets and liabilities measured at fair value on a recurring basis during the three months ended June 30, 2013, using quoted prices in active markets for identical assets (Level 1); significant other observable inputs (Level 2); and significant unobservable inputs (Level 3).

(Amounts in 000 s)	Level 1:	Level 2:	Level 3:	Total at June 30
Derivative liability - 2013			\$ 3,284	\$ 3,284
Derivative liability - 2012			\$ 3,630	\$ 3,630

Set forth below is a reconciliation of the beginning and ending balances for the derivative liability measured at fair value on a recurring basis using significant unobservable inputs (Level 3) during the three months ended June 30, 2013:

(Amounts in 000 s)	Derivative Liability
Beginning balance, December 31, 2012	\$ 3,630
Converted debt	(157)
Derivative gain	(189)
Ending balance, June 30, 2013	\$ 3,284

The derivative liability is the result of the Company issuing subordinated convertible notes in 2010. The notes are convertible into shares of common stock of the Company at a current conversion price of \$3.73 (adjusted for various stock dividends) that is subject to future reductions if the Company issues equity instruments at a lower price. Because there is no minimum conversion price, an indeterminate number of shares may be issued in the future. Accordingly, the Company determined an embedded derivative existed that was required to be bifurcated from the subordinated convertible notes and accounted for separately as a derivative liability recorded at fair value. The Company estimates the fair value of the derivative liability using the Black-Scholes Merton option-pricing model with changes in fair value being reported in the consolidated statement of operations. This model requires certain key inputs that are significant unobservable inputs (Level 3).

The Company currently has no plans to issue equity instruments at a price lower than the conversion price of \$3.73, the current conversion price of the subordinated convertible notes issued in 2010. The derivative liability is a non-cash item. Upon conversion to common stock, the debt and derivative liability will be extinguished, the current fair market value of the common stock will be reflected as common stock and additional paid-in capital, and there may be a resulting gain or loss on the debt extinguishment. If not converted to common stock, upon settlement at the date of maturity, the debt and derivative liability will result in a gain on debt extinguishment for the remaining fair value of the derivative.

**NOTE 16. COMMITMENTS AND CONTINGENCIES***Regulatory Matters*

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Laws and regulations governing Federal Medicare and state 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 compliance in all material respects 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. Any significant future change to reimbursement rates could have a material effect on the Company's operations.

### *Operating Leases*

The Company leases certain office space and nine skilled nursing facilities under non-cancelable operating leases, most of which have initial lease terms of ten to twelve years with rent escalation clauses and provisions for payments by the Company of real estate taxes, insurance and maintenance costs. Facility rent expense totaled \$1.8 million and \$3.5 million for the three and six months ended June 30, 2013, respectively, and \$1.7 million and \$3.5 million for the three and six months ended June 30, 2012, respectively.

Table of Contents

Five of the Company's facilities are operated under a single master lease arrangement. The lease has a term of ten years ending 2020. Under the master lease, a breach at a single facility could subject one or more of the other facilities covered by the same master lease to the same default risk. Failure to comply with regulations or governmental authorities, such as Medicare and Medicaid provider requirements, is a default under the Company's master lease agreement. In addition, other potential defaults related to an individual facility may cause a default of the entire master lease agreement. 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. The Company is not aware of any defaults as of June 30, 2013.

Two of the Company's facilities are operated under a separate lease agreement. The lease is a single indivisible lease; therefore, a breach at a single facility could subject the second facility to the same default risk. The lease has a term of 12 years into 2022 and includes covenants and restrictions. A commitment is included that requires minimum capital expenditures of \$375 per licensed bed per lease year at each facility which amounts to \$0.1 million per year for both facilities. In recent periods, including as of June 30, 2013, the Company has not been in compliance with certain financial and administrative covenants of this lease agreement. The Company has obtained a waiver for each instance of such non-compliance.

*Legal Matters*

The skilled nursing business involves a significant risk of liability due to 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, which may allege 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 potential 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 payer. A violation may provide the basis for exclusion from federally funded healthcare programs. As of June 30, 2013, the Company does not have any material loss contingencies recorded or requiring disclosure based upon the evaluation of the probability of loss from known claims, except as disclosed below.

