

ADCARE HEALTH SYSTEMS, INC

Form 10-Q/A

October 22, 2013

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UNITED STATES SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Amendment No. 2 on

FORM 10-Q/A

(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, 2012

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.

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(Exact name of registrant as specified in its charter)

Ohio
(State or other jurisdiction)

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

of incorporation)

1145 Hembree Road, Roswell, GA 30076

(Address of principal executive offices)

(678) 869-5116

(Registrant's telephone number, including area code)

5057 Troy Road, Springfield, OH 45502-9032

(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 June 30, 2012: 13,696,538 shares of common stock with no par value were outstanding.

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EXPLANATORY NOTE

This Amendment No. 2 on Form 10-Q/A (this Amendment No. 2) of AdCare Health Systems, Inc. and subsidiaries (collectively, the Company or we) amends the Company's Quarterly Report on Form 10-Q for the quarter ended June 30, 2012, originally filed with the Securities and Exchange Commission (the Commission) on August 7, 2012 (the Original Filing Date), as amended by Amendment No. 1 thereto (Amendment No. 1) filed with the Commission on July 8, 2013 (as so amended by Amendment No. 1, the Original Report). This Amendment No. 2 amends the Original Report to revise Note 2, *Restatement of Previously Issued Consolidated Financial Statements for Cost of services and General and administrative expense* and including certain disclosure for *Interest expense, net*, Note 9, *Notes Payable and Other Debt*, to the unaudited consolidated financial statements included therein and Item 2., *Management's Discussion and Analysis of Financial Condition and Results of Operations*, to include certain disclosure regarding debt covenant compliance.

This Amendment No. 2 also includes as exhibits certifications from the Company's Chief Executive Officer and Chief Financial Officer dated as of the date of filing of this Amendment No. 2. Except as described above, no other portions of the Original Filing have been revised by this Amendment No. 2.

The Original Report continues to speak as of the Original Filing Date, and the Company has not updated disclosures contained therein to reflect information or events that have occurred since the Original Filing Date, except to reflect the revisions set forth in Amendment No. 1 and as discussed above. Accordingly, this Amendment No. 2 should be read in conjunction with the Company's other filings made with the Commission subsequent to the Original Filing Date, including any amendments to those filings.

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AdCare Health Systems, Inc.

Form 10-Q/A

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Item 1. Financial Statements

ADCARE HEALTH SYSTEMS, INC. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

(Amounts in 000 s)

| | June 30, 2012 Restated (Note 2) (Unaudited) | December 31, 2011 |
|--|---|----------------------|
| <u>ASSETS</u> | | |
| Current Assets: | | |
| Cash and cash equivalents | \$ 9,073 | \$ 7,364 |
| Restricted cash and investments | 3,624 | 1,883 |
| Accounts receivable, net of allowance of \$2,820 and \$1,346 | 25,127 | 18,782 |
| Prepaid expenses and other | 525 | 663 |
| Assets of disposal group held for sale | 38 | 47 |
| Total current assets | 38,387 | 28,739 |
| Restricted cash and investments | 5,812 | 4,870 |
| Property and equipment, net | 132,924 | 102,449 |
| Intangible assets - bed licenses | 2,377 | 1,189 |
| Intangible assets - lease rights, net | 7,925 | 8,460 |
| Goodwill | 3,112 | 3,600 |
| Escrow deposits for acquisitions | 1,513 | 3,172 |
| Lease deposits | 1,725 | 1,685 |
| Deferred loan costs, net | 5,269 | 4,818 |
| Other assets | 71 | 122 |
| Total assets | \$ 199,115 | \$ 159,104 |
| <u>LIABILITIES AND STOCKHOLDERS' EQUITY</u> | | |
| Current Liabilities: | | |
| Current portion of notes payable and other debt | \$ 30,485 | \$ 4,567 |
| Revolving credit facilities and lines of credit | 7,064 | 7,343 |
| Accounts payable | 15,609 | 12,075 |
| Accrued expenses | 11,793 | 9,881 |
| Liabilities of disposal group held for sale | 143 | 240 |
| Total current liabilities | 65,094 | 34,106 |
| Notes payable and other debt, net of current portion: | | |
| Senior debt, net of discounts | 83,038 | 87,771 |
| Convertible debt, net of discounts | 15,035 | 14,614 |
| Revolving credit facilities | 1,900 | 1,308 |
| Other debt | 12,880 | 1,400 |
| Derivative liability | 1,127 | 1,889 |
| Other liabilities | 1,729 | 2,437 |
| Deferred tax liability | 119 | 86 |
| Total liabilities | 180,922 | 143,611 |

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Commitments and contingencies (Note 15)

Stockholders' equity:

| | | |
|--|------------|------------|
| Preferred stock, no par value; 1,000 shares authorized; no shares issued or outstanding | | |
| Common stock and additional paid-in capital, no par value; 29,000 shares authorized; 13,697 and 12,193 shares issued and outstanding | 39,846 | 35,047 |
| Accumulated deficit | (21,185) | (18,713) |
| Total stockholders' equity | 18,661 | 16,334 |
| Noncontrolling interest in subsidiaries | (468) | (841) |
| Total equity | 18,193 | 15,493 |
| Total liabilities and equity | \$ 199,115 | \$ 159,104 |

See accompanying notes to 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, 2012 | | Six Months Ended June 30, 2012 | |
|--|---|-------------|---|-------------|
| | Restated (Note 2) | 2011 | Restated (Note 2) | 2011 |
| Revenues: | | | | |
| Patient care revenues | \$ 51,266 | \$ 33,872 | \$ 97,573 | \$ 64,404 |
| Management revenues | 525 | 484 | 1,049 | 982 |
| Total revenues | 51,791 | 34,356 | 98,622 | 65,386 |
| Expenses: | | | | |
| Cost of services (exclusive of facility rent, depreciation and amortization) | 40,316 | 27,104 | 79,123 | 52,279 |
| General and administrative | 4,345 | 3,167 | 8,338 | 6,091 |
| Facility rent expense | 2,050 | 1,947 | 4,115 | 3,850 |
| Depreciation and amortization | 1,594 | 705 | 3,304 | 1,352 |
| Salary retirement and continuation costs | | 622 | | 622 |
| Total expenses | 48,305 | 33,545 | 94,880 | 64,194 |
| Income from Operations | 3,486 | 811 | 3,742 | 1,192 |
| Other Income (Expense): | | | | |
| Interest expense, net | (3,444) | (1,852) | (6,122) | (3,288) |
| Acquisition costs, net of gains | (524) | (622) | (817) | 357 |
| Derivative gain (loss) | 353 | (2,588) | 763 | (3,938) |
| Loss on extinguishment of debt | | (77) | | (77) |
| Other income (expense) | (13) | (19) | (27) | 587 |
| Total other income (expense), net | (3,628) | (5,158) | (6,203) | (6,359) |
| Loss from Continuing Operations Before Income Taxes | (142) | (4,347) | (2,461) | (5,167) |
| Income Tax Expense | (33) | (124) | (18) | (210) |
| Loss from Continuing Operations | (175) | (4,471) | (2,479) | (5,377) |
| Loss from Discontinued Operations, Net of Tax | (170) | (91) | (279) | (126) |
| Net Loss | (345) | (4,562) | (2,758) | (5,503) |
| Net Loss Attributable to Noncontrolling Interests | 141 | 165 | 286 | 341 |
| Net Loss Attributable to AdCare Health Systems, Inc. | \$ (204) | \$ (4,397) | \$ (2,472) | \$ (5,162) |
| Net (Loss) per Common Share Basic: | | | | |
| Continuing Operations | \$ 0.00 | \$ (0.49) | \$ (0.17) | \$ (0.57) |
| Discontinued Operations | (0.01) | (0.01) | (0.02) | (0.01) |
| | \$ (0.01) | \$ (0.50) | \$ (0.19) | \$ (0.58) |
| Net (Loss) per Common Share Diluted: | | | | |
| Continuing Operations | \$ 0.00 | \$ (0.49) | \$ (0.17) | \$ (0.57) |
| Discontinued Operations | (0.01) | (0.01) | (0.02) | (0.01) |
| | \$ (0.01) | \$ (0.50) | \$ (0.19) | \$ (0.58) |

See accompanying notes to consolidated financial statements

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

(Unaudited)

| | Common Stock and Additional Paid-in Capital | Accumulated Deficit | Noncontrolling Interests | Total | |
|--|--|--------------------------------|-------------------------------------|-----------------|-----------|
| | Restated | Restated | Restated | Restated | |
| | (Note 2) | (Note 2) | (Note 2) | (Note 2) | |
| | Common Stock Shares | | | | |
| Balance, January 1, 2012 | 12,193 | \$ 35,047 | \$ (18,713) | \$ (841) | \$ 15,493 |
| Deconsolidation of variable interest entity | | | | 660 | 660 |
| Nonemployee warrants for services | | 565 | | | 565 |
| Stock based compensation expense | | 346 | | | 346 |
| Public stock offering, net | 1,165 | 3,768 | | | 3,768 |
| Exercises of options and warrants | 69 | 95 | | | 95 |
| Issuance of restricted stock | 270 | 25 | | | 25 |
| Net loss | | | (2,472) | (286) | (2,758) |
| Balance, June 30, 2012 | 13,697 | \$ 39,846 | \$ (21,185) | \$ (468) | \$ 18,193 |

See accompanying notes to consolidated financial statements

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

CONSOLIDATED STATEMENTS OF CASH FLOWS

(Amounts in 000 \$)

(Unaudited)

| | Six Months Ended June 30, | |
|--|----------------------------------|-------------|
| | 2012 | |
| | Restated | 2011 |
| | (Note 2) | |
| Cash flows from operating activities: | | |
| Net loss | \$ (2,758) | \$ (5,503) |
| Loss from discontinued operations, net of tax | 279 | 126 |
| Loss from continuing operations | (2,479) | (5,377) |
| Adjustments to reconcile loss from continuing operations to net cash provided by (used in) operating activities: | | |
| Depreciation and amortization | 3,304 | 1,352 |
| Warrants issued for services | | 297 |
| Stock based compensation expense | 371 | 467 |
| Lease expense in excess of cash | 291 | 379 |
| Amortization of deferred financing costs | 977 | 407 |
| Amortization of debt discounts | 427 | 445 |
| Derivative (gain) loss | (763) | 3,938 |
| Loss on debt extinguishment | | 77 |
| Deferred tax expense | 33 | 95 |
| (Gain) loss on disposal of assets | (2) | 126 |
| Gain on acquisitions | | (1,104) |
| Provision for bad debts | 1,676 | 351 |
| Other noncash expenses | | 45 |
| Changes in certain assets and liabilities, net of acquisitions: | | |
| Accounts receivable | (8,820) | (3,538) |
| Prepaid expenses and other | 102 | 278 |
| Other assets | 156 | (29) |
| Accounts payable and other liabilities | 5,108 | 3,010 |
| Net cash provided by operating activities continuing operations | 381 | 1,219 |
| Net cash (used in) provided by operating activities discontinued operations | (269) | 14 |
| Net cash provided by operating activities | 112 | 1,233 |
| Cash flows from investing activities: | | |
| Proceeds from sale of property and equipment | 3 | |
| Change in restricted cash and investments and escrow deposits for acquisitions | (2,683) | (110) |
| Acquisitions | (36,655) | (32,636) |
| Purchase of property and equipment | (1,676) | (1,943) |
| Net cash used in investing activities continuing operations | (41,011) | (34,689) |
| Net cash used in investing activities discontinued operations | | |
| Net cash used in investing activities | (41,011) | (34,689) |
| Cash flows from financing activities: | | |
| Proceeds from debt | 47,188 | 31,673 |
| Debt issuance costs | (1,526) | (175) |
| Change in lines of credit | 313 | 4,287 |
| Exercise of warrants and options | 95 | 219 |

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| | | |
|---|----------|----------|
| Proceeds from stock issuances, net | 3,768 | |
| Repayment of notes payable | (6,953) | (709) |
| Net cash provided by financing activities – continuing operations | 42,885 | 35,295 |
| Net cash used in financing activities – discontinued operations | (97) | (89) |
| Net cash provided by financing activities | 42,788 | 35,206 |
| Net Change in Cash | 1,889 | 1,750 |
| Cash, Beginning | 7,364 | 3,911 |
| Cash decrease due to deconsolidation of variable interest entities (Note 2) | (180) | |
| Cash, Ending | \$ 9,073 | \$ 5,661 |
| Supplemental Disclosure of Cash Flow Information: | | |
| Cash paid during the period for: | | |
| Interest | \$ 5,807 | \$ 2,438 |
| Income taxes | \$ | \$ |
| Supplemental Disclosure of Non-cash Activities: | | |
| Acquisitions in exchange for debt and equity instruments | \$ 5,000 | \$ |
| Warrants issued for financings costs | \$ 565 | \$ 330 |
| Other assets acquired in exchange for debt | \$ | \$ 3,427 |

See accompanying notes to consolidated financial statements

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ADCARE HEALTH SYSTEMS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

(Unaudited)

NOTE 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation

The consolidated financial statements are presented in accordance with accounting principles generally accepted in the United States. These statements include the accounts of AdCare Health Systems, Inc. and its controlled subsidiaries (collectively, AdCare, the Company or we). Controlled subsidiaries include AdCare's majority owned subsidiaries and variable interest entities (VIE) in which 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.

The Company delivers skilled nursing, assisted living and home health services through wholly owned separate operating subsidiaries. All inter-company accounts and transactions were eliminated in the consolidation. The accompanying unaudited consolidated financial statements have been prepared in accordance with U.S. generally accepted accounting principles for interim financial information and with the instructions to Form 10-Q and Rule 8-03 of Regulation S-X. Accordingly, they do not include all of the information and notes required for complete annual financial statements and should be read in conjunction with the Company's audited consolidated financial statements and notes included in the Company's Annual Report on Form 10-K for the year ended December 31, 2011 (the Annual Report). In the opinion of the Company's management, all adjustments considered for a fair presentation are included and are of a normal recurring nature. Operating results for the three and six months ended June 30, 2012 are not necessarily indicative of the results that may be expected for the year ending December 31, 2012. Certain prior year amounts have been reclassified to conform to the current year presentation.

As described in the Explanatory Note to this Form 10-Q/A herein and in Note 2, the interim consolidated financial statements for 2012 presented herein have been restated from those previously issued.

Earnings per Share

Basic earnings per share is computed by dividing net income or loss by the weighted-average number of common shares outstanding during the period. Diluted earnings per share is similar to basic earnings per share except net income or loss is adjusted by the impact of the assumed issuance of common shares upon conversion or exercise of convertible securities and the weighted-average number of common shares outstanding includes potentially dilutive securities, such as options, warrants, non-vested shares, and additional shares issuable under convertible notes outstanding during the period when such potentially dilutive securities are not anti-dilutive. Potentially dilutive securities from options,

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warrants and non-vested shares are calculated in accordance with the treasury stock method, which assumes that proceeds from the exercise of all options and warrants with exercise prices exceeding the average market value are used to repurchase common stock at market value. The incremental shares remaining after the proceeds are exhausted represent the potentially dilutive effect of the securities. Potentially dilutive securities from convertible debt are calculated based on the assumed issuance at the beginning of the period, as well as any adjustment to income that would result from their assumed issuance.

| (Amounts in 000 s, except per share data) | Income (loss) Restated (Note 2) | Three Months Ended June 30, | | | | 2011 | |
|--|--|-----------------------------|--------------|------------|---------------|-----------|--|
| | | 2012 Shares (1) | Per Share | Loss | Shares (1) | Per Share | |
| Continuing Operations: | | | | | | | |
| Loss from continuing operations | \$ (175) | | | \$ (4,471) | | | |
| Net loss attributable to noncontrolling interests | 141 | | | 165 | | | |
| Basic income (loss) from continuing operations | \$ (34) | 13,463 | \$ 0.00 | \$ (4,306) | 8,847 | \$ (0.49) | |
| Effect from options, warrants and non-vested shares | | | | | | | |
| Effect from assumed issuance of convertible shares (2) | | | | | | | |
| Diluted net income (loss) from continuing operations | \$ (34) | 13,463 | \$ 0.00 | \$ (4,306) | 8,847 | \$ (0.49) | |
| Discontinued Operations: | | | | | | | |
| Basic loss from discontinued operations | \$ (170) | 13,463 | \$ (0.01) | \$ (91) | 8,847 | \$ (0.01) | |
| Diluted loss from discontinued operations | \$ (170) | 13,463 | \$ (0.01) | \$ (91) | 8,847 | \$ (0.01) | |
| Net Loss Attributable to AdCare: | | | | | | | |
| Basic net loss | \$ (204) | 13,463 | \$ (0.01) | \$ (4,397) | 8,847 | \$ (0.50) | |
| Diluted net loss | \$ (204) | 13,463 | \$ (0.01) | \$ (4,397) | 8,847 | \$ (0.50) | |

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Notes to Consolidated Financial Statements

(Unaudited) (Continued)

| (Amounts in 000 s, except per share data) | Loss Restated (Note 2) | Six Months Ended June 30, | | | | 2011 | |
|--|------------------------|---------------------------|-----------|------------|------------|-----------|--|
| | | 2012 Shares (1) | Per Share | Loss | Shares (1) | Per Share | |
| Continuing Operations: | | | | | | | |
| Loss from continuing operations | \$ (2,479) | | | \$ (5,377) | | | |
| Net loss attributable to noncontrolling interests | 286 | | | 341 | | | |
| Basic loss from continuing operations | \$ (2,193) | 12,844 | \$ (0.17) | \$ (5,036) | 8,806 | \$ (0.58) | |
| Effect from options, warrants and non-vested shares | | | | | | | |
| Effect from assumed issuance of convertible shares (2) | | | | | | | |
| Diluted net loss from continuing operations | \$ (2,193) | 12,844 | \$ (0.17) | \$ (5,036) | 8,806 | \$ (0.58) | |
| Discontinued Operations: | | | | | | | |
| Basic loss from discontinued operations | \$ (279) | 12,844 | \$ (0.02) | \$ (126) | 8,806 | \$ (0.01) | |
| Diluted loss from discontinued operations | \$ (279) | 12,844 | \$ (0.02) | \$ (126) | 8,806 | \$ (0.01) | |
| Net Loss Attributable to AdCare: | | | | | | | |
| Basic net loss | \$ (2,472) | 12,844 | \$ (0.19) | \$ (5,162) | 8,806 | \$ (0.59) | |
| Diluted net loss | \$ (2,472) | 12,844 | \$ (0.19) | \$ (5,162) | 8,806 | \$ (0.59) | |

(1) The weighted average shares outstanding includes retroactive adjustments for the stock dividend issued on October 1, 2011 (see Note 10).

(2) The impact of the conversion of the 2010 and 2011 convertible notes were excluded as the impact would be anti-dilutive.

Intangible Assets and Goodwill

There have been no required impairment adjustments to intangible assets and goodwill during the six months ended June 30, 2012.

Intangible assets consist of the following:

| Amounts in (000 s) | Lease Rights | Bed Licenses (included in | Bed Licenses - Separable | Total |
|--------------------|--------------|---------------------------|--------------------------|-------|
|--------------------|--------------|---------------------------|--------------------------|-------|

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| | | | property and equipment) Restated (Note 2) | | | | | |
|----------------------------------|----|-------|--|---------|----|-------|----|---------|
| Balances, December 31, 2011, net | \$ | 8,460 | \$ | 22,922 | \$ | 1,189 | \$ | 32,571 |
| Deconsolidation of Oklahoma | | | | | | | | |
| Owners | | | | (3,458) | | | | (3,458) |
| Acquisitions | | | | 7,297 | | 1,188 | | 8,485 |
| Amortization expense | | (535) | | (355) | | | | (890) |
| Balances, June 30, 2012, net | \$ | 7,925 | \$ | 26,406 | \$ | 2,377 | \$ | 36,708 |

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Notes to Consolidated Financial Statements

(Unaudited) (Continued)

Intangible Assets and Goodwill (cont.)

