

ADCARE HEALTH SYSTEMS INC
Form 10-Q
August 13, 2009

UNITED STATES SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

QUARTERLY REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended June 30, 2009

TRANSITION REPORT UNDER SECTION 13 OR 15(d) OF THE EXCHANGE ACT

For the transition period from _____ to _____

Commission file number 333-131542

AdCare Health Systems, Inc.

(Exact name of registrant as specified in its charter)

Ohio

31-1332119

(State or Other Jurisdiction

(IRS Employer Identification Number)

of Incorporation)

5057 Troy Rd, Springfield, OH 45502-9032

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(Address of principal executive offices)

(937) 964-8974

(Registrant's telephone number)

NA

(Former name, former address, or 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 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. (Check one):

| | | | |
|--|--|--|---|
| Large accelerated filer <input type="checkbox"/> | Accelerated filer <input type="checkbox"/> | Non-accelerated filer <input type="checkbox"/> | Smaller reporting company <input checked="" type="checkbox"/> |
| | | | (Do not check if a 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

The number of shares of the registrant's common stock outstanding as of August 13, 2009: 3,786,129.

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AdCare Health Systems, Inc.

Form 10-Q

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| | <u>EX-32.2</u> | Certification of CFO pursuant to Section 906 of the Sarbanes-Oxley Act |
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Item 1. Financial Statements

ADCARE HEALTH SYSTEMS, INC. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEET

| | June 30, 2009 (Unaudited) | December 31, 2008 |
|---|---------------------------------|----------------------|
| <u>ASSETS</u> | | |
| Current Assets: | | |
| Cash | \$ 1,808,604 | \$ 1,266,315 |
| Accounts receivable: | | |
| Long-term care resident receivables, net | 1,965,901 | 2,008,847 |
| Management, consulting and development receivables, net | 167,900 | 258,811 |
| Advances and receivables from affiliates | 16,407 | 17,635 |
| Prepaid expenses and other | 537,277 | 478,534 |
| Total current assets | 4,496,089 | 4,030,142 |
| Restricted cash | 1,176,960 | 1,155,596 |
| Property and equipment, net | 16,462,360 | 16,772,660 |
| License, net | 1,189,307 | 1,189,307 |
| Goodwill | 2,679,482 | 2,679,482 |
| Other assets | 906,269 | 1,012,340 |
| Total assets | \$ 26,910,467 | \$ 26,839,527 |

**LIABILITIES AND
STOCKHOLDERS EQUITY**

| | | |
|---|------------|------------|
| Current Liabilities: | | |
| Current portion of notes payable and other debt | \$ 729,157 | \$ 713,323 |
| Current portion of notes payable to stockholder | 9,432 | 9,432 |
| Accounts payable | 875,325 | 1,009,002 |
| Accrued expenses | 2,606,873 | 2,838,407 |
| Total current liabilities | 4,220,787 | 4,570,164 |

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| | | |
|--|---------------|---------------|
| Notes payable and other debt, net of current portion | 16,645,776 | 16,974,788 |
| Notes payable to stockholder, net of current portion | 30,623 | 34,626 |
| Other liabilities | 695,229 | 299,314 |
| Income tax payable | 191,291 | 170,007 |
| Total liabilities | 21,783,705 | 22,048,899 |
| Stockholders' equity: | | |
| Preferred stock, no par value; 500,000 shares authorized; no shares issued or outstanding | - | - |
| Common stock and additional paid-in capital, no par value; 14,500,000 shares authorized; 3,786,129 shares issued and outstanding | 14,835,191 | 14,766,967 |
| Accumulated deficit | (10,002,617) | (10,245,532) |
| Total stockholders' equity | 4,832,574 | 4,521,435 |
| Noncontrolling interest in subsidiaries | 294,188 | 269,193 |
| Total equity | 5,126,762 | 4,790,628 |
| Total liabilities and stockholders' equity | \$ 26,910,467 | \$ 26,839,527 |