In 2012, the Company was named as a defendant in two related lawsuits asserting breach of contract claims arising out of consulting agreements executed in 2010 in connection with the Company's becoming the operator of certain leased facilities that were previously operated by a third-party. The same transaction was already the subject of litigation commenced by the Company in 2011 against several entities which had previously operated the leased facilities. After becoming the operator of the leased facilities, the Company incurred certain losses for pre-closing activities for which the Company was entitled to indemnification. The Company sought to enforce its rights to indemnity by filing a lawsuit against the former operators of the leased facilities for breach of contract and related tort claims, and the Company proceeded to set off its losses against payment due under the consulting agreements referenced above. The defendants filed counterclaims against the Company. In the third quarter of 2012, a settlement was reached with respect to the three lawsuits that permitted the Company to eliminate a previously accrued liability in light of the lower than expected settlement amount of \$1.0 million resulting in a non-cash settlement gain of \$0.4 million recognized in the third quarter of 2012. During the third quarter of 2012, \$0.3 million of the settlement was paid. During the six months ended June 30, 2013, \$0.1 million of the settlement was paid, leaving \$0.2 million remaining balance to be paid during the remainder of 2013.



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On June 24, 2013, South Star Services, Inc. ( SSSI ), Troy Clanton and Rose Rabon (collectively, the Plaintiffs ) filed a complaint in the District Court of Oklahoma County, State of Oklahoma against: (i) AdCare, certain of its wholly owned subsidiaries and AdCare s Chief Executive Officer (collectively, the AdCare Defendants ); (ii) Christopher Brogdon, Vice Chairman of the Board of Directors, and his wife; and (iii) five entities controlled by Mr. and Mrs. Brogdon, which entities own five skilled-nursing facilities located in Oklahoma (the Oklahoma Facilities ) that are managed by an AdCare subsidiary. The Company believes that the complaint is without merit and intends to vigorously defend itself against the claims set forth therein.

The complaint alleges, with respect to the AdCare Defendants, that: (i) the AdCare Defendants tortuously interfered with contractual relations between the Plaintiffs and Mr. Brogdon, and with Plaintiffs prospective economic advantage, relating to SSSI s right to manage the Oklahoma Facilities and seven other skilled-nursing facilities located in Oklahoma (collectively, the Facilities ), respectively; (ii) the AdCare Defendants fraudulently induced the Plaintiffs to perform work and incur expenses with respect to the Facilities; and (iii) one of the AdCare subsidiaries which is an AdCare Defendant provided false and defamatory information to an Oklahoma regulatory authority regarding SSSI s management of one of the Oklahoma Facilities. The complaint seeks damages against the AdCare Defendants, including punitive damages, in an unspecified amount, as well as costs and expenses, including reasonable attorney fees. On July 26, 2013, the AdCare Defendants (with the other defendant parties) filed: (i) a motion to dismiss the fraud claims; and (ii) a motion to transfer the proceeding to the U.S. District Court for the Northern District of Georgia.

Table of Contents

*Commitments*

Special Termination Benefits

During the quarter ended June 30, 2013, the Company incurred certain salary retirement and continuation costs \$0.1 million related to separation agreements with certain of the Company's former officers. The benefits include wage continuation and fringe benefits which are to be paid out to these former employees over various future periods ranging up to a 6-month period. The remaining unpaid balance accrued as of June 30, 2013 is \$0.1 million.

Commitment to Future Lease Payments

A leased skilled nursing facility has signed a security agreement associated with the lessor, Covington Realty, LLC, in conjunction with the lessor's refinancing of the project through HUD. The commitment gives the lender the right to pursue the facility for unpaid lease payments to the lessor.

**NOTE 17. RELATED PARTY TRANSACTIONS**

As of June 30, 2013, there have been no material changes to the disclosure with respect to related party transactions included in Item 13 to our Annual Report on Form 10-K for the year ended December 31, 2012, except for the following:

Riverchase Management Agreement Termination

On June 22, 2013, the Company and Riverchase, an entity owned and controlled by Mr. Brogdon, agreed to mutually terminate the five-year management agreement, dated June 22, 2010. Riverchase owns Riverchase Village, a 105-bed assisted living facility located in Hoover, Alabama. Pursuant to the management agreement, a subsidiary of the Company supervised the management of the Riverchase Village facility for a monthly fee equal to 5% of the monthly gross revenues of the Riverchase Village facility.