For the six months ended June 30, 2012, amortization expense was approximately \$355,000 for bed licenses included in property and equipment. There was no amortization of bed licenses for the six months ended June 30, 2011. For the six months ended June 30, 2012 and 2011, amortization expense was \$535,000 and \$442,000, respectively, for lease rights. Estimated amortization expense for each of the following years ending December 31 is as follows:

| (Amounts in 000 s) | Bed Licenses Restated (Note 2) | | Lease Rights | |
|--------------------|---|--------|---------------------|-------|
| 2012 (remainder) | \$ | 354 | \$ | 534 |
| 2013 | | 709 | | 1,069 |
| 2014 | | 709 | | 1,010 |
| 2015 | | 709 | | 885 |
| 2016 | | 709 | | 885 |
| Thereafter | | 23,216 | | 3,542 |
| Total | \$ | 26,406 | \$ | 7,925 |

The following table summarizes the changes in the carrying amount of goodwill at June 30, 2012 as compared with December 31, 2011:

| Amounts in (000 s) | June 30, 2012 | |
|---|----------------------|---------|
| | Restated | |
| | (Note 2) | |
| Balance, December 31, 2011 | \$ | 3,600 |
| Deconsolidation of variable interest entities | | (1,123) |
| Acquired in acquisitions | | 635 |
| Impairment charge | | |
| Balance, June 30, 2012 | \$ | 3,112 |

Goodwill as previously reported in the 2011 consolidated financial statements was \$0.9 million. In 2012, a reclassification adjustment was made to the December 31, 2011 balance sheet to recognize \$2.7 million of goodwill from 2011 acquisitions that was previously reported as bed licenses in property and equipment. The Company does not amortize goodwill or indefinite lived intangibles.

Compensated Absences

In 2012, the Company removed the ability for employees to accumulate earned but unused vacation beyond the current calendar year. As a result, vacation time previously accumulated must be used by the employee by December 31, 2012 or it will be forfeited. Management has estimated the potential forfeitures and has adjusted the vacation accrual accordingly.

NOTE 2. RESTATEMENT OF PREVIOUSLY ISSUED CONSOLIDATED FINANCIAL STATEMENTS

In this Amendment No.1 on Form 10-Q/A to the Company's Quarterly Report on Form 10-Q for the three and six months ended June 30, 2012, we are restating the consolidated financial statements for the second quarter of 2012. Concurrent with the filing of this Form 10-Q/A, we are also filing amended quarterly reports on Form 10-Q/A for each of the first and third quarters of 2012 to restate our consolidated financial statements therein. The effects of these restatements, to the extent applicable, are reflected in the items revised herein. The restatements relate to the following:

- Correction in the application of the Company's accounting for certain variable interest entities further described as follows:

As further discussed in Note 19, *Variable Interest Entities*, and Note 21, *Related Party Transactions*, found in the Company's audited consolidated financial statements and notes included in the Company's Annual Report on Form 10-K for the year ended December 31, 2011 (the Annual Report), effective August 1, 2011 entities (the Oklahoma Owners) controlled by Christopher Brogdon and his spouse, Connie Brogdon (related parties to the Company) acquired five skilled nursing facilities located in Oklahoma (the Oklahoma Facilities). The Company

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entered into a Management Agreement with the Oklahoma Owners pursuant to which a wholly-owned subsidiary of the Company supervises the management of the Oklahoma Facilities for a monthly fee equal to 5% of the monthly gross revenues of the Oklahoma Facilities. Upon acquisition, the Company concluded it was the primary beneficiary of the Oklahoma Owners and pursuant to Financial Accounting Standards Board Accounting Standards Codification Topic 810-10, *Consolidation-Overall*, consolidated the Oklahoma Owners in its 2011 consolidated financial statements.

During the process of finalizing the 2012 consolidated financial statements, the Company re-assessed its prior conclusion that it should consolidate the Oklahoma Owners. In the reassessment process, the Company concluded that it should not have consolidated the Oklahoma Owners. In the accompanying consolidated financial statements, the Company has deconsolidated the Oklahoma Owners effective January 1, 2012 and the balance sheet, operations and cash flows of the Oklahoma Owners are not included in the Company's 2012 consolidated financial statements. The Company further concluded that including the Oklahoma Owners in its 2011 consolidated financial statements was not material to such consolidated financial statements and therefore no adjustments have been made to the previously issued quarterly and annual 2011 consolidated financial statements.

- Accounting errors and certain accounting estimates that were identified in the process of finalizing our consolidated financial statements for the year ended December 31, 2012. These matters include the following for the six months ended June 30, 2012:

- *Patient care revenues* - Adjustments totaling \$136,000 and \$413,000 for the three and six months ended June 30, 2012, respectively, related primarily to the following items:

The timing of certain revenue recognition adjustments to ensure proper recognition in the appropriate interim reporting period with in the 2012 year. Adjustments totaling \$136,000 for the three months ended June 30, 2012 related to the overstatement of \$81,000 in managed care revenue due to billing errors and a \$56,000 reclassification to reduce managed care revenue due to the improper recognition of bad debt expense subsequently identified by the Company. Adjustments totaling \$413,000 for the six months ended June 30, 2012 relating to the overstatement of \$221,000 in managed care revenue due to billing errors and a \$192,000 reclassification to reduce managed care revenue due to the improper recognition of bad debt expense subsequently identified by the Company.

- *Management revenues* Adjustments totaling \$162,000 and \$323,000 for the three and six months ended June 30, 2012, respectively, related primarily to the reversal of the eliminated management fee expense associated with the correction in the application of the Company's accounting for certain variable interest entities which also has been recorded in costs of services for each period.

- *Accounts receivable, net* - Adjustments totaling \$699,000 related primarily to the following:

The timing of certain revenue recognition adjustments to ensure proper recognition in the appropriate interim reporting period with in the 2012 year. Adjustments totaling \$220,000 related to the overstatement in managed care revenue due to billing errors, the timing of the correction of certain operating and other costs incurred within the 2012 year that were deferred or capitalized to the balance sheet that should have been expensed in the interim reporting period in which the costs were incurred related to approximately \$119,000, the issues primarily related to required adjustments resulting from the timing of recognition for state recoupments for Medicaid overpayments for certain facilities totaling \$403,000, the delays in collection efforts and lack of timely follow-up on open patient accounts in 2012 for certain facilities totaling \$284,000, offset by the reversal of the eliminated management fee expense and other receivables associated with the correction in the application of the

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Company's accounting for certain variable interest entities in the amount of \$327,000.

- *Costs of services* Adjustments totaling \$1,215,000 and \$2,831,000 for the three and six months ended June 30, 2012, respectively, related primarily to the following items:

The timing of expense recognition related to direct care compensation obligations incurred for the facilities located in Arkansas to reflect proper recognition in the appropriate interim reporting period within the 2012 year. For the six months ended June 30, 2012 the adjustment totaled approximately \$918,000 offset by the reversal of the overstated direct care compensation expense of \$258,000 for the three months ended June 30, 2012 resulting in a \$660,000 expense restatement for the six months ended June 30, 2012. The related expense and obligation was being recognized over the period until the respective payment date. However, the obligations should have been expensed immediately in the period incurred as the obligation related to prior services rendered.

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The timing of recognition of certain payroll related operating expenses and other necessary adjustments to related accrued liabilities to ensure proper recognition in the appropriate interim reporting period within the 2012 year. The issues primarily relate to insufficient processes related to accounting for accrued vacation of \$643,000 and \$803,000 for the three and six months ended June 30, 2012, respectively and the untimely identification and recognition of expenses associated with certain unemployment tax accrual adjustments of \$41,000 and \$82,000 for the three and six months ended June 30, 2012, respectively.

The timing of the correction of certain operating and other costs incurred within the 2012 year that were deferred or capitalized to the balance sheet that should have been expensed in the interim reporting period in which the costs were incurred related to approximately \$468,000 for the three months and the six months ended June 30, 2012 and the \$3,000 and \$5,000 of certain operating expenses that were not recorded in the interim reporting period for the three and six months ended June 30, 2012, respectively.

The adjustment of the reversal of the eliminated management fee expense associated with the correction in the application of the Company's accounting for certain variable interest entities for approximately \$162,000 and \$323,000 for the three and six months ended June 30, 2012, respectively.

The timing of certain adjustments to the provision for bad debts in the appropriate interim reporting period within the 2012 year. The issues primarily related to required adjustments resulting from the timing of recognition for state recoupments for Medicaid overpayments for certain facilities totaling \$403,000 for the six months ended June 30, 2012, the delays in collection efforts and lack of timely follow-up on open patient accounts in 2012 for certain facilities totaling \$212,000 and \$279,000 for the three and six months ended June 30, 2012, respectively, offset by the improper recognition of bad debt expense relating to managed care revenue discussed above in the amount of \$56,000 and \$192,000 for the three and six months ended June 30, 2012, respectively.

| (Amounts in 000 \$) | Three Months Ended June 30, 2012 | Six Months Ended June 30, 2012 |
|--|-------------------------------------|-----------------------------------|
| Cost of services (Exclusive of facility rent, depreciation and amortization): | | |
| 1) Recognition of direct care compensation obligations incurred for the facilities located in Arkansas to reflect proper recognition in the appropriate interim reporting period with the 2012 year | \$ (258) | \$ 660 |
| 2) Recognition of certain payroll related operating expenses: | | |
| a) Incorrect accounting for accrued vacation | 643 | 803 |
| b) Untimely identification and recognition of expenses associated with certain unemployment tax accrual adjustments | 41 | 82 |
| 3) Correction of certain operating and other costs incurred within the 2012 year that were incorrectly deferred or capitalized to the balance sheet that should have been expensed in the interim reporting period | 468 | 468 |
| 4) Recognition of certain operating expenses that were not recorded in the interim reporting period | 3 | 5 |
| 5) Reversal of the eliminated management fee expense associated with the correction in the application of the Company's accounting for certain variable interest entities | 162 | 323 |
| 6) Recognition of certain adjustments to the provision for bad debts in the appropriate interim reporting period within the 2012 year: | | |
| a) Untimely recognition of state recoupments for Medicaid overpayments for certain facilities | | 403 |
| b) Delays in collection efforts and lack of timely follow-up on open patient accounts in 2012 for certain facilities | 212 | 279 |
| c) Offset by the improper recognition of bad debt expense relating to managed care revenue | (56) | (192) |
| Total | \$ 1,215 | \$ 2,831 |

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- *General and administrative* - Adjustments totaling \$584,000 and \$522,000 for the three and six months ended June 30, 2012, respectively, resulted primarily due to the following items:

The timing of certain payroll related operating expenses and other necessary adjustments to related accrued liabilities to ensure proper recognition in the appropriate interim reporting period within the 2012 year. The timing of the reversal of \$700,000 expense relating to changes to the accrued performance-based incentive obligation during the three months ended June 30, 2012 offset by \$25,000 of expense recognition related to an adjustment to the fair value of warrants granted to non-employees for the six months ended June 30, 2012.

The timing of the expense incorrectly capitalized on the balance sheet that should have been expensed in the interim reporting period in which the costs were incurred during the 2012 period of \$53,000 and \$74,000 for the three and six months ended June 30, 2012, respectively.

The insufficient processes related to accounting for accrued vacation of \$62,000 and \$77,000 for the three and six months ended June 30, 2012, respectively, and the untimely identification and recognition of expenses associated with certain unemployment tax accrual adjustments of \$1,000 and \$2,000 for the three and six months ended June 30, 2012.

| (Amounts in 000 s) | Three Months Ended June 30, 2012 | Six Months Ended June 30, 2012 |
|--|-------------------------------------|-----------------------------------|
| General and administrative | | |
| 1) Recognition of certain payroll related operating expenses and other necessary adjustments: | | |
| a) Reversal of expense relating to changes to the accrued performance-based incentive obligation | \$ (700) | \$ (700) |
| b) Offset by expense recognition related to an adjustment to the fair value of warrants granted to non-employees | | 25 |
| 2) Incorrect expense capitalized on the balance sheet that should have been expensed in the interim reporting period in which the costs were incurred during the 2012 period | 53 | 74 |
| 3) Incorrect accounting for accrued vacation | 62 | 77 |
| 4) Untimely identification and recognition of expenses associated with certain unemployment tax accrual adjustments | 1 | 2 |
| Total | \$ (584) | \$ (522) |

- *Interest expense, net* Adjustments totaling \$350,000 and \$349,000 for the three and six months ended June 30, 2012, respectively, related primarily to the following items:

The correction of interest capitalized on the balance sheet that should have been expensed in the interim reporting period in which the costs were incurred during the 2012 year was approximately \$269,000 for the three and six months ended June 30, 2012.

The recognition of expense related to the fair value of warrants granted to non-employees in connection with loan financing fees of approximately \$81,000 for the three and six months ended June 30, 2012.

| (Amounts in 000 s) | Three Months Ended June 30, 2012 | Six Months Ended June 30, 2012 |
|------------------------------|-------------------------------------|-----------------------------------|
| Interest expense, net | | |

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| | | | | |
|--|-----------|------------|-----------|------------|
| 1) Correction of interest capitalized on the balance sheet that should have been expensed in the interim reporting period in which the costs were incurred during the 2012 | \$ | 269 | \$ | 269 |
| 2) Recognition of expense related to the fair value of warrants granted to non-employees in connection with loan financing fees | | 81 | | 81 |
| 3) Rounding | | | | (1) |
| Total | \$ | 350 | \$ | 349 |

- Depreciation and amortization* Adjustments totaling a decrease of \$37,000 and an increase \$284,000 for the three and six months ended June 30, 2012, respectively related primarily to the impairment of an office building of \$389,000 acquired through a 2011 acquisition that was vacated and abandoned in first quarter of 2012 to market value less cost to sell offset by \$5,000 decrease in depreciation expense during the three months ended June 30, 2012 related to the office building impairment in first quarter of 2012 and \$32,000 and \$100,000 for the three and six months ended June 30, 2012, respectively, resulted from a decrease in amortization of certain intangibles related to adjustments that decreased the underlying intangible asset values and increased the related goodwill resulting from the respective acquisitions.

- Property and equipment, net* Adjustments of \$1,523,000 related primarily to the \$389,000 impairment of an office building acquired in 2011 acquisition offset by a \$5,000 decrease in depreciation expense during the three months ended June 30, 2012 related to the office building impairment in first quarter of 2012; \$100,000 decrease in amortization of certain intangibles related to adjustments that decreased the underlying intangible asset values and increased the related goodwill resulted from the respective acquisitions of \$547,000 and \$692,000 of expense inadvertently capitalized on the balance sheet that should have been expensed in the interim reporting period in which the costs were incurred during the 2012 period.

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- *Goodwill and Intangible assets bed licenses* - Adjustments of \$635,000 related to an acquisition reclassification to goodwill from the capitalized intangible assets bed licenses of \$87,000 and \$547,000 from property and equipment during the 2012 period.

- *Deferred loan costs, net* Adjustment of \$94,000 related to an adjustment to the fair value of warrants granted to non-employees which related to the costs incurred in connection with loan costs.

- *Current portion of notes payable and other debt* Reclassification of the PrivateBank loan from long-term debt to current as a result of a loan modification agreement with PrivateBank that, among other things, amended the loan agreement to reflect a maturity date of March 30, 2013. The Company anticipates that it will re-finance the PrivateBank loan later this year with long-term financing; however, the Company does not have a formal noncancelable agreement with PrivateBank. As such, the entire balance is reflected as a current obligation at June 30, 2012 in the amount of \$21.3 million.

- *Revolving credit facilities and lines of credit* Reclassification of the Gemino Credit Facility from long-term Revolving credit facilities as a result of the Company's termination and pay off of the amounts outstanding under that certain Credit Agreement, dated October 29, 2010, between Gemino and the Company on September 20, 2012. As such, the entire balance is reflected as a current obligation at June 30, 2012, in the amount of \$7.0 million.

- *Statement of cash flows* Adjustments to the statement of cash flows result primarily from the adjustments related to the Oklahoma Owners as discussed above; changes in net loss and the related adjustments to the various working capital related balance sheet accounts resulting from the other adjustments described above; and adjustments to show \$31.4 million of debt incurred in conjunction with certain acquisitions as cash provided by financing activities and cash used in investing activities.

The following table presents the Company's previously issued (the "As Reported") and restated (the "As Restated") consolidated balance sheet as of June 30, 2012 (*in thousands*):

| | At June 30, 2012 | | | |
|---|------------------|--------------------|----------------------|-------------|
| | As Reported | Oklahoma Owners | Other Adjustments | As Restated |
| ASSETS | | | | |
| Cash and cash equivalents | \$ 9,373 | \$ (300) | \$ | \$ 9,073 |
| Restricted cash and investments | 3,624 | | | 3,624 |
| Accounts receivable, net | 26,964 | (1,138) | (699) | 25,127 |
| Prepaid expenses and other | 668 | (143) | | 525 |
| Assets of disposal group held for sale | 38 | | | 38 |
| Total current assets | 40,667 | (1,581) | (699) | 38,387 |
| Restricted cash and investments | 5,812 | | | 5,812 |
| Property and equipment, net (net of reclassification of \$2,694) (Note 1) | 144,399 | (9,952) | (1,523) | 132,924 |
| Intangible assets bed licenses | 2,464 | | (87) | 2,377 |
| Intangible assets lease rights, net | 7,925 | | | 7,925 |

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| | | | | |
|--|------------|-------------|------------|------------|
| Goodwill (reclassification of \$2,694) (Note 1) | 3,600 | (1,123) | 635 | 3,112 |
| Escrow deposits for acquisitions | 1,513 | | | 1,513 |
| Lease deposits | 1,725 | | | 1,725 |
| Deferred loan costs, net | 5,733 | (558) | 94 | 5,269 |
| Other assets | 71 | | | 71 |
| Total assets | \$ 213,909 | \$ (13,214) | \$ (1,580) | \$ 199,115 |

LIABILITIES AND STOCKHOLDERS EQUITY

| | | | | |
|---|------------|-------------|------------|------------|
| Current portion of notes payable and other debt | \$ 9,401 | \$ (196) | \$ 21,280 | \$ 30,485 |
| Revolving credit facilities and lines of credit | 1,900 | | 5,164 | 7,064 |
| Accounts payable | 16,601 | (1,320) | 328 | 15,609 |
| Accrued expenses | 11,424 | (449) | 818 | 11,793 |
| Liabilities of disposal group held for sale | 143 | | | 143 |
| Total current liabilities | 39,469 | (1,965) | 27,590 | 65,094 |
| Senior debt, net of discounts | 116,603 | (12,288) | (21,277) | 83,038 |
| Convertible debt, net of discounts | 15,035 | | | 15,035 |
| Revolving credit facilities | 7,064 | | (5,164) | 1,900 |
| Other debt | 12,880 | | | 12,880 |
| Derivative liability | 1,127 | | | 1,127 |
| Other liabilities | 1,729 | | | 1,729 |
| Deferred tax liability | 87 | | 32 | 119 |
| Total liabilities | 193,994 | (14,253) | 1,181 | 180,922 |
| Common stock and additional paid-in capital | 39,647 | | 199 | 39,846 |
| Accumulated deficit | (18,240) | | (2,945) | (21,185) |
| Total stockholders equity | 21,407 | | (2,746) | 18,661 |
| Noncontrolling interest in subsidiaries | (1,492) | 1,039 | (15) | (468) |
| Total equity | 19,915 | 1,039 | (2,761) | 18,193 |
| Total liabilities and equity | \$ 213,909 | \$ (13,214) | \$ (1,580) | \$ 199,115 |