Riverchase Option Agreement Extension

On June 22, 2013, a wholly owned subsidiary of the Company and Mr. Brogdon amended the Option Agreement, dated June 22, 2010, pursuant to which the Company has the exclusive and irrevocable right to acquire from Mr. Brogdon all of the issued and outstanding membership interests in Riverchase, which owns the Riverchase Village facility. The amendment extended the option provided for thereby from June 22,

2013 to June 22, 2014.

**NOTE 18. SUBSEQUENT EVENTS**

The Company has evaluated all subsequent events through the date the consolidated financial statements were issued and filed with the SEC. The following is a summary of the material subsequent events.

On July 26, 2013, a wholly-owned subsidiary of the Company entered into management agreements with entities owned and controlled by Mr. Brogdon, which entities own the skilled-nursing facilities located in Oklahoma known as Harrah Nursing Center, McLoud Nursing Center and Mecker Nursing Center. Pursuant to the management agreements, the AdCare subsidiary has agreed to manage the operations of these facilities. The management agreements have initial terms of five years and shall renew automatically for one-year terms thereafter. Pursuant to the management agreements, the entities owned and controlled by Mr. Brogdon which own the facilities shall pay to the AdCare subsidiary a fee equal to 5% of the monthly gross revenues of the facilities. The management agreements may be terminated by the parties at any time upon 30 days prior written notice.

On August 1, 2013, a wholly-owned subsidiary of the Company entered into a settlement agreement with Avalon Health Care, LLC ( Avalon ) and Hughes and White ( H&W ) in connection with the termination of the Purchase and Sale Agreement and the distribution of the \$0.4 million previously deposited earnest money escrow deposits. Pursuant to the agreement, H&W released and distributed \$0.3 million to the Company and \$0.1 million to Avalon of the \$0.4 million earnest money escrow deposits.

Table of Contents**Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations.***Overview*

AdCare Health Systems, Inc. ( AdCare ) and its controlled subsidiaries (collectively with AdCare, the Company or we ), owns and operates skilled nursing and assisted living facilities in the states of Alabama, Arkansas, Georgia, Missouri, North Carolina, Ohio, Oklahoma and South Carolina. The Company, through wholly owned separate operating subsidiaries, as of June 30, 2013, operates 47 facilities comprised of 43 skilled nursing facilities, three assisted living facilities and one independent living/senior housing facility totaling approximately 4,800 beds. The Company's facilities provide a range of health care services to their patients and residents including, but not limited to, skilled nursing and assisted living services, social services, various therapy services, and other rehabilitative and healthcare services for both long-term residents and short-stay patients. As of June 30, 2013, of the total 47 facilities, the Company owned and operated 26 facilities, leased and operated nine facilities, and managed 12 facilities, one of which is a consolidated variable interest entity. As part of the Company's strategy to focus on the growth of skilled nursing facilities, the Company decided in the fourth quarter of 2011 to exit the home health business; therefore, this business is reported as discontinued operations (see Note 11 *Discontinued Operations*). The Company sold the assets of the home health business in 2012. Additionally, in the fourth quarter of 2012, the Company entered into an agreement to sell six assisted living facilities located in Ohio and executed a sublease arrangement to exit the skilled nursing business in Jeffersonville, Georgia. The six Ohio assisted living facilities and the Jeffersonville, Georgia skilled nursing facility have an aggregate of 313 units in service. These seven facilities are also reported as discontinued operations (see Note 11 *Discontinued Operations*). The Company sold the assets of four of the six Ohio assisted living facilities in December 2012, one in February 2013, and one in May, 2013. On June 30, 2013, the Company executed two sublease agreements to exit the skilled nursing business in Tybee Island, Georgia. The two skilled nursing facilities had an aggregate of 135 units in service. These two facilities are also reported as discontinued operations (see Note 11 *Discontinued Operations*).

The Company owns and manages skilled nursing facilities ( SNF ) and assisted living facilities. The Company delivers skilled nursing, assisted living and home health services through wholly owned separate operating subsidiaries. During the first quarter of 2013, the Company discontinued management services on one facility, and in the second quarter the Company entered into two sublease agreements and reported two additional discontinued operations, bringing our Company's total bed count to 4,781 at June 30, 2013. The following tables provide summary information regarding our recent acquisitions and facility composition.

	June 30, 2013	June 30, 2012
Cumulative number of facilities	47	41
Cumulative number of operational beds	4,781	4,149

State	Number of Operational Beds/Units	Number of Facilities at June 30, 2013				Total
		Owned	Leased	Managed For Third Parties	VIE	
Alabama	408	2			1	3
Arkansas	1,041	10				10
Georgia	1,379	4	7			11
Missouri	80		1			1
North Carolina	106	1				1
Ohio	705	4	1	3		8
Oklahoma	882	3		8		11
South Carolina	180	2				2
<b>Total</b>	<b>4,781</b>	<b>26</b>	<b>9</b>	<b>11</b>	<b>1</b>	<b>47</b>

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Skilled Nursing	4,482	24	9	10	43
Independent Living	83			1	1

Table of Contents

*Liquidity*

For the six months ended and as of June 30, 2013, we had a net loss of \$9.7 million and negative working capital of \$28.4 million. At June 30, 2013, we had \$10.2 million in cash and cash equivalents and \$164.4 million in indebtedness, including current maturities and discontinued operations, of which \$31.0 million is current debt (including the Company's outstanding subordinated convertible promissory notes with a principal amount in the aggregate of \$11.4 million and \$4.5 million that mature in October 2013 and March 2014, respectively). Our ability to achieve profitable operations is dependent on continued growth in revenue and controlling costs.

We anticipate that scheduled debt service (excluding outstanding subordinated convertible promissory notes and approximately \$7.0 million of bullet maturities due February 2014 that the Company believes will be refinanced on a longer term basis but including principal, interest, collateral and capital improvement fund or other escrow deposits) will total approximately \$16.3 million and cash outlays for acquisition costs, maintenance capital expenditures, dividends on our Series A Preferred Stock and income taxes will total approximately \$4.7 million for the 12 months ending June 30, 2014. We routinely have ongoing discussions with existing and potential new lenders to refinance current debt on a longer term basis and, in recent periods, have refinanced shorter term acquisition debt, including seller notes, with traditional longer term mortgage notes, some of which have been executed under government guaranteed lending programs. Although, we anticipate the conversion to common stock of the Company's outstanding subordinated convertible promissory notes with a principal amount in the aggregate of \$11.4 million and \$4.5 million that mature in October 2013 and March 2014, respectively, we believe that our anticipated cash flow and committed funding sources would allow us to pay these notes in cash. These promissory notes are convertible at the option of the holder into shares of common stock of the Company at \$3.73 per share and \$4.80 per share, respectively. The closing price of the common stock exceeded \$4.00 per share from January 1, 2013 through August 8, 2013, except for the last three trading days in March 2013. We have been successful in recent years in raising new equity capital and believe, based on recent discussions that these markets will continue to be available to us for raising capital in 2013. As discussed further below, if we were required to pay these subordinated convertible promissory notes in cash and were unable to refinance the \$7.0 million of bullet maturities due February 2014, then the Company may be required to restructure its outstanding indebtedness, implement further cost reduction initiatives, sell assets, or delay, modify, or abandon its expansion plans due to our limited liquidity in such an event.

Based on existing cash balances, anticipated cash flows for the 12 months ending June 30, 2014, the anticipated refinancing of the \$7.0 million of bullet maturities due February 2014, and anticipated new sources of capital, we believe there will be sufficient funds for our operations, scheduled debt service, and capital expenditures at least through the next 12 months. On a longer term basis, we have approximately \$73.9 million of debt payments and maturities due between 2015 and 2017, excluding subordinated convertible promissory notes which are convertible into shares of common stock. We believe our long-term liquidity needs will be satisfied by these same sources, as well as borrowings as required to refinance indebtedness.