Table of Contents**NOTE 2. RESTATEMENT OF PREVIOUSLY ISSUED CONSOLIDATED FINANCIAL STATEMENTS** *(continued)*

The following tables present the Company's previously issued (the "As Reported") and restated (the "As Restated") consolidated statement of operations for the three and six months ended June 30, 2012 *(in thousands, except per share information)*:

| | Three Months Ended June 30, 2012 | | | |
|--|---|----------------------------|------------------------------|--------------------|
| | As Reported | Oklahoma Owners | Other Adjustments | As Restated |
| Revenues | | | | |
| Patient care revenues | \$ 54,642 | \$ (3,240) | \$ (136) | \$ 51,266 |
| Management revenues | 363 | | 162 | 525 |
| Total revenues | 55,005 | (3,240) | 26 | 51,791 |
| Expenses: | | | | |
| Cost of services (Exclusive of facility rent, depreciation and amortization) | 42,227 | (3,126) | 1,215 | 40,316 |
| General and administrative | 4,929 | | (584) | 4,345 |
| Facility rent expense | 2,050 | | | 2,050 |
| Depreciation and amortization | 1,761 | (130) | (37) | 1,594 |
| Total expenses | 50,967 | (3,256) | 594 | 48,305 |
| Income from Operations | 4,038 | 16 | (568) | 3,486 |
| Other Income (Expense): | | | | |
| Interest expense, net | (3,366) | 272 | (350) | (3,444) |
| Acquisition costs, net of gains | (524) | | | (524) |
| Derivative gain | 353 | | | 353 |
| Other expense | (13) | | | (13) |
| Total other expense, net | (3,550) | 272 | (350) | (3,628) |
| Income (Loss) from Continuing Operations Before Income Taxes | 488 | 288 | (918) | (142) |
| Income Tax Benefit (Expense) | (45) | | 12 | (33) |
| Income (Loss) from Continuing Operations | 443 | 288 | (906) | (175) |
| Loss from discontinued operations, net of tax | (160) | | (10) | (170) |
| Net Income (Loss) | 283 | 288 | (916) | (345) |
| Net Income (Loss) Attributable to Noncontrolling Interest | 396 | (288) | 33 | 141 |
| Net Income (Loss) Attributable to AdCare Health Systems, Inc. | \$ 679 | \$ | \$ (883) | \$ (204) |
| Net Income (Loss) per Common Share - Basic: | | | | |
| Continuing Operations | \$ 0.06 | \$ (0.00) | \$ (0.06) | \$ 0.00 |
| Discontinued Operations | (0.01) | | | (0.01) |
| | \$ 0.05 | \$ (0.00) | \$ (0.06) | \$ (0.01) |
| Net Income (Loss) per Common Share - Diluted | | | | |

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| | | | | | | | | |
|-------------------------|----|--------|----|--------|----|--------|----|--------|
| Continuing Operations | \$ | 0.06 | \$ | (0.00) | \$ | (0.06) | \$ | 0.00 |
| Discontinued Operations | | (0.01) | | | | | | (0.01) |
| | \$ | 0.05 | \$ | (0.00) | \$ | (0.06) | \$ | (0.01) |

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| | Six Months Ended June 30, 2012 | | | |
|--|--------------------------------|--------------------|----------------------|-------------|
| | As Reported | Oklahoma Owners | Other Adjustments | As Restated |
| Revenues | | | | |
| Patient care revenues | \$ 104,450 | \$ (6,464) | \$ (413) | \$ 97,573 |
| Management revenues | 726 | | 323 | 1,049 |
| Total revenues | 105,176 | (6,464) | (90) | 98,622 |
| Expenses: | | | | |
| Cost of services (Exclusive of facility rent, depreciation and amortization) | 82,350 | (6,058) | 2,831 | 79,123 |
| General and administrative | 8,860 | | (522) | 8,338 |
| Facility rent expense | 4,115 | | | 4,115 |
| Depreciation and amortization | 3,258 | (238) | 284 | 3,304 |
| Total expenses | 98,583 | (6,296) | 2,593 | 94,880 |
| Income from Operations | 6,593 | (168) | (2,683) | 3,742 |
| Other Income (Expense): | | | | |
| Interest expense, net | (6,320) | 547 | (349) | (6,122) |
| Acquisition costs, net of gains | (817) | | | (817) |
| Derivative gain | 763 | | | 763 |
| Other expense | (29) | | 2 | (27) |
| Total other expense, net | (6,403) | 547 | (347) | (6,203) |
| Income (Loss) from Continuing Operations Before Income Taxes | 190 | 379 | (3,030) | (2,461) |
| Income Tax Benefit (Expense) | (99) | | 81 | (18) |
| Income (Loss) from Continuing Operations | 91 | 379 | (2,949) | (2,479) |
| Loss from discontinued operations, net of tax | (269) | | (10) | (279) |
| Net Loss | (178) | 379 | (2,959) | (2,758) |
| Net Income (Loss) Attributable to Noncontrolling Interest | 651 | (379) | 14 | 286 |
| Net Income (Loss) Attributable to AdCare Health Systems, Inc. | \$ 473 | \$ | \$ (2,945) | \$ (2,472) |
| Net Income (Loss) per Common Share - Basic: | | | | |
| Continuing Operations | \$ 0.06 | \$ (0.00) | \$ (0.23) | \$ (0.17) |
| Discontinued Operations | \$ (0.02) | | | \$ (0.02) |
| | \$ 0.04 | \$ (0.00) | \$ (0.23) | \$ (0.19) |
| Net Income (Loss) per Common Share - Diluted | | | | |
| Continuing Operations | \$ 0.06 | \$ (0.00) | \$ (0.23) | \$ (0.17) |
| Discontinued Operations | \$ (0.02) | | | \$ (0.02) |
| | \$ 0.04 | \$ (0.00) | \$ (0.23) | \$ (0.19) |

Table of Contents**NOTE 2. RESTATEMENT OF PREVIOUSLY ISSUED CONSOLIDATED FINANCIAL STATEMENTS** *(continued)*

The following table presents the Company's previously issued (the "As Reported") and restated (the "As Restated") consolidated statement of cash flows for the six months ended June 30, 2012 *(in thousands)*:

| | As Reported | Six Months Ended June 30, 2012 | | As Restated |
|--|-------------|--------------------------------|----------------------|-------------|
| | | Oklahoma Owners | Other Adjustments | |
| Cash flows from operating activities: | | | | |
| Net loss | \$ (178) | \$ 380 | \$ (2,960) | \$ (2,758) |
| Loss from discontinued operations, net of tax | 269 | | 10 | 279 |
| Loss from continuing operations | 91 | 380 | (2,950) | (2,479) |
| Adjustments to reconcile net loss from continuing operations to net cash provided by operating activities: | | | | |
| Depreciation and amortization | 3,258 | (238) | 284 | 3,304 |
| Warrants issued for services | | | | |
| Stock based compensation expense | 347 | | 24 | 371 |
| Lease expense in excess of cash | 291 | | | 291 |
| Amortization of deferred financing costs | 975 | (105) | 107 | 977 |
| Amortization of debt discounts | 429 | | (2) | 427 |
| Derivative gain | (763) | | | (763) |
| Deferred tax expense | 1 | | 32 | 33 |
| Gain on disposal of assets | (2) | | | (2) |
| Provision for bad debts | 1,233 | (52) | 495 | 1,676 |
| Other noncash items | 29 | | (29) | |
| Changes in certain assets and liabilities, net of acquisitions: | | | | |
| Accounts receivable | (9,306) | 389 | 97 | (8,820) |
| Prepaid expenses and other | (4) | 107 | (1) | 102 |
| Other assets | 50 | 57 | 49 | 156 |
| Accounts payable and accrued expenses | 5,081 | (953) | 980 | 5,108 |
| Net cash provided by operating activities - continuing operations | 1,710 | (415) | (914) | 381 |
| Net cash used in operating activities - discontinued operations | (426) | | 157 | (269) |
| Net cash provided by operating activities | 1,284 | (415) | (757) | 112 |
| Cash flows from investing activities: | | | | |
| Proceeds from sale of property and equipment | 3 | | | 3 |
| Change in restricted cash and investments and escrow deposits for acquisitions | (485) | | (2,198) | (2,683) |
| Acquisitions | (8,849) | | (27,806) | (36,655) |
| Purchase of property and equipment | (2,569) | 201 | 692 | (1,676) |
| Net cash used in investing activities - continuing operations | (11,900) | 201 | (29,312) | (41,011) |
| Net cash used in investing activities - discontinued operations | | | | |
| Net cash used in investing activities | (11,900) | 201 | (29,312) | (41,011) |
| Cash flows from financing activities: | | | | |
| Proceeds from debt | 11,515 | | 35,673 | 47,188 |
| Debt issuance costs | (205) | | (1,321) | (1,526) |
| Change in line of credit | 312 | | 1 | 313 |

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| | | | | |
|---|----------|----------|---------|----------|
| Exercise of warrants and options | 95 | | | 95 |
| Proceeds from stock issuances, net | 3,768 | | | 3,768 |
| Repayment of notes payable | (2,763) | 94 | (4,284) | (6,953) |
| Net cash provided by financing activities - continuing operations | 12,722 | 94 | 30,069 | 42,885 |
| Net cash used in financing activities - discontinued operations | (97) | | | (97) |
| Net cash provided by financing activities | 12,625 | 94 | 30,069 | 42,788 |
| Net Change in Cash | 2,009 | (120) | | 1,889 |
| Cash, Beginning | 7,364 | (180) | | 7,184 |
| Cash, Ending | \$ 9,373 | \$ (300) | \$ | \$ 9,073 |

Supplemental Disclosure of Cash Flow Information:

Cash paid during the period for:

| | | | | |
|--------------|----------|----|----------|----------|
| Interest | \$ 4,630 | \$ | \$ 1,177 | \$ 5,807 |
| Income taxes | \$ 46 | \$ | \$ (46) | \$ |

Supplemental Disclosure of Non-cash Activities:

| | | | | |
|--|-----------|----|-------------|----------|
| Acquisitions in exchange for debt and equity instruments | \$ 32,720 | \$ | \$ (27,720) | \$ 5,000 |
| Warrants issued for financings costs | \$ 390 | \$ | \$ 175 | \$ 565 |
| Noncash debt issuance costs | \$ 3,490 | \$ | \$ (3,490) | \$ |

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NOTE 3. LIQUIDITY AND PROFITABILITY

The Company had net loss of approximately \$345,000 and \$2,758,000 for the three and six months ended June 30, 2012, respectively, and a net loss of \$4,562,000 and \$5,503,000 for the three and six months ended June 30, 2011, respectively. The Company had negative working capital of approximately \$26,706,000 at June 30, 2012. The Company's ability to sustain profitable operations is dependent on continued growth in revenue and controlling costs.

Management's plans for increasing liquidity and profitability in future years include the following:

- increasing facility occupancy and improving the occupancy mix by increasing Medicare patients;
- acquiring additional long term care facilities with existing cash flowing operations to expand our operations, and
- refinancing debt where possible to obtain more favorable terms.

Management believes that the foregoing actions, if taken by the Company, should provide the opportunity for the Company to improve liquidity and achieve profitability; however, there is no assurance that such actions will occur or, if they do occur, that they will result in improved liquidity or profitability. The consolidated financial statements do not include any adjustments that might result from the outcome of this uncertainty.

NOTE 4. 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. This segment represented less than 2% of total revenues for the Company over the past year.

As a result of the decision to exit the home health business, the assets and liabilities that are expected to be sold are reflected as assets and liabilities held for sale and are comprised of the following:

| (Amounts in 000 s) | June 30, 2012 | | December 31, 2011 | |
|--|---------------|-----|-------------------|-----|
| Property and equipment, net | \$ | 36 | \$ | 45 |
| Other assets | | 2 | | 2 |
| Assets of disposal group held for sale | \$ | 38 | \$ | 47 |
| Current portion of debt | \$ | 143 | \$ | 197 |

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| | | | | |
|---|----|-----|----|-----|
| Notes payable | | | | 43 |
| Liabilities of disposal group held for sale | \$ | 143 | \$ | 240 |

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Notes to Consolidated Financial Statements

(Unaudited) (Continued)

NOTE 5. SEGMENTS

The Company reports its operations in three segments: Skilled Nursing Facility (SNF), Assisted Living Facility (ALF), and Corporate & Other. The SNF and ALF segments provide services to individuals needing long-term care in a nursing home or assisted living setting, and the management of those facilities. The Corporate & Other segment engages in the management of facilities and accounting and IT services. We evaluate financial performance and allocate resources primarily based upon segment operating income (loss). Segment operating results excludes interest expense and other non-operating income and expenses. The table below sets forth our segment information for the three and six months ended June 30, 2012 and 2011.

| (Amounts in 000 \$) | SNF | ALF | Corporate & Other | Eliminations | Total |
|---|------------|-----------|----------------------|--------------|------------|
| Three months ended June 30, 2012 Restated (Note 2) | | | | | |
| Net revenues | \$ 47,853 | \$ 3,413 | \$ 3,133 | \$ (2,608) | \$ 51,791 |
| Cost of services | 40,259 | 2,606 | 59 | (2,608) | 40,316 |
| General and administrative | (36) | | 4,381 | | 4,345 |
| Facility rent expense | 2,000 | | 50 | | 2,050 |
| Depreciation and amortization | 1,202 | 219 | 173 | | 1,594 |
| Operating income/(loss) | \$ 4,428 | \$ 588 | \$ (1,530) | \$ | \$ 3,486 |
| Three months ended June 30, 2011 | | | | | |
| Net revenues | \$ 31,462 | \$ 2,410 | \$ 2,585 | \$ (2,101) | \$ 34,356 |
| Cost of services | 27,283 | 1,869 | 53 | (2,101) | 27,104 |
| General and administrative | | | 3,167 | | 3,167 |
| Facility rent expense | 1,902 | | 45 | | 1,947 |
| Depreciation and amortization | 504 | 161 | 40 | | 705 |
| Salary retirement and continuation costs | | | 622 | | 622 |
| Operating income/(loss) | \$ 1,773 | \$ 380 | \$ (1,342) | \$ | \$ 811 |
| Six months ended June 30, 2012 Restated (Note 2) | | | | | |
| Net revenues | \$ 90,897 | \$ 6,676 | \$ 5,982 | \$ (4,933) | \$ 98,622 |
| Cost of services | 79,040 | 4,975 | 41 | (4,933) | 79,123 |
| General and administrative | | | 8,338 | | 8,338 |
| Facility rent expense | 4,026 | | 89 | | 4,115 |
| Depreciation and amortization | 2,532 | 429 | 343 | | 3,304 |
| Operating income/(loss) | \$ 5,299 | \$ 1,272 | \$ (2,829) | \$ | \$ 3,742 |
| Total assets, June 30, 2012 | \$ 139,963 | \$ 29,403 | \$ 29,749 | \$ | \$ 199,115 |
| Six months ended June 30, 2011 | | | | | |
| Net revenues | \$ 59,653 | \$ 4,751 | \$ 5,297 | \$ (4,315) | \$ 65,386 |

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| | | | | | |
|--|------------|-----------|------------|------------|------------|
| Cost of services | 52,607 | 3,854 | 133 | (4,315) | 52,279 |
| General and administrative | | | 6,091 | | 6,091 |
| Facility rent expense | 3,805 | | 45 | | 3,850 |
| Depreciation and amortization | 963 | 313 | 76 | | 1,352 |
| Salary retirement and continuation costs | | | 622 | | 622 |
| Operating income/(loss) | \$ 2,278 | \$ 584 | \$ (1,670) | \$ | \$ 1,192 |
| Total assets, December 31, 2011 | \$ 110,532 | \$ 22,328 | \$ 35,792 | \$ (9,548) | \$ 159,104 |

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ADCARE HEALTH SYSTEMS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

(Unaudited) (Continued)

NOTE 6. PROPERTY AND EQUIPMENT

| (Amounts in 000 s) | Estimated Useful Lives (Years) | June 30, 2012 Restate (Note 2) | December 31, 2011 |
|--|-----------------------------------|---|----------------------|
| Buildings and improvements | 5-40 | \$ 121,648 | \$ 93,371 |
| Equipment | 2-10 | 10,060 | 7,108 |
| Land | | 9,206 | 7,636 |
| Computer related | 2-10 | 2,487 | 2,414 |
| Construction in process | | 187 | 77 |
| | | 143,588 | 110,606 |
| Less: accumulated depreciation expense | | 9,868 | 7,624 |
| Less: accumulated amortization expense | | 796 | 533 |
| Property and equipment, net | | \$ 132,924 | \$ 102,449 |

For the six months ended June 30, 2012 and 2011, depreciation and amortization expense was approximately \$3,304,000 and \$1,352,000, respectively.

In 2012, a reclassification adjustment was made to the December 31, 2011 balance sheet to recognize \$2.7 million of goodwill acquired in acquisitions that was previously reported as bed licenses in property and equipment. The Company does not amortize goodwill or indefinite lived intangibles.

During the quarter ended March 31, 2012, the Company recognized a \$389,000 impairment charge to write down the carrying value of an office building located in Rogers, Arkansas. The office building was acquired in a 2011 acquisition. 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 and is included in the Company's Skilled Nursing Facility segment.

NOTE 7. RESTRICTED CASH AND INVESTMENTS

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

| (Amounts in 000 s) | June 30, 2012 | | December 31, 2011 | |
|---|------------------|-------|----------------------|-------|
| HUD escrow deposits | \$ | 249 | \$ | 326 |
| Funds held in trust for residents | | 21 | | 45 |
| Refundable escrow deposit | | | | 500 |
| Collateral certificates of deposit | | 3,354 | | 1,012 |
| Total current portion | | 3,624 | | 1,883 |
| HUD reserve replacements | | 1,111 | | 1,130 |
| Reserves for capital improvements | | 2,429 | | 1,767 |
| Restricted investments for other debt obligations | | 2,272 | | 1,973 |
| Total noncurrent portion | | 5,812 | | 4,870 |
| Total restricted cash and investments | \$ | 9,436 | \$ | 6,753 |

Table of Contents**NOTE 8. ACCRUED EXPENSES**

Accrued expenses consist of the following:

| (Amounts in 000 s) | June 30, 2012 Restated (Note 2) | December 31, 2011 |
|-----------------------------|--|----------------------|
| Accrued payroll related | \$ 4,914 | \$ 5,040 |
| Accrued employee benefits | 2,985 | 2,023 |
| Real estate and other taxes | 1,244 | 982 |
| Other accrued expenses | 2,650 | 1,836 |
| Total accrued expenses | \$ 11,793 | \$ 9,881 |

NOTE 9. NOTES PAYABLE AND OTHER DEBT

Notes payable and other debt consist of the following:

| (Amounts in 000 s) | June 30, 2012 Restated (Note 2) | December 31, 2011 |
|---|--|----------------------|
| Revolving credit facilities and lines of credit | \$ 8,964 | \$ 8,651 |
| Senior debt guaranteed by HUD | 15,802 | 15,738 |
| Senior debt guaranteed by USDA | 28,659 | 38,717 |
| Senior debt guaranteed by SBA | 4,996 | 5,087 |
| Senior debt bonds, net of discount | 13,083 | 6,176 |
| Senior debt other mortgage indebtedness | 56,210 | 23,823 |
| Other debt | 7,653 | 4,197 |
| Convertible debt issued in 2010, net of discount | 10,526 | 10,105 |
| Convertible debt issued in 2011 | 4,509 | 4,509 |
| Total notes payable and other debt | 150,402 | 117,003 |
| Less current portion of notes payable and other debt | 30,485 | 4,567 |
| Less current portion of revolving credit facility and lines of credit | 7,064 | 7,343 |
| Notes payable and other debt, net of current portion | \$ 112,853 | \$ 105,093 |

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

Notes to Consolidated Financial Statements

(Unaudited) (Continued)

Scheduled Maturities

The following is a summary of the scheduled maturities of indebtedness as of June 30, 2012 for each of the next five years and thereafter:

| | (Amounts in 000 s) | |
|------------------------------------|--------------------|---------|
| 2013 | \$ | 37,549 |
| 2014 | | 21,026 |
| 2015 | | 1,916 |
| 2016 | | 7,080 |
| 2017 | | 6,415 |
| Thereafter | | 77,976 |
| Subtotal | | 151,962 |
| Less: unamortized discounts | | (1,560) |
| Total notes payable and other debt | \$ | 150,402 |

Debt Covenant Compliance

As of June 30, 2012, the Company (including its consolidated variable interest entity) had 27 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, 2012, the 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.

Revolving Credit Facilities***Gemino Credit Facility***

At December 31, 2011, the outstanding balance of approximately \$7,265,000 for the revolving credit agreement was classified as current as a result of the required lockbox arrangement and subjective acceleration clauses. At June 30, 2012, the outstanding balance is reflected as current in the amount of approximately \$7,041,000 (see Note 2). At June 30, 2012, the Company's outstanding balance was in excess of the borrowing base restriction and the portion in excess is presented as a current obligation.

Senior debt guaranteed by HUD

Hearth and Home of Vandalia

In connection with the Company's January 2012 refinance of the assisted living facility located in Vandalia, Ohio known as Hearth and Home of Vandalia, a wholly owned subsidiary of AdCare obtained a term loan insured by U.S. Department of Housing and Urban Development (HUD) with a financial institution for a total amount of \$3,721,500 that matures in 2041. The HUD term loan requires monthly principal and interest payments of approximately \$17,500 with a fixed interest rate of 3.74%. Deferred financing costs incurred on the term loan amounted to approximately \$201,000 and are being amortized to interest expense over the life of the loan. The HUD term loan has a prepayment penalty of 8% through 2014 declining by 1% each year through 2022.

Senior debt other mortgage indebtedness

Woodland Manor

In connection with the Company's January 2012 acquisition of the skilled nursing facility located in Springfield, Ohio, known as Woodland Manor, a wholly owned subsidiary of the Company entered into a loan agreement for \$4,800,000. The loan matures in December 2016 with a required final payment of approximately \$4,300,000 and accrues interest at the LIBOR rate plus 4% with a minimum rate of 6% per annum. The loan requires monthly principal payments of \$8,500 plus interest for total current monthly payments of approximately \$33,000. Deferred financing costs incurred on the loan amounted to approximately \$107,300 and are being amortized to interest expense over the life of the loan. The loan has a prepayment penalty of 5% through 2012 declining by 1% each year through 2015. The loan is secured by the Woodland Manor facility and guaranteed by AdCare.

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ADCARE HEALTH SYSTEMS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

(Unaudited) (Continued)

Senior debt other mortgage indebtedness (continued)

Little Rock, Northridge and Woodland Hills

In connection with the Company's April 2012 acquisition of three skilled nursing facilities located in Arkansas known as Little Rock, Northridge and Woodland Hills, certain wholly owned subsidiaries of AdCare entered into a loan agreement for \$21,800,000 with the Private Bank. The loan matures in March 2017 with a required final payment of approximately \$19,700,000 and accrues interest at the LIBOR rate plus 4% with a minimum rate of 6% per annum. The loan requires monthly principal payments of \$37,000 plus interest for total current monthly payments of approximately \$153,000. Deferred financing costs incurred on the loan amounted to approximately \$410,000 and are being amortized to interest expense over the life of the loan. The loan has a prepayment penalty of 5% through 2012 declining by 1% each year through 2015. The loan is secured by the three facilities and guaranteed by AdCare. The Company has approximately \$1,810,000 of restricted assets related to this loan.

On June 15, 2012, certain wholly owned subsidiaries of AdCare entered into a modification agreement with Private Bank to modify the terms of the loan agreement. The loan modification agreement, among other things, amended the loan agreement to reflect a maturity date of March 30, 2013. The Company anticipates that it will re-finance the Little Rock, Northridge and Woodland Hills facilities later this year with long-term financing. However, the Company does not have a formal noncancelable agreement with Private Bank. As such, the entire balance is reflected as a current obligation at June 30, 2012 (See Note 2).

Abington Place

In connection with the Company's June 2012 acquisition of the skilled nursing facility located in Little Rock, Arkansas known as Abington Place, a wholly owned subsidiary of AdCare entered into a short-term loan agreement for \$3,425,000 with Metro City Bank. The loan matures in September 2012 and accrues interest at the prime rate plus 2.25% with a minimum rate of 6.25% per annum. Deferred financing costs incurred on the loan amounted to approximately \$130,000 and are being amortized to interest expense over the life of the loan. The loan may be prepaid at any time without penalty. The loan is secured by the Abington Place facility and guaranteed by AdCare.

Stone County

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In June 2012, a wholly owned subsidiary of AdCare financed the skilled nursing facility located in Mountain View, Arkansas known as Stone County by entering into a loan agreement for \$1,810,000 with Metro City Bank. The loan matures in June 2022 and accrues interest at the prime rate plus 2.25% with a minimum rate of 6.25% per annum. Deferred financing costs incurred on the loan amounted to approximately \$67,000 and are being amortized to interest expense over the life of the loan. The loan has a prepayment penalty of 10% through 2012 declining by 1% each year through 2021. The loan is secured by the Stone County facility and guaranteed by AdCare.

In June 2012, a wholly owned subsidiary of AdCare entered into a short-term loan agreement for \$1,267,000 with Metro City Bank. The loan matured in July 2012 and accrued interest at a fixed rate of 6.25% per annum. Deferred financing costs incurred on the loan amounted to approximately \$12,000 and are being amortized to interest expense over the life of the loan. The loan may be prepaid at any time without penalty. The loan is secured by the Stone County facility and guaranteed by AdCare. This loan was refinanced subsequent to June 30, 2012. For information regarding the refinancing subsequent to June 30, 2012, see Note 17 in the Notes to Consolidated Financial Statements.

Senior debt bonds, net of discount

Eaglewood Village Bonds

In April 2012, a wholly owned subsidiary of AdCare entered into a loan agreement with the City of Springfield in the State of Ohio (City of Springfield) pursuant to which City of Springfield lent to such subsidiary the proceeds from the sale of City of Springfield s Series 2012 Bonds. The Series 2012 Bonds consist of \$6,610,000 in Series 2012A First Mortgage Revenue Bonds and \$620,000 in Taxable Series 2012B First Mortgage Revenue Bonds. The Series 2012 Bonds were issued pursuant to an April 2012 Indenture of Trust between the City of Springfield and the Bank of Oklahoma. The Series 2012A Bonds mature in May 2042 and accrue interest at a fixed rate of 7.65% per annum. The Series 2012B Bonds mature in May 2021 and accrue interest at a fixed rate of 8.5% per annum. Deferred financing costs incurred on the loan amounted to approximately \$575,000 and are being amortized to interest expense over the life of the loan. The loan is secured by the Company s assisted living facility located in Springfield, Ohio known as Eaglewood Village and guaranteed by AdCare. There is an original issue discount of approximately \$250,000 and restricted assets of \$317,000 related to this loan.

Other Debt

Eaglewood Village Promissory Note

In January 2012, two wholly owned subsidiaries of AdCare issued a promissory note in the amount of \$500,000 in connection with the January 2012 acquisition of the assisted living facility located in Springfield, Ohio. The note

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ADCARE HEALTH SYSTEMS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

(Unaudited) (Continued)

matures in January 2014 and bears interest at 6.5% per annum payable monthly beginning February 2012. The note requires monthly principal and interest payments of \$3,700. The note may be prepaid without penalty at any time.

Cantone Promissory Notes

In March 2012, AdCare issued an unsecured promissory note to Cantone Asset Management LLC in the amount of \$3,500,000. The promissory note bears interest at 10% per annum and matures in October 2012. The interest rate increases 1% each month beginning in July 2012 through October 2012. The note may also be prepaid without penalty at any time; provided, however, if the note is prepaid prior to October 1, 2012, the interest on the note through such date is payable. In connection with the issuance of the note, Cantone Research, Inc. agreed to provide AdCare with certain consulting services for a monthly fee if the Company and Cantone Asset Management LLC (or an affiliated entity) do not agree to the terms of an additional financing arrangement pursuant to which it (or affiliated entity) would loan to us at least \$4,000,000 for a four-year term.

In April 2012, AdCare issued a promissory note to Cantone Asset Management LLC in the amount of \$1,500,000. The promissory note bears interest at 10% per annum and matures in October 2012. The interest rate increases 1% each month beginning in July 2012 through October 2012. Deferred financing costs incurred on the loan amounted to approximately \$78,000 and are being amortized to interest expense over the life of the loan. The note may also be prepaid without penalty at any time; provided, however, if the note is prepaid prior to October 1, 2012, then interest on the note through such date is payable.

The promissory notes issued to Cantone Asset Management LLC in March and April 2012 were refinanced and the consulting arrangement with Cantone Research, Inc. was revised subsequent to June 30, 2012. For information regarding the refinancing and the revision to the consulting arrangement, see Note 17 in the Notes to Consolidated Financial Statements.

Strome Note

On April 1, 2012, AdCare issued an unsecured promissory note in the amount of \$5,000,000 to Strome Alpha Offshore Ltd. The promissory note matures on November 1, 2012 and accrues interest at a fixed rate of 10% per annum. The promissory note requires interest payments of approximately \$125,000 on July 1, 2012 and October 1, 2012. The promissory note may be prepaid at any time without penalty.

NOTE 10. ACQUISITIONS*Summary of 2012 Acquisitions*

During the six months ended June 30, 2012, the Company acquired a total of five skilled nursing facilities and one assisted living facility described further below. The Company has incurred a total of approximately \$817,000 of acquisition costs related to these acquisitions and has recorded the cost in the Other Income (Expense) section of the Consolidated Statements of Operations.

Eaglewood Care Center and Eaglewood Village

On January 1, 2012, the Company obtained control of the Eaglewood Care Center, a skilled nursing facility and the Eaglewood Village facility, an assisted living facility each located in Springfield, Ohio. The total purchase price was \$12,412,000 after final closing adjustments.

| | (Amounts in 000 s) | |
|-------------------------------------|--------------------|--------|
| Consideration transferred: | | |
| Net proceeds from loans | \$ | 4,693 |
| Seller notes | | 5,000 |
| Cash from earnest money deposits | | 250 |
| Cash (prepaid on December 30, 2011) | | 2,469 |
| Total consideration transferred | \$ | 12,412 |
| Assets acquired: | | |
| Land | \$ | 370 |
| Building | | 9,656 |
| Equipment and furnishings | | 1,199 |
| Intangible assets – bed licenses | | 1,188 |
| Goodwill | | 87 |
| Total assets acquired | | 12,500 |
| Liabilities assumed: | | |
| Real estate taxes and other | | (88) |
| Total identifiable net assets | \$ | 12,412 |

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Notes to Consolidated Financial Statements

(Unaudited) (Continued)

Little Rock, Northridge and Woodland Hills

On April 1, 2012, the Company obtained control of the Little Rock, Northridge and Woodland Hills facilities, three skilled nursing facilities located in Little Rock, Arkansas. The total purchase price was \$27,231,000 after final closing adjustments.

| | (Amounts in 000 s) |
|--|-----------------------|
| Consideration transferred: | |
| Net proceeds from loans | \$ 19,732 |
| Cash | 5,899 |
| Cash from earnest money deposits | 1,600 |
| Total consideration transferred | \$ 27,231 |
| Assets acquired: | |
| Land | \$ 1,582 |
| Building | 17,256 |
| Equipment and furnishings | 1,620 |
| Intangible Assets - bed licenses | 6,510 |
| Goodwill | 312 |
| Total assets acquired | 27,280 |
| Liabilities assumed: | |
| Real estate taxes and other | (49) |
| Total identifiable net assets | \$ 27,231 |

Abington Place

On June 1, 2012, the Company obtained control of the Abington Place, a skilled nursing facility located in Little Rock, Arkansas. The total purchase price was \$3,581,000 after final closing adjustments.

| | (Amounts in 000 s) |
|--|-----------------------|
| Consideration transferred: | |
| Net proceeds from loans | \$ 3,296 |
| Cash from earnest money deposits | 250 |
| Security deposit for lease/May rent | 35 |
| Total consideration transferred | \$ 3,581 |

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| | | |
|--------------------------------|----|-------|
| Assets acquired: | | |
| Land | \$ | 210 |
| Building | | 225 |
| Equipment and furnishings | | 2,090 |
| Intangible assets bed licenses | | 840 |
| Goodwill | | 235 |
| Total assets acquired | | 3,600 |
| Liabilities assumed: | | |
| Real estate taxes and other | | (19) |
| Total identifiable net assets | \$ | 3,581 |

Unaudited Pro forma Financial Information

The above acquisitions have been included in the consolidated financial statements since the dates the Company gained control. Combined revenue for all 2012 acquisitions is approximately \$9,300,000 and resulted in income from operations of approximately \$732,000 for the six months ended June 30, 2012.

The following table represents pro forma results of consolidated operations as if all of the 2011 and 2012 acquisitions had occurred at the beginning of the earliest fiscal year being presented, after giving effect to certain adjustments.

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Notes to Consolidated Financial Statements

(Unaudited) (Continued)

| (Amounts in 000 s) | Six Months Ended June 30, | |
|----------------------------------|---------------------------|------------|
| | 2012 | 2011 |
| Pro forma revenue | \$ 103,968 | \$ 101,908 |
| Pro forma operating expenses | \$ 100,169 | \$ 98,468 |
| Pro forma income from operations | \$ 3,799 | \$ 3,440 |

The foregoing 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. STOCKHOLDERS EQUITY*2012 Public Stock Offering*

In March 2012, the Company closed a firm commitment underwritten public offering of 1,100,000 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 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 approximately \$3.8 million after deducting underwriting discounts and other offering-related expenses of approximately \$0.6 million.

NOTE 12. STOCK BASED COMPENSATION*Employee Common Stock Warrants & Options*

In February 2012, the Company granted non-qualified stock options to Christopher Brogdon, the Company's Vice Chairman and Chief Acquisition Officer, pursuant to the Company's 2011 Stock Incentive Plan (the 2011 Plan). A total of 50,000 options were granted with an exercise price per share of \$7.00 and 100,000 options were granted with an exercise price of \$8.00. The options vest in September of 2013 and 2014, respectively. The options are exercisable until the term expires in February 2022. The fair value of the options was estimated at \$1.19 and \$1.03 per share, respectively, and is being recognized as share-based compensation expense over the requisite service period of the awards.

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In March 2012, the Company granted incentive stock options to certain members of management pursuant to the 2011 Plan. A total of 429,200 options were granted with an exercise price per share of \$4.13. The options vest ratably on the day before each of the three subsequent anniversaries. The options are exercisable until the term expires in March 2017. The fair value of the options was estimated at \$1.34 per share and is being recognized as share-based compensation expense over the requisite service period of the awards.

On June 1, 2012, at the Annual Meeting of Shareholders of the Company, the shareholders approved an amendment to the 2011 Plan to increase the maximum number of shares of common stock that may be issued under the 2011 Plan to an aggregate of 2,000,000 shares from the current maximum of 1,000,000. The Company's management, key employees (including the Company's principal executive officer, principal financial officer and named executive officers), directors and consultants are eligible to participate in the 2011 Plan.

Nonemployee Common Stock Warrants

On March 29, 2012, in connection with the issuance of the \$3,500,000 promissory note to Cantone Asset Management LLC, the Company granted to Cantone Asset Management LLC a warrant to purchase 300,000 shares of common stock at an exercise price per share of \$4.00. The warrant is exercisable until March 2015. The fair value of the warrant was estimated at \$0.64 per share and is included in deferred loan costs and is being amortized as interest expense over the life of the promissory note. During the restatement process (Note 2), the fair value of the warrants was reviewed, and the Company determined that the warrants should be revalued using an estimated life correlating to the legal term of the warrant. The revised fair value was estimated to be \$0.92; the additional expense is included in deferred loan costs and is being amortized as interest expense over the life of the promissory note.

On April 1, 2012, in connection with the issuance of the \$5,000,000 promissory note to Strome Alpha Offshore Ltd., the Company granted to Strome Alpha Offshore Ltd. a warrant to purchase 312,500 shares of common stock at an exercise price per share of \$4.00. The warrant is exercisable until April 2015. The fair value of the warrant was estimated at \$0.64 per share and is included in deferred loan costs and is being amortized as interest expense over the life of the promissory note. During the restatement process (Note 2), the fair value of the warrants was reviewed, and the Company determined that the warrants should be revalued using an estimated life correlating to the legal term of the warrant. The revised fair value was estimated to be \$0.92; the additional expense is included in deferred loan costs and is being amortized as interest expense over the life of the promissory note.

Restricted Stock

In June 2012, the Company approved issuing 270,000 shares of common stock with a three year restriction on transfer to its nine directors. The restricted stock is subject to forfeiture if the recipient is not a director at the end of the three year restriction. The restricted stock has all the rights of a shareholder from the date of grant, including, without limitation the right

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(Unaudited) (Continued)

to receive dividends and the right to vote. The Company determined the fair value of the restricted stock to be equal to the grant date closing stock price of \$3.36. The related compensation expense is being recognized over the three year restricted period. The compensation expense for the three months ended June 30, 2012 was \$25,200 with unrecognized compensation expense of \$882,000 remaining at June 30, 2012.

The following summarizes the Company's restricted stock activity for the period ended June 30, 2012:

| | Number of Shares | Weighted Avg. Grant Date Fair Value |
|------------------------------|------------------------|---|
| Nonvested at January 1, 2012 | | |
| Granted | 270,000 | \$ 3.20 |
| Vested | | |
| Forfeited | | |
| Nonvested at June 30, 2012 | 270,000 | 3.20 |

NOTE 13. VARIABLE INTEREST ENTITIES

As further described in Note 19 to the consolidated financial statements in the Annual Report, the Company has certain variable interest entities that are required to be consolidated. In June 2012, the Company amended the Option Agreement to purchase Riverchase Village Facility to extend the option exercise period to June 22, 2013. In connection with the restatement process (Note 2), the Company has determined that certain entities which the Company had recognized as variable interest entities and consolidated their results with the results of the Company during the first three quarters of 2012 as well as the third and fourth quarter of 2011, should not have been consolidated. These entities are the five skilled nursing facilities located in Oklahoma which are managed by the Company (known as the Oklahoma Owners). As a result of the restatements described in Note 2, the Company's consolidated financial statements for the second quarter of 2012 do not include the results of the Oklahoma Owners. The following summarizes the assets and liabilities of the variable interest entities included in the consolidated balance sheets at June 30, 2012 and December 31, 2011:

Riverchase Village Facility - Assets and Liabilities:

| (Amounts in 000s) | June 30, 2012 | December 31, 2011 |
|-----------------------------|---------------|-------------------|
| Cash | \$ 16 | \$ 16 |
| Accounts receivable | 26 | 10 |
| Restricted investments | 413 | 451 |
| Property and equipment, net | 5,920 | 5,999 |

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| | | | | |
|-------------------------|----|-------|----|-------|
| Other assets | | 432 | | 432 |
| Total assets | \$ | 6,791 | \$ | 6,908 |
| Accounts payable | \$ | 1,055 | \$ | 740 |
| Accrued expenses | | 97 | | 174 |
| Notes payable | | 6,107 | | 6,176 |
| Noncontrolling interest | | (468) | | (182) |
| Total liabilities | \$ | 6,791 | \$ | 6,908 |

The balances related to the Oklahoma Owners variable interest entities that were consolidated as of December 31, 2011 but that the Company subsequently determined should not be consolidated were as follows:

Oklahoma Owners - Assets and Liabilities:

| (Amounts in 000 s) | December 31, 2011 | |
|-----------------------------|-------------------|--------|
| Cash | \$ | 180 |
| Accounts receivable | | 800 |
| Property and equipment, net | | 9,989 |
| Goodwill | | 1,122 |
| Other assets | | 641 |
| Total assets | \$ | 12,732 |
| Accounts Payable | \$ | 458 |
| Accrued expenses | | 356 |
| Notes payable | | 12,578 |
| Noncontrolling interest | | (660) |
| Total liabilities | \$ | 12,732 |

NOTE 14. FAIR VALUE MEASUREMENTS

The following are the major categories of assets and liabilities measured at fair value on a recurring basis during the six months ended June 30, 2012, using quoted prices in active markets for identical assets (Level 1); significant other observable inputs (Level 2); and significant unobservable inputs (Level 3).