In order to satisfy these capital needs, we intend to: (i) improve our operating results by increasing facility occupancy, optimizing our payor mix by increasing the proportion of sub-acute patients within our skilled nursing facilities, continuing our cost optimization and efficiency strategies and acquiring additional long-term care facilities with existing operating cash flow; (ii) expand our borrowing arrangements with certain existing lenders; (iii) refinance current debt where possible to obtain more favorable terms; and (iv) raise capital through the issuance of debt or equity securities. We anticipate that these actions, if successful, will provide the opportunity for us to maintain liquidity on a short and long term basis, thereby permitting us to meet our operating and financing obligations for the next 12 months and provide for the continuance of our acquisition strategy. However, there is no guarantee that such actions will be successful or that anticipated operating results will be achieved. We currently have limited borrowing availability under our existing revolving credit facilities. If the Company is unable to improve operating results, expand existing borrowing agreements, refinance current debt (including the \$7.0 million of bullet maturities due February 2014), raise capital through the issuance of securities, or the subordinated convertible promissory notes due October 2013 and March 2014 are not converted into common stock and are required to be repaid by us in cash, then the Company may be required to restructure its outstanding indebtedness, implement further cost reduction initiatives, sell assets, or delay, modify, or abandon its expansion plans.

*Acquisitions*

The Company has embarked on a strategy to grow its business through acquisitions and leases of senior care facilities.

On February 15, 2013, the Company entered into a Purchase and Sale Agreement with Avalon Health Care, LLC to acquire certain land, buildings, improvements, furniture, vehicles, contracts, fixtures and equipment comprising: (i) a 180-bed skilled nursing facility known as Bethany Health and Rehab; and (ii) a 240-bed skilled nursing facility known as Trevecca Health and Rehab, both located in Nashville, Tennessee. The Company deposited \$0.4 million of earnest money escrow deposits in February 2013. On June 1, 2013, the Purchase and Sale Agreement was terminated due to the failure of the transaction to close by May 31, 2013. In connection with the termination of the Purchase and Sale Agreement, the Company is seeking the return of \$0.4 million previously deposited earnest

Table of Contents

money escrow deposits. On August 1, 2013, the Company entered into a settlement agreement regarding the return of the \$0.4 million previously deposited earnest money escrow deposits (see *Note 18-Subsequent Events*).

The Company incurred acquisition costs total of approximately \$0.5 million and \$0.6 million during the three and six months ended June 30, 2013, respectively, and \$0.5 million and \$0.8 million during the three and six months ended June 30, 2012, respectively. Acquisition costs are recorded in Other Income (Expense) section of the consolidated statements of operations.

During the six months ended June 30, 2012, the Company acquired a total of five skilled nursing facilities and one assisted living facility.

*Divestitures*

As part of the Company's strategy to focus on the growth of its skilled nursing business, the Company decided in the fourth quarter of 2011 to exit the home health business. In the fourth quarter of 2012, the Company continued this strategy and entered into an agreement to sell six assisted living facilities located in Ohio. The Company also entered into a sublease arrangement in the fourth quarter of 2012 to exit the operations of a skilled nursing facility in Jeffersonville, Georgia. On June 12, 2013, the Company executed two sublease arrangements to exit the skilled nursing business in Tybee Island, Georgia effective June 30, 2013 relating to two facilities. The results of operations and cash flows for the home health business, the six Ohio assisted living facilities, the Jeffersonville, Georgia skilled nursing facility, and the two facilities in Tybee Island, Georgia are reported as discontinued operations in 2013 and 2012.

On February 28, 2013, the Company completed the sale of the facility known as Lincoln Lodge Retirement Residence and used the proceeds to pay the principal balance of the HUD mortgage note with respect to the facility of \$1.9 million. The Company recognized a gain on the sale of approximately \$0.1 million and cash proceeds, net of costs and debt payoff, of \$0.6 million.