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

Notes to Consolidated Financial Statements

(Unaudited) (Continued)

| (Amounts in 000 s) | Level 1: | Level 2: | Level 3: | Total at June 30, 2012 |
|----------------------|----------|----------|----------|---------------------------|
| Derivative Liability | \$ | \$ | \$ 1,127 | \$ 1,127 |

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 six months ended June 30, 2012:

| (Amounts in 000 s) | Derivative Liability |
|--------------------|-------------------------|
| Beginning Balance | \$ 1,889 |
| Other | 1 |
| Total gain | (763) |
| Ending Balance | \$ 1,127 |

NOTE 15. COMMITMENTS AND CONTINGENCIES*Legal Matters*

The skilled nursing and assisted living business involves a significant risk of liability given the age and health of the Company's patients and residents and the services the Company provides. The Company and others in the industry are subject to an increasing number of claims and lawsuits, including professional liability claims, 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 and others in the industry are also subject to potential lawsuits under the Federal False Claims Act and comparable state laws alleging submission of fraudulent claims for services to any healthcare program (such as Medicare) or payor. A violation may provide the basis for exclusion from federally-funded healthcare programs. As of June 30, 2012, the Company does not have any material loss contingencies recorded or requiring disclosure based on management's evaluation of the probability of loss from known claims.

Commitments

Tulsa Companion Care PSA

On March 14, 2012, a wholly owned subsidiary of AdCare entered into a Purchase and Sale Agreement with F & F Ventures, LLC and Tulsa Christian Care, Inc., doing business as Companions Specialized Care Center, to acquire a 121-bed skilled nursing facility located in Tulsa, Oklahoma for an aggregate purchase price of \$5,750,000. The purchase price consists of a \$5,000,000 cash payment and the issuance of shares of common stock with an aggregate value of \$750,000, with such shares valued at the average closing price of common stock for the ten-day period ending on the last business day prior to the closing of the acquisition. Pursuant to the Purchase and Sale Agreement, the Company deposited \$150,000 into escrow to be held as earnest money. On June 19, 2012, the Purchase and Sale Agreement was amended to (i) extend the closing date of the acquisition to July 31, 2012; (ii) require the Company to deliver an additional \$50,000 to the sellers to be held as earnest money; and (iii) provide that all amounts held as earnest money under the purchase agreement (including, but not limited to, the \$50,000 deposited by the Company pursuant to the amendment) shall be credited against the purchase price at closing (or returned to the Company in the event of a default by the sellers). On August 7, 2012, the Purchase and Sale Agreement was amended, effective as of July 31, 2012, to further extend the closing date of the acquisition to August 17, 2012. The Company expects to close on the acquisition in mid-August 2012.

Oklahoma PSA Amendment

On April 17, 2012, a wholly owned subsidiary of AdCare amended the Purchase and Sale Agreement with First Commercial Bank to acquire five skilled nursing facilities located in Oklahoma. The amendment requires an additional deposit of \$50,000 into escrow to be used as earnest money; amends the closing date to the date which is sixty (60) days after all required licenses are received, but in no event later than September 30, 2012; and releases \$200,000 from escrow to First Commercial Bank. Upon the closing of the purchase, the Company shall receive a \$200,000 credit against the purchase price; however, if the transaction fails to be consummated for any reason other than (i) default by First Commercial Bank; (ii) the failure of a condition to closing to be satisfied; or (iii) an event of casualty or condemnation, First Commercial Bank shall be entitled to retain the \$200,000 disbursed from escrow. If the transaction fails to be consummated for any reason other than as described in the preceding sentence, First Commercial Bank shall return the \$200,000 to the Company upon demand.

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ADCARE HEALTH SYSTEMS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

(Unaudited) (Continued)

Sumter Valley PSA

On April 27, 2012, a wholly owned subsidiary of AdCare entered into a Purchase and Sale Agreement with 1761 Pinewood Holdings, LLC to acquire a 96-bed skilled nursing facility located in Sumter, South Carolina for an aggregate purchase price of \$5,500,000. The purchase price consists of: (i) \$5,250,000 cash consideration; and (ii) a \$250,000 promissory note to be issued by one of AdCare's subsidiaries that shall bear interest at a fixed rate of 6% based on a 15-year amortization schedule. Pursuant to the Purchase and Sale Agreement, as amended, the Company deposited \$100,000 into escrow and delivered \$150,000 to the seller to be held as earnest money.

Hembree Road Property PA

On June 4, 2012, the Company entered into a purchase agreement with JRT Group Properties, LLC ("JRT") to acquire property comprising Building 1145 of the Offices at Hembree, a condominium, located in Roswell, Georgia, for an aggregate purchase price of \$1,083,781. The lender which the Company anticipates using to finance this acquisition has received a third party appraisal with respect to the property which is consistent with the purchase price. One member of JRT is a non-officer employee of the Company and another member of JRT is the son of Christopher Brogdon, the Company's Vice Chairman and Chief Acquisition Officer.

Benefit Plans

In the second quarter of 2012, it was determined that the Company has potential obligations related to the Company sponsored 401(k) plan. The Company has recorded an obligation based on an estimated amount of approximately \$0.1 million. The Company is pursuing remedial actions under the Voluntary Correction Programs ("VCP"). The Internal Revenue Service and the Federal Department of Labor may not accept the Company's VCP proposal thus the obligation may be adjusted in the future. However, management does not believe the ultimate impact of the resolution will be material to its results of operations and expects this issue to be resolved before the end of 2012.

NOTE 16. RELATED PARTY TRANSACTIONS

On January 17, 2012, a wholly owned subsidiary of AdCare entered into a Purchase and Sale Agreement with Gyman Properties, LLC to acquire a 141-bed skilled nursing facility located in Lonoke, Arkansas, known as Golden Years Manor, for an aggregate purchase price of \$6,486,000.

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Pursuant to the purchase and sale agreement, we deposited \$250,000 into escrow to be held as earnest money. On May 9, 2012, AdCare assigned all of its rights under the purchase and sale agreement to GL Nursing, LLC, an entity affiliated with Christopher Brogdon, AdCare's Vice Chairman and Chief Acquisition Officer and a beneficial owner of more than 10% of the common stock. GL Nursing, LLC has agreed to reimburse us the \$250,000 deposit and all of our out-of-pocket costs relating to Golden Years Manor upon the closing of the acquisition, which occurred on May 31, 2012. The Company has recorded a receivable for this amount.

On June 4, 2012, a wholly owned subsidiary of AdCare entered into a Purchase Agreement with JRT Group Properties, LLC (JRT) to acquire property comprising Building 1145 of the Offices at Hembree, a condominium, located in Roswell, Georgia for an aggregate purchase price of \$1,083,781. The closing of the Hembree Purchase is expected to occur on or before September 30, 2012. One member of JRT is a non-officer employee of AdCare and another member of JRT is the son of Christopher Brogdon. As previously disclosed in the Annual Report, AdCare leases the Hembree property for use as administrative offices.

On July 26, 2012, Hearth & Home of Ohio, Inc. (Hearth & Home), a wholly owned subsidiary of AdCare, entered into an Amendment with Christopher Brogdon which amends that certain Option Agreement, as previously amended, between Hearth & Home and Mr. Brogdon, dated June 22, 2010, to extend the last date on which the option provided for thereby may be exercised from June 22, 2012 to June 22, 2013. Pursuant to the option agreement, AdCare has an exclusive and irrevocable option exercisable until June 22, 2013 to purchase from Mr. Brogdon 100% percent of the issued and outstanding membership interests of Riverchase Village ADK, LLC (Riverchase) for a purchase price of \$100,000. As previously disclosed, AdCare: (i) entered into a five-year management contract with Riverchase on June 22, 2010 to manage the 105-bed assisted living facility located in Hoover, Alabama, known as Riverchase Village; and (ii) guaranteed the repayment by Riverchase of certain bonds owing to The Medical Clinic Board of the City of Hoover.

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ADCARE HEALTH SYSTEMS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

(Unaudited) (Continued)

NOTE 17. SUBSEQUENT EVENTS

Glenvue Acquisition

On July 2, 2012, the Company completed the acquisition of Glenview Health & Rehabilitation, a 160-bed skilled nursing facility located in Glennville, Georgia, pursuant to the previously announced Purchase and Sale Agreement, between the sellers and a wholly owned subsidiary of AdCare, dated as of April 3, 2012, for an aggregate purchase price of \$8,240,000. In connection with the closing of this acquisition, a wholly owned subsidiary of AdCare entered into a loan agreement with Private Bank in an aggregate principal amount of \$6,600,000.

The loan matures on July 2, 2014. Interest on the loan accrues on the principal balance thereof at an annual rate of the greater of (i) 6.0% per annum or (ii) the LIBOR rate plus 4.0% per annum, and payments for the interest and a portion of the principal balance are payable monthly, commencing on August 1, 2012. The entire outstanding balance of the loan, together with all accrued but unpaid interest thereon, is payable on July 2, 2014. The loan is secured by a first mortgage on the real property and improvements constituting Glenview Health & Rehabilitation and guaranteed by AdCare.

Quail Creek Acquisition

On July 3, 2012, the Company completed the acquisition of a 118-bed skilled nursing facility located in Oklahoma City, Oklahoma, pursuant to the previously announced Purchase and Sale Agreement, as amended, between the sellers and a wholly owned subsidiary of AdCare, dated as of March 12, 2012, for an aggregate purchase price of \$5,800,000. In connection with the closing of this acquisition, a wholly owned subsidiary of AdCare entered into an assignment and assumption agreement pursuant to which it assumed the seller's existing indebtedness under a loan agreement and indenture in an aggregate principal amount of \$2,800,000.

The loan matures on August 27, 2016. Interest on the loan accrues on the principal balance thereof at an annual rate of 10.25% per annum, and payments for the interest and a portion of the principal balance are payable monthly, commencing on August 27, 2012. The entire outstanding balance of the loan, together with all accrued but unpaid interest thereon, is payable on August 27, 2016. The loan is secured by a first mortgage on the real property and improvements constituting the facility.

Subordinated Convertible Notes

The Company entered into a Securities Purchase Agreement, dated as of June 28, 2012, with certain accredited investors signatory thereto (the Buyers) pursuant to which the Company issued and sold to the Buyers on July 2, 2012 an aggregate of \$7,500,000 in principal amount of the Company's 8% Subordinated Convertible Notes due 2015. The subordinated convertible notes bear interest at 8.0% per annum and such interest is payable quarterly in cash in arrears beginning on September 30, 2012. The subordinated convertible notes mature on July 31, 2015. The subordinated convertible notes are unsecured and subordinated in right of payment to existing and future senior indebtedness of the Company.

At any time on or after the six-month anniversary of the date of issuance of the subordinated convertible notes, the subordinated convertible notes are convertible at the option of the holder into shares of the common stock at an initial conversion price equal to \$4.17 per share, subject to adjustment for stock dividends, stock splits, combination of shares, recapitalization and other similar events.

If at any time on or after the six-month anniversary of the date of issuance of the subordinated convertible notes, the weighted average price of the common stock for any 20 trading days within a period of 30 consecutive trading days equals or exceeds 200% of the conversion price of \$4.17 and the average daily trading volume of the common stock during such 20 days exceeds 50,000 shares, then the Company may, subject to the satisfaction of certain other conditions, redeem the subordinated convertible notes in cash at a redemption price equal to the sum of: (i) 100% of the principal amount being redeemed; plus (ii) any accrued and unpaid interest on such principal.

On July 2, 2012, the Company and Cantone Asset Management LLC refinanced the two promissory notes issued by the Company in favor of Cantone Asset Management LLC in the aggregate amount of \$5,000,000. The promissory notes were canceled and terminated in exchange for the issuance of a convertible subordinated note with a \$5,000,000 principal amount to Cantone Asset Management LLC.

In connection with the above subordinated convertible notes, the consulting arrangement with Cantone Research, Inc. was revised so as to provide for a certain monthly fee payable to Cantone Research, Inc. regardless of whether the Company and Cantone Asset Management LLC (or a related entity) agree to an additional financing arrangement. On July 2, 2012, under the terms of this revised arrangement, the Company issued 50,000 common shares and 100,000 warrants to Cantone Research, Inc.

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ADCARE HEALTH SYSTEMS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

(Unaudited) (Continued)

Sumter Valley PSA Amendment

On July 19, 2012, the Company amended its Purchase and Sale Agreement with 1761 Pinewood Holdings, LLC to acquire a 96-bed skilled nursing facility located in Sumter, South Carolina. The amendment extends the closing date of the acquisition to August 31, 2012; (ii) requires the Company to deliver an additional \$150,000 to the seller to be held as earnest money; and (iii) provides that all amounts held as earnest money under the purchase agreement (including, but not limited to, the \$150,000 deposited by the Company pursuant to the amendment) shall be credited against the purchase price at closing (or returned to the Company in the event of a default by the seller).

Stone County Financing

In July 2012, the Company refinanced the Stone County facility short-term through the issuance of a term loan with the Economic Development Corporation of Fulton County, an economic development corporation working with the U.S. Small Business Administration (SBA) for a total amount of \$1,304,000.

The SBA loan matures in July 2032 and accrues interest at the rate of 2.42%. The SBA loan is payable in equal monthly installments of principal and interest based on a twenty (20) year amortization schedule. Each such payment is payable on the first business day of each month, commencing on August 1, 2012 and continuing until July 1, 2032, when all unpaid amounts are due. The SBA loan is secured by the Stone County facility and guaranteed by AdCare.

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ADCARE HEALTH SYSTEMS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

(Unaudited) (Continued)

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

Special Note Regarding Forward Looking Statements

Certain statements in this Quarterly Report on Form 10-Q/A (this Quarterly Report) constitute forward-looking statements. These forward-looking statements involve known or unknown risks, uncertainties and other factors that may cause the actual results, performance, or achievements of the Company to be materially different from any future results, performance or achievements expressed or implied by the forward-looking statements. 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. You can identify forward-looking statements by terminology such as may, will, should, expects, intends, plans, anticipates, estimates, predicts, potential, continues, or the negative of these terms or other comparable terminology. Although we believe that the expectations reflected in the forward-looking statements are reasonable, we do not guarantee future results, levels of activity, performance or achievements. We undertake no obligation to publicly update or revise any forward-looking statements, whether as a result of new information, future developments or otherwise, except as required by applicable laws. You should read this Management's Discussion and Analysis of Financial Condition and Results of Operations in conjunction with the consolidated financial statements and related notes included in this Quarterly Report and the Annual Report on Form 10-K, as well as other reports that we file with the SEC.

Change in Accounting for Variable Interest Entities

As further discussed in Note 19, *Variable Interest Entities*, and Note 21, *Related Party Transactions*, found in the Company's audited consolidated financial statements and notes included in the Company's Annual Report, effective August 1, 2011 entities (the Oklahoma Owners) controlled by Christopher Brogdon and his spouse, Connie Brogdon (related parties to the Company), acquired five skilled nursing facilities located in Oklahoma (the Oklahoma Facilities). The Company entered into a Management Agreement with the Oklahoma Owners pursuant to which a wholly-owned subsidiary of the Company supervises the management of the Oklahoma Facilities for a monthly fee equal to 5% of the monthly gross revenues of the Oklahoma Facilities. Upon acquisition, the Company concluded it was the primary beneficiary of the Oklahoma Owners and pursuant to Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) Topic 810-10, *Consolidation-Overall*, consolidated the Oklahoma Owners in its 2011 consolidated financial statements.

During the process of finalizing the 2012 consolidated financial statements, the Company re-assessed its prior conclusion that it should consolidate the Oklahoma Owners. In the reassessment process, the Company concluded that it should not have consolidated the Oklahoma Owners. In the accompanying consolidated financial statements, the Company has deconsolidated the Oklahoma Owners effective January 1, 2012 and the balance sheet, operations and cash flows of the Oklahoma Owners are not included in the Company's 2012 consolidated financial statements. The Company further concluded that including the Oklahoma Owners in its 2011, consolidated financial statements was not

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material to such consolidated financial statements and therefore no adjustments have been made to the previously issued quarterly and annual 2011 consolidated financial statements.

Overview

The Company owns and manages skilled nursing facilities and assisted living facilities. We deliver skilled nursing, assisted living and home health services through wholly owned separate operating subsidiaries. During the first six months of 2012, we acquired nine facilities (eight skilled nursing facilities and one assisted living facility), bringing our total bed count to 4,871 at June 30, 2012. The following tables provide summary information regarding our recent acquisitions and facility composition.

| | June 30, 2012 | March 31, 2012 | December 31, 2011 | June 30, 2011 | December 31, 2010 |
|---------------------------------------|----------------------|-----------------------|--------------------------|----------------------|--------------------------|
| Cumulative number of facilities | 53 | 52 | 44(*) | 30 | 27 |
| Cumulative number of operational beds | 4,871 | 4,794 | 3,916(*) | 2,813 | 2,428 |

(*) including the five Oklahoma Facilities which are not consolidated in 2012 as discussed in Note 2. The Oklahoma Facilities included 314 operational beds.

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| State | Number of Operational Beds/Units | Number of Facilities at June 30, 2012 | | | | Total |
|----------------------|--|---------------------------------------|-----|--------|------------------------------|-------|
| | | Owned | VIE | Leased | Managed for Third Parties | |
| Alabama | 408 | 2 | 1 | | | 3 |
| Arkansas | 1,041 | 10 | | | | 10 |
| Georgia | 1,497 | 3 | | 10 | | 13 |
| Missouri | 80 | | | 1 | | 1 |
| North Carolina | 106 | 1 | | | | 1 |
| Ohio | 981 | 10 | | 1 | 4 | 15 |
| Oklahoma | 758 | | | | 10 | 10 |
| Total | 4,871 | 26 | 1 | 12 | 14 | 53 |
| Facility Type | | | | | | |
| Skilled Nursing | 4,376 | 18 | | 12 | 13 | 43 |
| Assisted Living | 412 | 8 | 1 | | | 9 |
| Independent Living | 83 | | | | 1 | 1 |
| Total | 4,871 | 26 | 1 | 12 | 14 | 53 |

Acquisitions

We have embarked on a strategy to grow our business through acquisitions and leases of senior care facilities. During the first six months of 2012, we acquired six facilities (five skilled nursing facilities and one assisted living facility), bringing our total bed count to 4,871 at June 30, 2012.

- On January 1, 2012, we acquired a skilled nursing facility and an assisted living facility both located in Springfield, Ohio, for an aggregate adjusted purchase price of \$12,412,000. We obtained control and commenced operating these facilities on January 1, 2012.
- On April 1, 2012, we acquired three skilled nursing facilities located in Little Rock, Arkansas. The total purchase price was \$27,231,000. We obtained control and operations commenced on April 1, 2012.
- On April 30, 2012, we acquired a skilled nursing facility located in Little Rock, Arkansas for an aggregate purchase price of \$3,581,000. We obtained control and operations commenced on June 1, 2012.

Subsequent to June 30, 2012, the following acquisitions were completed:

- On July 2, 2012 we acquired a skilled nursing facility in Glennville, Georgia for an aggregate purchase price of \$8,240,000. We obtained control and operations commenced on July 2, 2012.

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- On July 2, 2012 we acquired a skilled nursing facility in Oklahoma City, Oklahoma for an aggregate purchase price of \$5,800,000. We obtained control and operations commenced on July 3, 2012.

In addition, the following potential acquisitions have been announced during the six months ended June 30, 2012:

- On April 27, 2012, we entered into a Purchase and Sale Agreement with 1761 Pinewood Holdings, LLC to acquire a 96-bed skilled nursing facility located in Sumter, South Carolina for an aggregate purchase price of \$5,500,000. We expect the closing of the acquisition to occur on August 31, 2012.

- On March 14, 2012, we entered into a Purchase and Sale Agreement with F & F Ventures, LLC and Tulsa Christian Care, Inc., doing business as Companions Specialized Care Center to acquire a 121-bed skilled nursing facility located in Tulsa, Oklahoma for an aggregate purchase price of \$5,750,000. We expect the closing of the acquisition to occur in mid-August 2012. Beginning April 1, 2012, we entered into a management agreement to operate the facility in the interim period. The Company has a variable interest in this arrangement but is not the primary beneficiary and thus consolidation of the results of operations is not required.

For information regarding purchase and sale agreements of facilities that have been entered into subsequent to June 30, 2012, see Note 17 in the Notes to Consolidated Financial Statements section of Part I, Item 1 of this Quarterly Report.

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The Company is currently evaluating potential acquisition opportunities in addition to those described above, and we continue to seek new opportunities to further our growth strategy. No assurance is made that any of these potential acquisition opportunities will be determined to be appropriate for us or that we will complete any of such acquisitions on terms acceptable to us, or at all.

Segments

The Company reports its operations in three segments: Skilled Nursing Facilities (SNF), Assisted Living Facilities (ALF), and Corporate & Other. The Company delivers services through wholly owned separate operating subsidiaries. The SNF and ALF segments provide services to individuals needing long-term care in a nursing home or assisted living setting and management of those facilities. The Corporate & Other segment engages in the management of facilities and accounting and IT services. We evaluate financial performance and allocate resources primarily based on segment operating income (loss). Segment operating results exclude interest expense and other non-operating income and expenses. See Note 5 in the Notes to Consolidated Financial Statements section of Part I, Item 1 of this Quarterly Report.

Skilled Nursing Facilities

We focus on two primary indicators in evaluating the financial performance in this segment. Those indicators are facility occupancy and patient mix. Facility occupancy is important because 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. We continue our work towards maximizing the number of patients covered by Medicare where our operating margins are higher. We include commercial insurance covered admissions that are reimbursed at the same level as those covered by Medicare in our Medicare utilization percentages and analysis.

For the three and six months ended June 30, 2012, revenue in our skilled nursing segment increased by approximately \$16,391,000 and \$31,244,000, respectively, compared to June 30, 2011, as a result of acquisition growth. For the three and six months ended June 30, 2012, this segment had an income from operations of \$4,428,000 and \$5,299,000 respectively, as a result of optimization of occupancy and quality mix as well as expense controls. We expect to continue to implement and refine strategies designed to sustain these goals. Total assets increased by \$29,431,000 due to acquisitions made since June 30, 2011 and other building improvements.

Average Occupancy

| | Three Months Ended June 30, | |
|----------------------------------|------------------------------------|-------------|
| | 2012 | 2011 |
| Same Facilities (1) | 84.6% | 86.8% |
| Recently Acquired Facilities (2) | 68.5% | 85.6% |
| Total | 77.3% | 86.7% |

| | Six Months Ended June 30, | |
|---------------------|----------------------------------|-------------|
| | 2012 | 2011 |
| Same Facilities (1) | 85.3% | 86.8% |

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| | | |
|----------------------------------|-------|-------|
| Recently Acquired Facilities (2) | 71.6% | 85.6% |
| Total | 79.7% | 86.8% |

- (1) Same Facilities results represent those owned and leased facilities we began to operate prior to April 1, 2011.
- (2) Recently Acquired Facilities results represents those owned and leased facilities we began to operate subsequent to April 1, 2011.

Patient Mix

Three Months Ended June 30,

| | Same Facilities | | Recently Acquired Facilities | | Total | |
|----------|-----------------|--------|------------------------------|-------|--------|--------|
| | 2012 | 2011 | 2012 | 2011 | 2012 | 2011 |
| Medicare | 15.6% | 15.1% | 12.2% | 8.5% | 14.3% | 14.5% |
| Medicaid | 72.5% | 75.3% | 73.8% | 81.5% | 73.0% | 75.9% |
| Other | 11.9% | 9.5% | 14.0% | 10.0% | 12.7% | 9.6% |
| Total | 100.0% | 100.0% | 100.0% | n/a% | 100.0% | 100.0% |

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Patient Mix

Six Months Ended June 30,

| | Same Facilities | | Recently Acquired Facilities | | Total | |
|----------|-----------------|--------|------------------------------|--------|--------|--------|
| | 2012 | 2011 | 2012 | 2011 | 2012 | 2011 |
| Medicare | 15.4% | 15.3% | 13.1% | 8.5% | 14.5% | 15.0% |
| Medicaid | 72.8% | 75.9% | 72.8% | 81.5% | 72.8% | 76.1% |
| Other | 11.8% | 8.8% | 14.1% | 10.0% | 12.6% | 8.9% |
| Total | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% |

For the Three Months Ended June 30, 2012:

| State (SNF Only) | Operational Beds at Period End(1) | Period s Average Operational Beds | Occupancy (Operational Beds) | Medicare Utilization (Skilled %ADC)(2) | 2012 QTD Total Revenues | Medicare (Skilled) \$PPD(3) | Medicaid \$PPD(3) |
|------------------|-----------------------------------|-----------------------------------|------------------------------|--|-------------------------|-----------------------------|-------------------|
| Alabama | 304 | 304 | 82.5% | 11.1% | \$ 4,984 | \$ 388.0 | \$ 192.01 |
| Arkansas | 1,009 | 957 | 61.2% | 10.9% | \$ 10,879 | \$ 392.81 | \$ 171.48 |
| Georgia | 1,497 | 1,497 | 85.7% | 15.7% | \$ 24,146 | \$ 455.63 | \$ 148.00 |
| Missouri | 80 | 80 | 63.0% | 16.2% | \$ 817 | \$ 407.07 | \$ 128.35 |
| North Carolina | 106 | 106 | 79.6% | 17.8% | \$ 1,709 | \$ 450.91 | \$ 163.31 |
| Ohio | 293 | 293 | 84.7% | 16.0% | \$ 5,318 | \$ 473.81 | \$ 158.63 |
| Total | 3,289 | 2,933 | 77.3% | 14.3% | \$ 47,853 | \$ 439.86 | \$ 159.39 |

For the Six Months Ended June 30, 2012:

| State (SNF Only) | Operational Beds at Period End(1) | Period s Average Operational Beds | Occupancy (Operational Beds) | Medicare Utilization (Skilled %ADC)(2) | 2012 YTD Total Revenues | Medicare (Skilled) \$PPD(3) | Medicaid \$PPD(3) |
|------------------|-----------------------------------|-----------------------------------|------------------------------|--|-------------------------|-----------------------------|-------------------|
| Alabama | 304 | 304 | 83.1% | 12.0% | \$ 9,865 | \$ 379.77 | \$ 187.40 |
| Arkansas | 1,009 | 728 | 64.5% | 11.6% | \$ 17,291 | \$ 376.20 | \$ 171.42 |
| Georgia | 1,497 | 1,497 | 86.1% | 15.2% | \$ 47,835 | \$ 456.19 | \$ 146.82 |
| Missouri | 80 | 80 | 62.2% | 20.1% | \$ 1,735 | \$ 399.85 | \$ 130.91 |
| North Carolina | 106 | 106 | 84.3% | 18.0% | \$ 3,614 | \$ 458.03 | \$ 159.00 |
| Ohio | 293 | 293 | 83.8% | 16.9% | \$ 10,558 | \$ 464.79 | \$ 158.69 |
| Total | 3,289 | 2,704 | 79.7% | 14.5% | \$ 90,898 | \$ 436.54 | \$ 157.40 |

(1) Excludes managed beds which are not consolidated.

(2) ADC is the Average Daily Census

(3) *PPD is the Per Patient Day equivalent*

Assisted Living Facilities

For the three and six months ended June 30, 2012, revenue in our ALF segment increased by approximately \$1,003,000 and \$1,925,000, respectively, compared to June 30, 2011 as a result of increased revenue from acquisitions, an annual increase in rates charged to privately paying residents and increasing occupancy. For the three and six months ended June 30, 2012, this segment had income from operations of \$588,000 and \$1,272,000, respectively. Total assets increased by \$7,075,000 primarily due to acquisitions since June 30, 2011 and other building improvements made during the last 12 months.

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| Average Occupancy Three Months Ended June 30, | | |
|---|--|-------|
| 2012 | | 2011 |
| 83.6% | | 75.6% |

| Six Months Ended June 30, | | |
|------------------------------|--|-------|
| 2012 | | 2011 |
| 82.5% | | 75.0% |

Residents of our assisted living facilities rely on their personal investments and wealth to pay for their stay. Although many of the risks still remain, such as declines in market values of investments, depressed market for the sale of private homes, and adult children caring for their elderly at home, we have seen an increase in census.

Corporate & Other

We manage three skilled nursing facilities and one independent living campus for third party owners under management agreements that either are for a fixed monthly fee or for a percentage of revenue generated by the managed facility. Depending on the type of management agreement, our revenues increase annually according to inflationary adjustments stipulated in our management agreements or they increase as the facility's revenue increases for the management agreements that are based on a percentage of revenue. This segment includes our corporate overhead expenses, which are made up of salaries of our senior management team members and various other corporate expenses, including, but not limited to, corporate office operating expenses, audit fees, legal fees and board activities. Additionally, non-cash charges for compensation expense related to warrants, restricted stock and stock options are included in corporate overhead. We do not allocate these expenses to the divisions or separate them from the management business for management review purposes.

Results of Operations

| (Amounts in 000 s) | Total Patient Care Revenues | | | |
|------------------------------|-----------------------------|-----------|---------------------------|-----------|
| | Three Months Ended June 30, | | Six Months Ended June 30, | |
| | 2012 | 2011 | 2012 | 2011 |
| Skilled Nursing | | | | |
| Same Facilities | \$ 29,298 | \$ 29,172 | \$ 58,131 | \$ 57,363 |
| Recently Acquired Facilities | 18,555 | 2,290 | 32,766 | 2,290 |
| Total | \$ 47,853 | \$ 31,462 | \$ 90,897 | \$ 59,653 |

| (Amounts in 000 s) | Total Patient Care Revenues | | | |
|------------------------------|-----------------------------|----------|---------------------------|----------|
| | Three Months Ended June 30, | | Six Months Ended June 30, | |
| | 2012 | 2011 | 2012 | 2011 |
| Assisted Living | | | | |
| Same Facilities | \$ 2,715 | \$ 2,410 | \$ 5,310 | \$ 4,751 |
| Recently Acquired Facilities | 698 | | 1,366 | |
| Total | \$ 3,413 | \$ 2,410 | \$ 6,676 | \$ 4,751 |

Comparison for the three months ended June 30, 2012 and 2011

Patient Care Revenues - For the periods presented, total patient care revenues increased by \$17.4 million, or 51%.

Revenue in our SNF segment increased by approximately \$16,391,000 when compared to the three months ended June 30, 2011, primarily as a result of additional facilities acquired since June 2011.

In addition, quality mix improved existing facilities. This segment had a net income from operations of \$4,428,000 which is \$2,655,000 higher compared to the three months ended June 30, 2011 as a result of higher revenue due to acquisitions and improved reimbursement. We are seeking to increase facility occupancy and to increase the number of patients covered by Medicare. We seek to continue to implement and refine strategies designed to achieve these goals.

Revenue in our ALF segment increased by approximately \$1,003,000 when compared to the three months ended June 30, 2011, as a result of increased census and levels of care as well as the addition of one new facility in 2012 and one new facility in the fourth quarter of 2011. This segment had income from operations of \$588,000 which is \$208,000 more than the same period in 2011 from increased occupancy and an annual increase in rates charged to residents of the facilities.

Management Revenue - For the periods presented, management revenues (net of eliminations) increased by \$41,000, or 8%, due to the management of the five Oklahoma facilities.

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Cost of Services - For the periods presented, cost of services was approximately \$40,316,000 or 79% of patient care revenue compared to \$27,104,000 or 80.0% of patient care revenue for the same period a year ago. This increase in overall cost is the result of numerous acquisitions over the past 12 months. The improvement as percent of patient care revenue reflects the implementation of consolidated purchasing programs and other cost reduction efforts. In 2012, the Company removed the ability for employees to accumulate earned but unused vacation beyond the current calendar year. As a result, vacation time previously accumulated must be used by the employee by December 31, 2012 or it will be forfeited. Management has estimated the potential forfeitures and has adjusted the vacation accrual accordingly.

General and Administrative - For the three months ended June 30, 2012, general and administrative expenses were approximately \$4.3 million in 2012 compared to \$3.2 million in 2011, an increase of \$1.1 million, or 37%. Wage and other employee related costs increased \$0.4 million as a result of additional staffing needed to support the growth in operations. The Company's goal is to become better known in the financial market place, which has resulted in additional investor relations expenses of approximately \$0.1 million.

Facility Rent Expense - For the periods presented, lease expenses increased by \$103,000 due to annual increases and the addition of the one new leased facility in the fourth quarter of 2011.

Depreciation and Amortization - For the periods presented, depreciation and amortization increased by \$889,000. The depreciation increase is directly related to acquisition activity that was not included in the 2011 results as it occurred in later periods. In addition, the acquisitions resulted in intangibles that are being amortized during the period.

Interest Expense, net - For the periods presented, interest expense, net increased by \$1,592,000, or 86%. We have entered into numerous debt instruments in relation to our growth strategy for the acquisition of the facilities which began in the third quarter of 2010. Several of the arrangements are short term in nature resulting in higher interest rates than previously experienced and an increase in the amortization of deferred loan costs associated with the new debt agreements.

Acquisition Costs, net of Gains - For the three months ended June 30, 2012, acquisition costs, net of gains was an expense of \$524,000, compared to \$622,000 for the comparative period. For the three months ended June 30, 2012, the total acquisition costs were legal fees directly related to acquisitions and other costs incurred on potential future acquisitions.

Derivative Gain/Loss - For the three months ended June 30, 2012, the derivative gain was \$353,000, compared to a loss of \$2,588,000 for the same period in 2011. The derivative is a product of a convertible debt instrument entered into during the third quarter of 2010. The expense associated with the derivative increases as the stock price climbs, and conversely decreases as the stock price declines. The price of the common stock declined during the three-month period from March 31, 2012 to June 30, 2012.

Comparison for the six months ended June 30, 2012 and 2011

Patient Care Revenues - For the periods presented, total patient care revenues increased by \$33.2 million, or 52%.

Revenue in our SNF segment increased by approximately \$31,244,000 when compared to the six months ended June 30, 2011, primarily as a result of additional facilities acquired since June, 2011. In addition, quality mix improved existing facilities. This segment had a net income from operations of \$5,299,000 which is \$3,021,000 higher compared to the six months ended June 30, 2011 as a result of higher revenue due to acquisitions and improved reimbursement. We are seeking to increase facility occupancy and to increase the number of patients covered by Medicare. We seek to continue to implement and refine strategies designed to achieve these goals.

Revenue in our ALF segment increased by approximately \$1,925,000 when compared to the six months ended June 30, 2011, as a result of increased census and levels of care as well as the addition of one new facility in 2012 and one new facility in the fourth quarter of 2011. This segment had income from operations of \$1,272,000 which is \$688,000 more than the same period in 2011 from increased occupancy and an annual increase in rates charged to residents of the facilities.

Management Revenue - For the periods presented, management revenues (net of eliminations) increased by \$67,000, or 7%, due to the management of the five Oklahoma facilities.

Cost of Services For the periods presented, cost of services was approximately \$79,123,000 or 81% of patient care revenue compared to \$52,279,000 or 81.1% of patient care revenue for the same period a year ago. This increase in overall cost is the result of numerous acquisitions over the past 12 months. In 2012, the Company removed the ability for employees to accumulate earned but unused vacation beyond the current calendar year. As a result, vacation time previously accumulated must be used by the employee by December 31, 2012 or it will be forfeited. Management has estimated the potential forfeitures and has adjusted the vacation accrual accordingly.

General and Administrative - For the six month period ended June 30, 2012, general and administrative expenses were approximately \$8.3 million in 2012 compared to \$6.1 million in 2011, an increase of \$2.2 million, or 36%. Wage and other employee related costs increased \$0.4 million as a result of additional staffing needed to support the growth in operations. Travel costs have increased approximately \$0.3 million as a result of acquisitions and more geographically dispersed operations. The Company's goal is to become better known in the financial market place, which has resulted in additional investor relations expenses of approximately \$0.2 million.

Facility Rent Expense - For the periods presented, lease expenses increased by \$265,000 due to annual increases in rental rates and the addition of one new leased facility in the fourth quarter of 2011.

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Depreciation and Amortization - For the periods presented, depreciation and amortization increased by \$1,952,000. The depreciation increase is directly related to acquisition activity that was not included in the 2011 results as it occurred in later periods and a \$400,000 impairment charge recognized by the Company on an office building located in Rogers, Arkansas. In addition, the acquisitions resulted in additional intangibles that are being amortized during the period.

Interest Expense, net - For the periods presented, interest expense, net increased by \$2,834,000 or 86%. We have entered into numerous debt instruments in relation to our growth strategy for the acquisition of the facilities which began in the third quarter of 2010. In addition, several of the arrangements are short term in nature resulting in higher interest rates than previously experienced and an increase in the amortization of deferred loan costs associated with the new debt agreements. The increase is offset by the deconsolidation of the Oklahoma Owners.

Acquisition Costs, net of Gains - For the six months ended June 30, 2012, acquisition costs, net of gains was an expense of \$817,000, compared to a gain of \$357,000 for the comparative period. For the six months ended June 30, 2012, the total acquisition costs were legal fees directly related to acquisitions during the six months ended June 30, 2012 and other costs incurred on potential future acquisitions.

Derivative Gain/Loss - For the six months ended June 30, 2012, the derivative gain was \$763,000, compared to a loss of \$3,938,000 for the same period in 2011. The derivative is a product of a convertible debt instrument entered into during the third quarter of 2010. The expense associated with the derivative increases as the stock price climbs, and conversely decreases as the stock price declines. The price of the common stock of the Company declined during the six-month period from December 31, 2011 to June 30, 2012.

Other Income/(Expense) - For the periods presented, other income decreased by \$614,000. There was a recovery of receivables recorded in the prior year which did not occur in the three months ended June 30, 2012.

Critical Accounting Policies and Use of Estimates

Except for the re-assessment of our application of FASB ASC Topic 810, *Consolidation-Overall*, related to the Oklahoma Owners, there have been no significant changes during the three months ended June 30, 2012 to the items that we disclosed as our critical accounting policies and use of estimates in our discussion and analysis of financial condition and results of operation contained in the Annual Report.