On May 6, 2013, Hearth & Home of Vandalia, Inc. (the Vandalia Seller), a wholly owned subsidiary of the Company, sold to H & H of Vandalia LLC (the Vandalia Purchaser), pursuant to that certain Agreement of Sale, dated October 11, 2012 and amended December 28, 2012 (as amended, the Ohio Sale Agreement), between the Company and certain of its subsidiaries, including the Vandalia Seller (together, the Ohio ALF Sellers), on the one hand, and CHP Acquisition Company, LLC (CHP) on the other hand, certain land, buildings, improvements, furniture, fixtures and equipment comprising the Vandalia facility located in Vandalia, Ohio. CHP had previously assigned its rights in the Ohio Sale Agreement with respect to the Vandalia facility to the Vandalia Purchaser.

The sale price for the Vandalia facility consisted of, among other items: (i) an assumption, by the Vandalia Purchaser, of a mortgage in an aggregate amount of \$3.6 million (the Vandalia Mortgage) that secures the Vandalia facility; and (ii) a release of the Vandalia Seller from its obligations to Red Mortgage Capital, LLC (the Vandalia Mortgagee) and HUD with respect to the Vandalia Mortgage, pursuant to a release and assumption agreement entered into among the Vandalia Purchaser, the Vandalia Seller, HUD and the Vandalia Mortgagee. In connection with the sale of the Vandalia facility, the Vandalia Seller and Vandalia Purchaser also entered into an assignment and assumption agreement of trust funds and service contracts, containing customary terms and conditions.



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In June 2013, the Company entered into a Release Agreement with CHP amending the terms of the \$3.6 million Seller Note issued in the connection with the sale of four of the six Ohio assisted living facilities sold to CHP in the fourth quarter of 2012. In exchange for a reduction in the Vandalia purchase price by \$0.4 million, CHP agreed to immediately payoff the Seller Note resulting in a net payment of \$3.2 million.

Proceeds from the \$3.2 million payment were used to fund a \$2.0 million increase in collateralized restricted cash required by one of the Company's lenders and \$1.2 million was received by the Company for working capital purposes. The Company recognized a loss on the sale of Vandalia of \$0.4 million.

On June 11, 2013, the Company completed the sale of its former Springfield, Ohio corporate office building which was sold for the approximate net book value. The Company used the proceeds to pay the principal balance of the mortgage note with respect to the building of approximately \$0.1 million.

Table of Contents

The following table summarizes the activity of Discontinued Operations for the three and six months ended June 30, 2013 and 2012:

(Amounts in 000 \$)	Three Months Ended June 30,	
	2013	2012
Total revenues from discontinued operations	\$ 1,693	\$ 5,182
Net (loss) income from discontinued operations	\$ (936)	\$ 163
Interest expense, net from discontinued operations	\$ 12	\$ 165
Income tax expense from discontinued operations	\$	\$ 10
Loss on sale of assets from discontinued operations	\$ 260	\$

(Amounts in 000 \$)	Six Months Ended June 30,	
	2013	2012
Total revenues from discontinued operations	\$ 3,942	\$ 10,286
Net (loss) income from discontinued operations	\$ (1,214)	\$ 77
Interest expense, net from discontinued operations	\$ 71	\$ 348
Income tax expense from discontinued operations	\$	\$ 12
Loss on sale of assets from discontinued operations	\$ 447	\$

**Primary Performance Indicators**

The Company owns and manages skilled nursing facilities and assisted living facilities, and delivers its services through wholly owned separate operating subsidiaries.

The Company focuses on two primary indicators in evaluating its financial performance. Those indicators are facility occupancy and patient mix. Facility occupancy is critical, since higher occupancy generally leads to higher revenues. In addition, concentrating on increasing the number of Medicare covered admissions (the patient mix) helps in increasing revenues. The Company includes commercial insurance covered admissions that are reimbursed at the same level as those covered by Medicare in the Company's Medicare utilization percentages and analysis. The Company also evaluates Same Facilities and Recently Acquired Facilities results. Same Facilities represent those owned and leased facilities the Company began to operate prior to April 1, 2012. Recently Acquired Facilities results represents those owned and leased facilities the Company began to operate subsequent to April 1, 2012.

Patient mix at the Company's skilled nursing facilities for the three and six months ended June 30, 2013 and 2012 was as follows:

	Patient Mix (SNF only)					
	Same Facilities		Recently Acquired Facilities		All Facilities	
	2013	2012	2013	2012	2013	2012
Medicare	15.1%	15.7%	17.5%	n/a	15.7%	14.9%
Medicaid	71.5%	71.7%	71.4%	n/a	71.5%	72.3%
Other	13.4%	12.6%	11.1%	n/a	12.8%	12.8%
Total	100.0%	100.0%	100.0%	n/a	100.0%	100.0%

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	Same Facilities		Patient Mix (SNF only) Six Months Ended June 30, Recently Acquired Facilities		All Facilities	
	2013	2012	2013	2012	2013	2012
Medicare	15.6%	15.6%	16.8%	n/a	15.9%	15.2%
Medicaid	70.8%	71.8%	71.3%	n/a	70.9%	72.1%
Other	13.6%	12.6%	11.9%	n/a	13.2%	12.7%
Total	100.0%	100.0%	100.0%	n/a	100.0%	100.0%

Table of Contents

Medicare reimburses our skilled nursing facilities under a prospective payment system ( PPS ) for certain inpatient covered services. Under the PPS, facilities are paid a predetermined amount per patient, per day, based on the anticipated costs of treating patients. The amount to be paid is determined by classifying each patient into a resource utilization group ( RUG ) category that is based upon each patient's acuity level. In October 2010, the number of RUG categories was expanded from 53 to 66 as part of the implementation of the RUGs IV system and the introduction of a revised and substantially expanded patient assessment tool called the Minimum Data Set, version 3.0.

On July 29, 2011, the Centers for Medicare & Medicaid Services ( CMS ) issued a final rule providing for, among other things, a net 11.1% reduction in PPS payments to skilled nursing facilities for CMS's fiscal year 2012 (which began October 1, 2011) as compared to PPS payments in CMS's fiscal year 2011 (which ended September 30, 2011). The 11.1% reduction is on a net basis, after the application of a 2.7% market basket increase, and reduced by a 1.0% multi-factor productivity adjustment required by the Patient Protection and Affordable Care Act of 2010 ( PPACA ). The final CMS rule also adjusted the method by which group therapy is counted for reimbursement purposes, and changed the timing in which patients who are receiving therapy must be reassessed for purposes of determining their RUG category.

The Middle Class Tax Relief and Job Creation Act of 2012 was signed into law on February 22, 2012, extending the Medicare Part B outpatient therapy cap exceptions process through December 31, 2012. The statutory Medicare Part B outpatient therapy cap for occupational therapy ( OT ) was \$1,880 for 2012, and the combined cap for physical therapy ( PT ) and speech-language pathology services ( SLP ) was also \$1,880 for 2012. This is the annual per beneficiary therapy cap amount determined for each calendar year. Similar to the therapy cap, Congress established a threshold of \$3,700 for PT and SLP services combined and another threshold of \$3,700 for OT services. All therapy services rendered above the \$3,700 amount are subject to manual medical review and may be denied unless pre-approved by the provider's Medicare Administrative Contractor. The law requires an exceptions process to the therapy cap that allows providers to receive payment from Medicare for medically necessary therapy services above the therapy cap amount. Beginning October 1, 2012, some therapy providers may submit requests for exceptions (pre-approval for up to 20 therapy treatment days for beneficiaries at or above the \$3,700 threshold) to avoid denial of claims for services above the threshold amount. The \$3,700 figure is the defined threshold that triggers the provision for an exception request. Prior to October 1, 2012, there was no provision for an exception request when the threshold was exceeded.

On July 27, 2012, CMS issued a final rule providing for, among other things, a net 1.8% increase in PPS payments to skilled nursing facilities for CMS's fiscal year 2013 (which began on October 1, 2012) as compared to PPS payments to skilled nursing facilities in CMS's fiscal year 2012 (which ended September 30, 2012). The 1.8% increase was on a net basis, reflecting the application of a 2.5% market basket increase, less a 0.7% multi-factor productivity adjustment mandated by PPACA. This increase is offset by the 2% sequestration reduction, discussed below, which became effective April 1, 2013.