As further discussed in Note 19, *Variable Interest Entities*, and Note 21, *Related Party Transactions*, found in the Company's audited consolidated financial statements and notes included in the Company's Annual Report, effective August 1, 2011 entities (the Oklahoma Owners) controlled by Christopher Brogdon and his spouse, Connie Brogdon (related parties to the Company), acquired five skilled nursing facilities located in Oklahoma (the Oklahoma Facilities). The Company entered into a Management Agreement with the Oklahoma Owners pursuant to which a wholly-owned subsidiary of the Company supervises the management of the Oklahoma Facilities for a monthly fee equal to 5% of the monthly gross revenues of the Oklahoma Facilities. Upon acquisition, the Company concluded it was the primary beneficiary of the Oklahoma Owners and pursuant to FASB ASC Topic 810, *Consolidation-Overall*, consolidated the Oklahoma Owners in its 2011 consolidated financial statements.

During the process of finalizing the 2012 consolidated financial statements, the Company re-assessed its prior conclusion that it should consolidate the Oklahoma Owners. In the reassessment process, the Company concluded that it should not have consolidated the Oklahoma Owners. In the accompanying consolidated financial statements the Company has deconsolidated the Oklahoma Owners effective January 1, 2012 and the balance sheet, operations and cash flows of the Oklahoma Owners are not included in the Company's second quarter 2012 consolidated financial statements. The Company further concluded that including the Oklahoma Owners in its 2011 consolidated financial statements was not material to such consolidated financial statements and therefore no adjustments have been made to the previously issued quarterly and annual 2011 consolidated financial statements.

Liquidity and Capital Resources

Overview

Liquidity is the measure of the Company's ability to have adequate cash or access to cash at all times in order to meet financial obligations when due, as well as to fund corporate expansion and other activities. Historically, the Company has met its liquidity requirements through a combination of net cash flow from operations, debt from third party lenders and issuances of other debt and equity securities.

We have negative working capital of approximately \$27,904,000 at June 30, 2012. Our ability to sustain profitable operations is dependent on continued growth in revenues and controlling costs.

During the next twelve months, the Company believes it will require additional financing to satisfy its financial obligations and implement its expansion strategy. The Company is currently exploring several financing alternatives and may seek to raise additional capital through the sale of additional debt or equity securities, although there is no assurance that the Company will be able to raise additional capital through the issuance of debt or equity securities on terms acceptable to it, or at all. If the Company is unable to secure such additional financing, then the Company may be required to restructure its outstanding indebtedness and delay or modify its expansion plans.

Woodland Manor Financing

On January 1, 2012, a wholly owned subsidiary of AdCare, entered into a loan agreement with Private Bank in an aggregate principal amount of \$4,800,000. The loan was used to fund the acquisition of the Woodland Manor facility located in Springfield, Ohio. The loan matures on December 30, 2016. Interest on the loan accrues on the principal balance thereof at an annual rate of the greater of (i) 6.0%

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per annum or (ii) the LIBOR rate plus 4.0% per annum, and payments for the interest and a portion of the principal balance are payable monthly, commencing on February 1, 2012 and ending on December 1, 2016. The entire outstanding principal balance of the loan, together with all accrued but unpaid interest thereon, is payable on December 30, 2016. The loan is secured by a first mortgage on the real property and improvements constituting the Woodland Manor facility and guaranteed by AdCare.

Eaglewood Village Financing

On January 1, 2012, two wholly owned subsidiaries of AdCare, jointly and severally issued two promissory notes to the seller of the Eaglewood Village facility located in Springfield, Ohio in the amounts of \$4,500,000 and \$500,000. Proceeds from the notes were used to fund the acquisition of the Eaglewood Village facility.

The \$500,000 note matures on December 30, 2016 and the \$4,500,000 note matures on June 30, 2012. Interest on the \$500,000 note accrues at a rate of 6.5% per annum and interest on the \$4,500,000 note accrues at a rate of (i) 6.5% per annum from January 1, 2012 to February 29, 2012; (ii) 8.5% per annum from March 1, 2012 to April 30, 2012; and (iii) 10.5% per annum from May 1, 2012 to June 30, 2012. Principal and interest payments under the notes shall be due and payable monthly, beginning on February 1, 2012. The notes are secured by a mortgage on the real property and improvements constituting the Eaglewood Village facility.

Eaglewood Village Bonds

In April 2012, a wholly owned subsidiary of AdCare entered into a loan agreement with City of Springfield pursuant to which City of Springfield lent to such subsidiary the proceeds from the sale of City of Springfield's Series 2012 Bonds. The Series 2012 Bonds consist of \$6,610,000 in Series 2012A First Mortgage Revenue Bonds and \$620,000 in Taxable Series 2012B First Mortgage Revenue Bonds. The Series 2012 Bonds were issued pursuant to an April 2012 Indenture of Trust between City of Springfield and Bank of Oklahoma. The Series 2012A Bonds mature in May 2042 and accrue interest at a fixed rate of 7.65% per annum. The Series 2012B Bonds mature in May 2021 and accrue interest at a fixed rate of 8.5% per annum. Deferred financing costs incurred on the loan amounted to approximately \$575,000 and are being amortized to interest expense over the life of the loan. The loan is secured by the real property and improvements constituting the Eaglewood Village facility and guaranteed by AdCare. There is an original issue discount of approximately \$250,000 and restricted assets of \$317,000 related to this loan.

HUD Financing

On January 31, 2012, we refinanced the mortgage on the Home & Hearth of Vandalia facility to obtain a term note guaranteed by HUD. The HUD mortgage note requires monthly principal and interest payments with an annual fixed interest rate of 3.74%. The note matures in 2041. The note has a prepayment penalty of 8% for any prepayment made prior to March 1, 2014, which penalty is reduced by 1% each year thereafter until the eighth anniversary of such date, after which there is no prepayment penalty.

Cantone Promissory Notes

On March 29, 2012, we issued an unsecured promissory note in favor of Cantone Asset Management LLC for an aggregate principal amount of \$3,500,000. The note matures on the earlier of: (i) October 1, 2012; or (ii) the date on which we shall receive proceeds, in an amount not less than \$6,000,000, from a public offering or private placement of our common stock. Interest on the note accrues on the principal balance thereof at an annual rate of 10%; provided, however, if the entire principal amount of the note is not paid by July 1, 2012, the interest rate shall increase by 1% for each month or part thereof during which any principal amount of the note shall remain unpaid. We may prepay the note in whole or in part, at any time, without notice or penalty; provided, however, if the note is prepaid prior to October 1, 2012, then we shall continue to pay interest on the note through such date.

In connection with the issuance of the note, Cantone Research, Inc. agreed to provide us with certain consulting services for a monthly fee if the Company and Cantone Asset Management LLC (or an affiliated entity) do not agree to the terms of an additional financing arrangement pursuant to which it (or affiliated entity) would loan to us at least \$4,000,000 for a four-year term.

In April 2012, the Company issued a promissory note to Cantone Asset Management LLC in the amount of \$1,500,000. The promissory note bears interest at 10% per annum and matures in October 2012. The interest rate increases 1% each month beginning in July 2012 through October 2012. Deferred financing costs incurred on the loan amounted to approximately \$78,000 and are being amortized to interest expense over the life of the loan. We may prepay the note in whole or in part, at any time, without notice or penalty; provided, however, if the note is prepaid prior to October 1, 2012, then we shall continue to pay interest on the note through such date.

The promissory notes issued in March and April 2012 were refinanced, and the consulting arrangement with Cantone Research, Inc. revised, subsequent to June 30, 2012. For information regarding the refinancing and revision to the consulting arrangement, see Note 16 in the Notes to Consolidated Financial Statements section of Part 1, Item 1 of this Quarterly Report.

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Little Rock, Northridge and Woodland Hills Financing

On April 1, 2012, certain wholly owned subsidiaries of AdCare, entered into a Loan Agreement with Private Bank in an aggregate principal amount of \$21,800,000. The loan was used to fund the acquisition of Little Rock, Northridge and Woodland Hills facilities, each located in Little Rock, Arkansas.

The loan matures on March 30, 2017. Interest on the loan accrues on the principal balance thereof at an annual rate of the greater of (i) 6.0% per annum or (ii) the LIBOR rate plus 4.0% per annum, and payments for the interest and a portion of the principal balance are payable monthly, commencing on May 1, 2012. The entire outstanding principal balance of the loan, together with all accrued but unpaid interest thereon, is payable on March 30, 2017. The loan is secured by a first mortgage on the real property and improvements constituting the facilities, a first priority security interest on all furnishings, fixtures and equipment associated with the facilities and an assignment of all rents paid under any existing or future leases and rental agreements with respect to the facilities. AdCare has unconditionally guaranteed all amounts owing under the loan. The Company has approximately \$1,810,000 of restricted assets related to this loan.

On June 15, 2012, certain wholly owned subsidiaries of AdCare entered into a modification agreement with Private Bank to modify the terms of the loan agreement. The loan modification agreement, among other things, amends the loan agreement to reflect a maturity date of March 30, 2013. The Company anticipates that it will re-finance the Little Rock, Northridge and Woodland Hills facilities later this year with long-term financing.

AdCare issued a promissory note in the amount of \$5,000,000 to Strome Alpha Offshore Ltd. The promissory note matures in November 2012 and accrues interest at a fixed rate of 10% per annum. The promissory note requires interest payments of approximately \$125,000 on July 1, 2012 and October 1, 2012. The promissory note may be prepaid at any time without penalty.

Abington Place Financing

On April 30, 2012, a wholly owned subsidiary of AdCare entered into a loan agreement with Metro City Bank in an aggregate principal amount of \$3,425,000. The loan was used to fund the acquisition of the Abington Place facility located in Little Rock, Arkansas.

The loan matures on September 1, 2012. Interest on the loan accrues on the principal balance thereof at an annual rate of 2.25% per annum plus the prime interest rate, to be adjusted on a monthly basis (and in no event shall the total interest be less than 6.25% per annum), and payments for the interest and a portion of the principal balance are payable monthly, commencing on June 1, 2012. The entire outstanding principal balance of the loan, together with all accrued but unpaid interest thereon, is payable on September 1, 2012. The loan is secured by the Abington Place facility and guaranteed by AdCare.

Stone County Financing

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In June 2012, the Company refinanced the Stone County facility through the issuance of: (i) a term loan with the Economic Development Corporation of Fulton County, an economic development corporation working with the SBA for a total amount of \$1,304,000 that matures in 2032; (ii) a term loan with Metro City Bank in the amount of \$1,810,000 that matures in 2022; and (iii) a term loan with Metro City Bank in the amount of \$1,267,000 that matured in July 2012.

The \$1,810,000 Metro City Bank loan matures in June 2022 and accrues interest at the prime rate plus 2.25% with a minimum rate of 6.25% per annum. The loan is payable in equal monthly installments of principal and interest based on a twenty-five (25) year amortization schedule. Each such payment is payable on the first day of each month, commencing on August 1, 2012 and continuing through and including the maturity date, June 8, 2022. The \$1,810,000 Metro City Bank loan has a prepayment penalty of 10% through 2012 declining by 1% each year through 2021. The loan is secured by the Stone County facility and guaranteed by AdCare.

The SBA loan matures in July 2032 and accrues interest at the rate of 2.42%. The SBA loan is payable in equal monthly installments of principal and interest based on a twenty (20) year amortization schedule. Each such payment is payable on the first business day of each month, commencing on January 1, 2012 and continuing until July 1, 2032, when all unpaid amounts are due. The SBA loan is secured by the Stone County facility and guaranteed by AdCare.

2012 Public Stock Offering

In March 2012, the Company closed a firm commitment underwritten public offering of 1,100,000 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 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 from the offering of approximately \$3.8 million after deducting underwriting discounts, and other offering-related expenses of approximately \$0.6 million. We intend to use the net proceeds from the offering for working capital and other general corporate purposes.

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For information on financings that have been entered into subsequent to June 30, 2012, see Note 17 in the Notes to Consolidated Financial Statements section of Part I, Item 1 of this Quarterly Report.

The following table presents selected data from our consolidated statement of cash flows for the periods presented (*in thousands*):

| | Six Months Ended June 30, | |
|---|----------------------------------|-------------|
| | 2012 | |
| | Restated | |
| | (Note 2) | 2011 |
| Net cash provided by operating activities - continuing operations | \$ 381 | \$ 1,219 |
| Net cash (used in) provided by operating activities - discontinued operations | (269) | 14 |
| Net cash used in investing activities - continuing operations | (41,011) | (34,689) |
| Net cash provided by financing activities - continuing operations | 42,885 | 35,295 |
| Net cash used in financing activities - discontinued operations | (97) | (89) |
| Net change in cash and cash equivalents | 1,889 | 1,750 |
| Cash and cash equivalents at beginning of period | 7,364 | 3,911 |
| Cash decrease due to deconsolidation of variable interest entities | (180) | |
| Cash and cash equivalents at end of period | \$ 9,073 | \$ 5,661 |

Six months ended June 30, 2012

Net cash provided by operating activities for the six months ended June 30, 2012, was approximately \$112,000 consisting primarily of our net income and changes in working capital, offset by noncash charges (primarily depreciation and amortization, share-based compensation, difference between straight-line rent and rent paid, and amortization of debt discounts and related deferred financing costs); all primarily the result of routine operating activities.

Net cash used in investing activities for the six months ended June 30, 2012, was approximately \$41,011,000. This is primarily the result of funding our acquisitions, including making escrow deposits.

Net cash provided by financing activities was approximately \$42,788,000 for the six months ended June 30, 2012. This is primarily the result of cash proceeds received from warrant exercises, the public stock offering, and proceeds from debt financings to fund our acquisitions, partially offset by repayments of existing debt obligations.

Six months ended June 30, 2011

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Net cash provided by operating activities for the six months ended June 30, 2011 was approximately \$1,233,000 consisting primarily of our income from operations less the noncash gain on acquisitions, and changes in working capital, and noncash charges (primarily depreciation and amortization, the derivative loss, share-based compensation, difference between straight-line rent and rent paid, and amortization of debt discounts and related deferred financing costs); all primarily the result of routine operating activities.

Net cash used in investing activities for the six months ended June 30, 2011, was approximately \$34,689,000. This is primarily the result of funding our acquisitions, including making escrow deposits.

Net cash provided by financing activities was approximately \$35,206,000 for the six months ended June 30, 2011. This is primarily the result of increases in borrowings on the line of credit, proceeds from debt financings to fund our acquisitions, partially offset by repayments of existing debt obligations.

Debt Covenant Compliance

As of June 30, 2012, the Company (including its consolidated variable interest entity) had 27 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, 2012, the 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.

The following table includes financial covenant requirements as of the last measurement date as of or prior to June 30, 2012 where the Company was not in compliance with the financial covenant or it achieved compliance with the covenant requirement by a margin of 10% or less. The table also identifies the related credit facility, outstanding balance at June 30, 2012 and the next applicable future financial covenant requirement inclusive of adjustments to covenant requirements resulting from amendments executed subsequent to June 30, 2012.

| Period Ended | Balance at June 30, 2012 (000 s) | Consolidated or Subsidiary Level Covenant Requirement | Financial Covenant | Measurement Period | June 30, 2012 | | |
|--|-------------------------------------|---|------------------------------------|-----------------------|--|---|---|
| | | | | | Min/Max Financial Covenant Required | As Reported Financial Covenant Metric Achieved | As Restated Financial Covenant Metric Achieved |
| Gemino - Line of Credit | \$ 7,041 | Consolidated | Fixed Charge Coverage Ratio (FCCR) | Quarterly | 1.10 | 0.68 | 0.37* |
| PrivateBank - Line of Credit (Bentonville LOC) | \$ 1,900 | Subsidiary | FCCR | Quarterly | 1.05 | 1.54 | 2.69 |
| PrivateBank - Mortgage Note - Homestead, Valley River, Bentonville | \$ 11,617 | Subsidiary | EBITDAR(000 s) | Quarterly | \$ 450 | \$ 460 | \$ 741 |
| | | Consolidated | DSCR | Annual | n/a | n/a | n/a |
| Square 1 USDA - Term Note - Homestead | \$ 3,562 | Subsidiary | Current ratio | Quarterly | 1.00 | 0.38 | 0.28* |

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| | | | | | | | | | |
|---|----|--------|-------------------------|------------------------------------|-----------|--------|----|-------|-----------|
| | | | Subsidiary | Maximum debt to net worth | Quarterly | 9.00 | | 6.76 | 12.23* |
| | | | Subsidiary | Tangible net worth | Quarterly | 10.0% | | 12.9% | 7.6%* |
| PrivateBank - Term Debt - Certain Arkansas Facilities | \$ | 21,724 | Subsidiary | EBITDAR (000 s) | Monthly | \$ 100 | \$ | 236 | \$ (268)* |
| | | | Subsidiary Consolidated | FCCR | Quarterly | 1.05 | | 1.71 | .61* |
| | | | Consolidated | DSCR | Annual | n/a | | n/a | n/a*** |
| | | | Consolidated | Maximum Annual Leverage | Annual | n/a | | n/a | n/a*** |
| PrivateBank - Mortgage Note - Woodland Manor | \$ | 4,758 | Subsidiary | Minimum quarterly EBITDAR (000 s) | Quarterly | \$ 250 | \$ | 264 | \$ 228* |
| | | | Subsidiary | Minimum trailing twelve month FCCR | Quarterly | 1.10 | | 1.82 | 1.64 |

* Waiver or amendment for violation of covenant obtained.

*** Covenants commenced in future quarter

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Item 4. Controls and Procedures

As previously disclosed, the Audit Committee, in consultation with management, concluded in March 2013 that: (i) the Company's previously issued financial statements for the quarters ended March 31, 2012, June 30, 2012 and September 30, 2012 (the Relevant Financial Statements) should no longer be relied upon due to errors in the Relevant Financial Statements identified in connection with the audit of the Company's consolidated financial statements for the year ended December 31, 2012; and (ii) the Company would restate the Relevant Financial Statements.

The Audit Committee initiated a further review of, and inquiry with respect to, the accounting and financial issues related to these and other potential errors and engaged counsel to assist the Audit Committee with such matters. The Audit Committee completed its inquiry and, in connection therewith, assisted in the correction of certain errors relating to accounting and financial matters and identified certain material weaknesses in the Company's internal control over financial reporting, including weakness in the Company's ability to appropriately account for complex or non-routine transactions and in the quality and sufficiency of the Company's finance and accounting resources.

On July 8, 2013, the Company restated the Relevant Financial Statements by filing with the SEC amendments to its Quarterly Reports on Form 10-Q for the quarters ended March 31, 2012, June 30, 2012 and September 30, 2012.

Evaluation of Disclosure Controls and Procedures

We maintain disclosure controls and procedures that are designed to ensure that information required to be disclosed in our reports filed pursuant to the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the rules and forms of the SEC and that such information is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate, to allow for timely decisions regarding required disclosure. In designing and evaluating the disclosure controls and procedures, management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives, and management is required to apply its judgment in evaluating the cost-benefit relationship of possible controls and procedures.

Our Chief Executive Officer and Chief Financial Officer have evaluated the effectiveness of our disclosure controls and procedures (as such term is defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act) as of the end of the period covered by this Quarterly Report (the "Evaluation Date"). Based on such evaluation, our Chief Executive Officer and Chief Financial Officer have concluded that, as of the Evaluation Date, our disclosure controls and procedures were not effective.

Management's Report on Internal Control Over Financial Reporting

Our management is responsible for establishing and maintaining adequate internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act). Our internal control over financial reporting is designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. Our internal control over financial reporting includes policies and procedures that are intended to:

- (1) maintain records that in reasonable detail accurately and fairly reflect the transactions and dispositions of our assets;

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(2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with U.S. GAAP, and that our receipts and expenditures are being made only in accordance with the authorization of our management and directors; and

(3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of our assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate due to changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate. A control system, no matter how well designed and operated, can provide only reasonable, but not absolute, assurance that the control system's objectives will be met. The

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design of a control system must reflect the fact that there are resource constraints, and the benefit of controls must be considered relative to their costs.