On January 1, 2013 the American Taxpayer Relief Act of 2012 (the ATRA ) extended the therapy cap exception process for one year. The ATRA also made additional changes to the Multiple Procedure Payment Reduction previously implemented in 2010. The existing discount to multiple therapy procedures performed in an outpatient environment during a single day was 25%. Effective April 1, 2013, ATRA increased the discount rate by an additional 25% to 50%. The ATRA additionally delayed the sequestration reductions of 2% to all Medicare payments until April 1, 2013.

On May 8, 2013, CMS issued a proposed rule providing for an increase of 1.4% in PPS payments to skilled nursing facilities for CMS's fiscal year 2014 (which begins October 1, 2013) as compared to the PPS payments in CMS's fiscal year 2013 (which ends September 30, 2013). The proposed 1.4% increase is on a net basis, after the application of a 2.3% market basket increase reduced by a 0.5% forecast error correction and further reduced by a 0.4% multifactor productivity adjustment required by PPACA.

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Should future changes in PPS include further reduced rates or increased standards for reaching certain reimbursement levels (including as a result of automatic cuts tied to federal deficit cut efforts or otherwise), our Medicare revenues derived from our skilled nursing facilities) could be reduced, with a corresponding adverse impact on our financial condition or results of operation.

We also derive a substantial portion of our consolidated revenue from Medicaid reimbursement, primarily through our skilled nursing business. Medicaid programs are administered by the applicable states and financed by both state and federal funds. Medicaid spending nationally has increased significantly in recent years, becoming an increasingly significant component of state budgets. This, combined with slower state revenue growth and other state budget demands, has led both the federal government to institute measures aimed at controlling the growth of Medicaid spending (and in some instances reducing it).

Historically, adjustments to reimbursement under Medicare and Medicaid have had a significant effect on our revenue and results of operations. Recently enacted, pending and proposed legislation and administrative rulemaking at the federal and state levels could have similar effects on our business. Efforts to impose reduced reimbursement rates, greater discounts and more stringent cost controls

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Table of Contents

by government and other payors are expected to continue for the foreseeable future and could adversely affect our business, financial condition and results of operations. Additionally, any delay or default by the federal or state governments in making Medicare and/or Medicaid reimbursement payments could materially and adversely affect our business, financial condition and results of operations.

Average occupancy and reimbursement rates at the Company's skilled nursing facilities for the three months ended June 30, 2013 and 2012 were as follows:

State (SNF Only)	Operational Beds at Period End (1)	Period's Average Operational Beds	For the Three Months Ended June 30, 2013:				
			Occupancy (Operational Beds)	Medicare Utilization (Skilled %ADC)(2)	Total Revenues	Medicare (Skilled) \$PPD(3)	Medicaid \$PPD(3)
Alabama	304	304	74.4%	9.7%	\$ 3,848	\$ 388.20	\$ 165.85
Arkansas	1,009	1,009	63.5%	18.2%	\$ 13,051	\$ 441.61	\$ 172.83
Georgia	1,379	1,379	90.6%	16.0%	\$ 23,612	\$ 445.80	\$ 155.82
Missouri	80	80	78.5%	17.8%	\$ 1,059	\$ 408.07	\$ 134.76
North Carolina	106	106	72.9%	14.7%	\$ 1,554	\$ 457.77	\$ 166.92
Ohio	293	293	85.6%	15.2%	\$ 5,127	\$ 436.25	\$ 166.21
Oklahoma	318	318	69.9%	14.3%	\$ 3,734	\$ 425.55	\$ 137.84
South Carolina	180	180	86.3%	14.5%	\$ 2,824	\$ 385.10	\$ 164.20
<b>Total</b>	<b>3,669</b>	<b>3,669</b>	<b>78.6%</b>	<b>15.7%</b>	<b>\$ 54,809</b>	<b>\$ 436.07</b>	<b>\$ 160.18</b>

State (SNF Only)	Operational Beds at Period End (1)	Period's Average Operational Beds	For the Three Months Ended June 30, 2012:				
			Occupancy (Operational)	Medicare Utilization (Skilled)	Total	Medicare (Skilled)	Medicaid