Management evaluated the effectiveness of our internal control over financial reporting as of December 31, 2012. In making this evaluation, management used the framework and criteria set forth in the report entitled *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). The COSO framework summarizes each of the components of a company s internal control system, including: (i) the control environment, (ii) risk assessment, (iii) control activities, (iv) information and communication and (v) monitoring.

Consistent with the results of the Audit Committee s review and inquiry, management identified material weaknesses in the Company s ability to appropriately account for complex or non-routine transactions and the quality and sufficiency of the Company s finance and accounting resources in relation to the increasing complexity and growth of the Company s operations.

As a result of the material weaknesses described above, management has concluded that our internal control over financial reporting was not effective at December 31, 2012 based on the guidelines established in Internal Control Integrated Framework issued by COSO.

Changes in Internal Control over Financial Reporting and Remediation

In response to the material weaknesses in the Company s internal control over financial reporting, and based in part on recommendations made by the Audit Committee to the Board of Directors following the completion of the Audit Committee s review and inquiry, we have implemented, or plan to implement, the changes to our internal control over financial reporting discussed below.

- We hired Ronald W. Fleming to serve as Chief Financial Officer of the Company effective May 15, 2013. Mr. Fleming has relevant industry experience as well as experience with generally accepted accounting principles and SEC reporting and compliance.
- We have empowered Mr. Fleming to hire additional accounting and finance staff to ensure adequate internal control over financial reporting and operations.
- We are seeking to hire a permanent Chief Accounting Officer, as further discussed below.
- We have expanded the scope of our annual internal audit plan to include quarterly internal audit procedures with emphasis on the review of journal entries and non-recurring transactions.

In April 2013, we engaged an Interim Chief Accounting Officer on a contract basis. We are currently discussing with our Interim Chief Accounting regarding the terms of her employment as the Company s Chief Accounting Officer and believe that we will reach agreement on such terms in the near term.

Since January 2013, the Company has hired eight new finance and accounting personnel, including a Vice President of Facility Accounting Operations. Our new finance and accounting leadership continue to evaluate the qualifications and sufficiency of our accounting and finance department. The expanded internal audit scope has commenced and will be completed prior to the Company filing its Quarterly Reports on Form 10-Q for each of the 2013 quarterly periods.

Due to the short time period since we commenced our efforts to remediate our material weaknesses, and because we have not fully completed our financial reporting process for the quarter ended March 31, 2013, we have not yet been able to fully evaluate the effectiveness of such efforts. We have incurred, and will continue to incur, additional incremental costs associated with our remediation efforts, primarily due to hiring new finance and accounting personnel and external consultants and the implementation and validation of improved accounting and financial reporting procedures. If we are not successful in remediating our material weaknesses, or if we determine in future fiscal periods that

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we have additional material weaknesses in our internal control over financial reporting, then the reliability of our financial reports may be adversely impacted, we may be unable to file our reports with the SEC in a timely fashion and we could be required to restate our financial results. This could cause our investors to lose confidence in our financial reporting, which could adversely affect the trading price of our stock.

Other than the remediation efforts discussed above, which occurred in 2013 and have included the involvement of our new finance and accounting leadership in the preparation, review, and approval of the consolidated financial statements included in this Quarterly Report, there have not been any changes in our internal control over financial reporting (as such term is defined in Rules 13a-15(f) and

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15d-15(f) under the Exchange Act) since January 1, 2013 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

In addition, there were not any changes in our internal control over financial reporting (as such term is defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) during the second quarter of 2012 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

Part II. Other Information

Item 6. Exhibits

The agreements included as exhibits to this Quarterly Report are included to provide information regarding the terms of these agreements and are not intended to provide any other factual or disclosure information about the Company, its business or the other parties to these agreements. These agreements may contain representations and warranties by each of the parties to the applicable agreement. These representations and warranties have been made solely for the benefit of the other parties to the applicable agreement and:

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- should not in all instances be treated as categorical statements of fact, but rather as a way of allocating the risk to one of the parties if those statements prove to be inaccurate;
- have been qualified by disclosures that were made to the other party in connection with the negotiation of the applicable agreement, which disclosures are not necessarily reflected in the agreement;
- may apply standards of materiality in a way that is different from what may be viewed as material to investors; and
- were made only as of the date of the applicable agreement or such other date or dates as may be specified in the agreement and are subject to more recent developments.

Accordingly, these representations and warranties may not describe the actual state of affairs as of the date they were made or at any other time, and should not be relied upon by investors.

| Exhibit No. | Description | Method of Filing |
|-------------|---|--|
| 2.1 | Purchase and Sale Agreement, dated as of April 3, 2012, between Evans Memorial Hospital, Inc. and AdCare Property Holdings, LLC | Incorporated by reference from Exhibit 2.1 to the Registrant's Current Report on Form 8-K filed April 9, 2012 |
| 2.2 | Third Amendment to Purchase and Sale Agreement, dated as of April 17, 2012, by and between First Commercial Bank and AdCare Property Holdings, LLC | Incorporated by reference from Exhibit 2.2 to the Registrant's Current Report on Form 8-K filed April 23, 2012 |
| 2.3 | Purchase Agreement, dated as of April 27, 2012, between AdCare Property Holdings, LLC and 1761 Pinewood Holdings, LLC | Incorporated by reference from Exhibit 2.1 to the Registrant's Current Report on Form 8-K filed May 3, 2012 |
| 2.4 | Second Amendment to Purchase and Sale Agreement, dated April 30, 2012, by and between Gyman Properties, LLC and AdCare Property Holdings, LLC | Incorporated by reference from Exhibit 2.2 to the Registrant's Current Report on Form 8-K filed May 3, 2012 |
| 2.5 | Second Amendment to Purchase and Sale Agreement, dated June 19, 2012, by and among F & F Ventures, LLC, Tulsa Christian Care, Inc., d/b/a Companions Specialized Care Center, George Perry Farmer, Jr., Jessica L. Farmer and AdCare Property Holdings, LLC | Previously filed |
| 2.6 | First Amendment to Purchase and Sale Agreement, dated May 15, 2012, by and between AdCare Property Holdings, LLC and Westlake Nursing Home Limited | Previously filed |
| 2.7 | Purchase Agreement, dated June 4, 2012, by and between AdCare Hembree Road Property, LLC and JRT Group Properties, LLC | Previously filed |

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3.1 Amended and Restated Articles of Incorporation

Incorporated by reference from Exhibit 3.1 of
the Registrant's Registration Statement
Form SB (Registration No. 333-131542) filed

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| Exhibit No. | Description | Method of Filing |
|-------------|---|--|
| | | February 3, 2006 |
| 3.2 | Code of Regulations | Incorporated by reference from Exhibit 3.2 of the Registrant's Registration Statement Form SB (Registration No. 333-131542) filed February 3, 2006 |
| 3.3 | Amendment to Amended and Restated Articles of Incorporation | Incorporated by reference to Exhibit 3.3 of the Registrant's Quarterly Report on Form 10-Q for the quarter ended September 30, 2011 |
| 3.4 | Affidavit, dated June 28, 2012 | Incorporated by reference to Exhibit 3.1 of the Registrant's Current Report on Form 8-K filed on July 5, 2012 |
| 4.1 | Warrant to Purchase 312,500 Shares of Common Stock, dated April 1, 2012, issued by AdCare Health Systems, Inc. to Strome Alpha Offshore Ltd. | Incorporated by reference to Exhibit 4.1 of the Registrant's Quarterly Report on Form 10-Q for the quarter ended March 30, 2012 |
| 4.2 | Warrant to Purchase 300,000 Shares of Common Stock, dated March 30, 2012, issued by AdCare Health Systems, Inc. to Cantone Asset Management LLC | Incorporated by reference to Exhibit 4.2 of the Registrant's Quarterly Report on Form 10-Q for the quarter ended March 30, 2012 |
| 4.3 | Warrant to Purchase 100,000 Shares of Common Stock, dated July 2, 2012, issued by AdCare Health Systems, Inc. to Cantone Research, Inc. | Previously filed |
| 10.1 | Loan Agreement, dated as of April 12, 2012, between the City of Springfield, Ohio and Eaglewood Property Holdings, LLC | Incorporated by reference to Exhibit 10.18 of the Registrant's Quarterly Report on Form 10-Q for the quarter ended March 30, 2012 |
| 10.2 | Guaranty Agreement, dated as of April 12, 2012, made and entered into by AdCare Health Systems, Inc., to and for the benefit of BOKF, NA dba Bank of Oklahoma | Incorporated by reference to Exhibit 10.19 of the Registrant's Quarterly Report on Form 10-Q for the quarter ended March 30, 2012 |
| 10.3 | Land Use Restriction Agreement, dated as of April 12, 2012, by and between BOKF, NA dba Bank of Oklahoma and Eaglewood Property Holdings, LLC | Incorporated by reference to Exhibit 10.20 of the Registrant's Quarterly Report on Form 10-Q for the quarter ended March 30, 2012 |
| 10.4 | Open-End Mortgage, Assignment of Leases and Security Agreement, dated April 12, 2012, from Eaglewood Property Holdings, LLC to BOKF, NA dba Bank of Oklahoma | Incorporated by reference to Exhibit 10.21 of the Registrant's Quarterly Report on Form 10-Q for the quarter ended March 30, 2012 |
| 10.5 | Loan Agreement, dated April 30, 2012, by and between APH&R Property Holdings, LLC and Metro City Bank | Incorporated by reference from Exhibit 99.1 to the Registrant's Current Report on Form 8-K filed May 3, 2012 |

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| Exhibit No. | Description | Method of Filing |
|-------------|--|--|
| 10.6 | Promissory Note, dated April 30, 2012, issued by APH&R Property Holdings, LLC in favor of Metro City Bank in the amount of \$3,425,500 | Incorporated by reference from Exhibit 99.2 to the Registrant's Current Report on Form 8-K filed May 3, 2012 |
| 10.7 | Mortgage and Security Agreement, dated April 30, 2012, between APH&R Property Holdings, LLC and Metro City Bank | Incorporated by reference from Exhibit 99.3 to the Registrant's Current Report on Form 8-K filed May 3, 2012 |
| 10.8 | Security Agreement, dated April 30, 2012, between APH&R Property Holdings, LLC and Metro City Bank | Incorporated by reference from Exhibit 99.4 to the Registrant's Current Report on Form 8-K filed May 3, 2012 |
| 10.9 | Guaranty, dated as of April 30, 2012, between APH&R Property Holdings, LLC in favor of Metro City Bank | Incorporated by reference from Exhibit 99.5 to the Registrant's Current Report on Form 8-K filed May 3, 2012 |
| 10.10 | Guaranty, dated as of April 30, 2012, between AdCare Health Systems, Inc. in favor of Metro City Bank | Incorporated by reference from Exhibit 99.6 to the Registrant's Current Report on Form 8-K filed May 3, 2012 |
| 10.11 | Collateral Assignment of Certificate of Deposit, dated April 30, 2012, by and between APH&R Property Holdings, LLC and Metro City Bank | Incorporated by reference from Exhibit 99.7 to the Registrant's Current Report on Form 8-K filed May 3, 2012 |
| 10.12 | Promissory Note, dated April 27, 2012, issued by Cantone Asset Management LLC in favor of AdCare Health Systems, Inc. in the amount of \$1,500,000 | Incorporated by reference from Exhibit 99.8 to the Registrant's Current Report on Form 8-K filed May 3, 2012 |
| 10.13 | Promissory Note, dated June 8, 2012, issued by Mt. V Property Holdings, LLC in favor of Metro City Bank in the amount of \$1,800,000 | Previously filed |
| 10.14 | Loan Agreement, dated June 8, 2012, by and between Mt. V Property Holdings, LLC and Metro City Bank | Previously filed |
| 10.15 | Mortgage and Security Agreement, dated June 8, 2012, by and between Mt. V Property Holdings, LLC and Metro City Bank | Previously filed |
| 10.16 | Assignment of Leases and Rents, dated June 8, 2012, by and between Mt. V Property Holdings, LLC and Metro City Bank | Previously filed |
| 10.17 | Security Agreement, dated June 8, 2012, by and between Mt. V Property Holdings, LLC and Metro City Bank | Previously filed |
| 10.18 | Guaranty, dated June 8, 2012, made by AdCare Health Systems, Inc. in favor of Metro City Bank | Previously filed |
| 10.19 | Promissory Note, dated June 8, 2012, issued by Mt. V Property Holdings, LLC in favor of Metro City Bank in the amount of \$1,267,000 | Previously filed |

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| Exhibit No. | Description | Method of Filing |
|-------------|--|------------------|
| 10.20 | Loan Agreement, dated June 8, 2012, by and between Mt. V Property Holdings, LLC and Metro City Bank | Previously filed |
| 10.21 | Mortgage and Security Agreement, dated June 8, 2012, by and between Mt. V Property Holdings, LLC and Metro City Bank | Previously filed |
| 10.22 | Assignment of Leases and Rents, dated June 8, 2012, by and between Mt. V Property Holdings, LLC and Metro City Bank | Previously filed |
| 10.23 | Security Agreement, dated June 8, 2012, by and between Mt. V Property Holdings, LLC and Metro City Bank | Previously filed |
| 10.24 | Guaranty, dated June 8, 2012, made by AdCare Health Systems, Inc. in favor of Metro City Bank | Previously filed |
| 10.25 | Promissory Note, dated June 8, 2012, issued by Mt. V Property Holdings, LLC in favor of Economic Development Corporation of Fulton County in the amount of \$1,304,000 | Previously filed |
| 10.26 | Loan Agreement, dated June 8, 2012, by and between Mt. V Property Holdings, LLC, Mountain View Nursing, LLC and Economic Development Corporation of Fulton County | Previously filed |
| 10.27 | Security Agreement, dated June 8, 2012, by and between Mt. V Property Holdings, LLC and Economic Development Corporation of Fulton County | Previously filed |
| 10.28 | Mortgage and Security Agreement, dated June 8, 2012, by and between Mt. V Property Holdings, LLC and Economic Development Corporation of Fulton County | Previously filed |
| 10.29 | Assignment of Leases and Rents, dated June 8, 2012, by and between Mt. V Property Holdings, LLC and Economic Development Corporation of Fulton County | Previously filed |
| 10.30 | Unconditional Guarantee, dated June 8, 2012, issued by Mountain View Nursing, LLC in favor of Economic Development Corporation of Fulton County | Previously filed |
| 10.31 | Unconditional Guarantee, dated June 8, 2012, issued by AdCare Health Systems, Inc. in favor of Economic Development Corporation of Fulton County | Previously filed |
| 10.32 | Loan Agreement, dated as of July 2, 2012, by and between Glenvue H&R Property Holdings, LLC and the PrivateBank and Trust Company | Previously filed |
| 10.33 | Promissory Note, dated July 2, 2012, issued by Glenvue H&R Property Holdings, LLC in favor of the PrivateBank and Trust Company in the amount of \$6,600,000 | Previously filed |
| 10.34 | Deed to Secure Debt, Security Agreement and Assignment of Leases and Rents, dated as of July 2, 2012, from Glenvue H&R Property Holdings, LLC to the PrivateBank and Trust Company | Previously filed |
| 10.35 | | Previously filed |

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Assignment of Leases and Rents, dated as of July 2, 2012, from Glenvue H&R
Property Holdings, LLC to the PrivateBank and

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| Exhibit No. | Description | Method of Filing |
|-------------|--|---|
| | Trust Company | |
| 10.36 | Guaranty of Payment and Performance, dated as of July 2, 2012, issued by Glenvue H&R Property Holdings, LLC and AdCare Health Systems, Inc. for the benefit of The PrivateBank and Trust Company | Previously filed |
| 10.37 | Assignment and Assumption Agreement, dated as of July 1, 2012, by and between Westlake Nursing Home Limited Partnership and QC Property Holdings, LLC | Previously filed |
| 10.38 | Loan Agreement and Indenture of First Mortgage, dated as of September 1, 1986, by and among Oklahoma County Industrial Authority, Westlake Nursing Home Limited Partnership and The Liberty National Bank and Trust Company of Oklahoma City, as Trustee | Previously filed |
| 10.39 | First Amendment to Loan Agreement and Indenture of First Mortgage, dated September 1, 2001, by and among Oklahoma County Industrial Authority, Westlake Nursing Home, L.P. and Bank One Trust Company, N.A., as Trustee | Previously filed |
| 10.40 | Bond Purchase Agreement, dated April 10, 2012, among Lawson Financial Corporation, The City of Springfield, Ohio and Eaglewood Property Holdings, LLC | Previously filed |
| 10.41 | Note Purchase Agreement, dated April 12, 2012, by and between Cantone Asset Management LLC and AdCare Health Systems, Inc. | Previously filed |
| 10.42 | Employment Agreement, dated August 6, 2012, between AdCare Health Systems, Inc. and Martin D. Brew | Previously filed |
| 10.43 | Modification Agreement, dated June 15, 2012, among Little Rock HC&R Property Holdings, LLC, Northridge HC&R Property Holdings, LLC, Woodland Hills HC Property Holdings, LLC and The PrivateBank and Trust Company | Previously filed |
| 10.44 | Form of Securities Purchase Agreement, dated as of June 28, 2012, between AdCare Health Systems, Inc. and the Buyers signatory thereto | Incorporated by reference from Exhibit 99.1 to the Registrant's Current Report on Form 8-K filed July 5, 2012 |
| 10.45 | Form of Registration Rights Agreement, dated as of June 28, 2012, between AdCare Health Systems, Inc. and the Buyers signatory thereto | Incorporated by reference from Exhibit 99.2 to the Registrant's Current Report on Form 8-K filed July 5, 2012 |
| 10.46 | Form of 8% Subordinated Convertible Note Due 2015, issued by AdCare Health Systems, Inc. | Incorporated by reference from Exhibit 99.3 to the Registrant's Current Report on Form 8-K filed July 5, 2012 |
| 10.47 | Amendment, entered into as of July 26, 2012, by and between Christopher F. Brogdon and Hearth & Home of Ohio, Inc. | Previously filed |
| 10.48 | Employment Agreement, dated August 6, 2012, between AdCare Health Systems, Inc. and Melissa L. Green | Previously filed |
| 31.1 | Certification of CEO pursuant to Section 302 of the | Filed herewith |

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| Exhibit No. | Description | Method of Filing |
|-------------|---|------------------|
| | Sarbanes-Oxley Act | |
| 31.2 | Certification of CFO pursuant to Section 302 of the Sarbanes-Oxley Act | Filed herewith |
| 32.1 | Certification of CEO pursuant to Section 906 of the Sarbanes-Oxley Act | Filed herewith |
| 32.2 | Certification of CFO pursuant to Section 906 of the Sarbanes-Oxley Act | Filed herewith |
| 101 | The following financial information from AdCare Health Systems, Inc. Quarterly Report on Form 10-Q for the quarter ended June 30, 2012, formatted in XBRL (eXtensible Business Reporting Language): (i) Consolidated Statements of Operations for the three months ended June 30, 2012 and 2011 and for the six months ended June 30, 2012 and 2011, (ii) Consolidated Balance Sheets as of June 30, 2012 and December 31, 2011, (iii) Consolidated Statements of Cash Flows for the six months ended June 30, 2012 and 2011, (iv) Consolidated Statements of Stockholders' Equity for the six months ended June 30, 2012 and (v) the Notes to Consolidated Financial Statements. | Filed herewith |

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SIGNATURES

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

**ADCARE HEALTH SYSTEMS, INC.
(Registrant)**

Date: October 22, 2013

/s/ Boyd P. Gentry
Boyd P. Gentry
Chief Executive Officer
(Principal Executive Officer)

Date: October 22, 2013

/s/ Ronald W. Fleming
Ronald W. Fleming
Chief Financial Officer
(Principal Financial and Accounting Officer)