See notes to consolidated financial statements

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ADCARE HEALTH SYSTEMS, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF OPERATIONS
(Unaudited)

| | Three-Months Ended | | Six-Months Ended | |
|--|--------------------|-----------|------------------|--------------|
| | June 30, | | June 30, | |
| | 2009 | 2008 | 2009 | 2008 |
| Revenues: | | | | |
| | | | | \$ |
| Patient care revenues | \$ 6,162,746 | 5,574,114 | \$12,079,581 | \$11,142,175 |
| Management, consulting and development fee revenue | 450,381 | 442,422 | 918,435 | 866,903 |
| Total revenue | 6,613,127 | 6,016,536 | 12,998,016 | 12,009,078 |
| Expenses: | | | | |
| Payroll and related payroll costs | 3,709,728 | 3,697,477 | 7,447,457 | 7,284,874 |
| Other operating expenses | 2,150,161 | 2,113,128 | 4,168,087 | 4,136,385 |
| Depreciation and amortization | 225,878 | 206,324 | 451,186 | 433,018 |
| Total expenses | 6,085,767 | 6,016,929 | 12,066,730 | 11,854,277 |
| Income (Loss) from Operations | 527,360 | (393) | 931,286 | 154,801 |
| Other Income (Expense): | | | | |
| Interest income | 1,098 | 5,096 | 2,406 | 14,228 |
| Interest expense, others | (299,804) | (393,358) | (593,947) | (619,710) |
| Interest expense, related parties | (510) | (13,574) | (1,228) | (28,446) |
| Other expense | (53,524) | - | (49,324) | - |
| | (352,740) | (401,836) | (642,092) | (633,928) |
| Gain on Acquisition | - | 413,593 | - | 413,593 |
| Income (Loss) Before Income Taxes | 174,620 | 11,364 | 289,194 | (65,534) |
| Income Tax Expense | (10,642) | (10,642) | (21,284) | (21,284) |
| Net Income (Loss) | 163,978 | 722 | 267,910 | (86,818) |
| Net Income (Loss) Attributable to Noncontrolling Interests | (16,877) | 22,241 | (24,995) | (29,689) |
| Net Income (Loss) Attributable to AdCare Health Systems | \$ 147,101 | 22,963 | \$ 242,915 | \$ (116,507) |

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| | | | | |
|---------------------------------------|---------|---------|---------|-----------|
| Net Income (Loss) Per Share, Basic: | \$ 0.04 | \$ 0.01 | \$ 0.07 | \$ (0.02) |
| Net Income (Loss) Per Share, Diluted: | \$ 0.04 | \$ 0.01 | \$ 0.07 | \$ (0.02) |

Weighted Average Common Shares
Outstanding,

| | | | | |
|---------|-----------|-----------|-----------|-----------|
| Basic | 3,786,129 | 3,786,129 | 3,786,129 | 3,786,129 |
| Diluted | 3,890,681 | 3,786,129 | 3,890,681 | 3,786,129 |

See notes to consolidated financial statements.

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ADCARE HEALTH SYSTEMS, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENT OF STOCKHOLDERS EQUITY
(Unaudited)

| | Total | Accumulated Deficit | Common Stock and Additional Paid-in Capital | Noncontrolling Interest |
|---|-------------|------------------------|--|----------------------------|
| Balance, December 31, 2008: | \$4,790,628 | \$(10,245,532) | \$14,766,967 | \$269,193 |
| Warrants issued in connection with consulting agreement | 15,908 | - | 15,908 | - |
| Stock option compensation expense | 22,316 | - | 22,316 | - |
| Stock issuance | 30,000 | - | 30,000 | - |
| Net income | 242,915 | 242,915 | - | - |
| Net income attributable to noncontrolling interest | 24,995 | - | - | 24,995 |
| Balance, June 30, 2009 | \$5,126,762 | \$(10,002,617) | \$14,835,191 | \$294,188 |

See notes to consolidated financial statements

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ADCARE HEALTH SYSTEMS, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited)

| | Six-Months Ended June 30, | |
|---|---------------------------|-------------|
| | 2009 | 2008 |
| Cash flows from operating activities: | | |
| Net income (loss) inclusive of noncontrolling interest | \$ 267,910 | \$ (86,818) |
| Adjustments to reconcile net income (loss) to net cash Provided by operating activities: | | |
| Depreciation and amortization | 451,186 | 433,018 |
| Warrants issued for services | 37,276 | 55,105 |
| Stock option compensation expense | 22,316 | 19,151 |
| Note receivable forgiveness exchanged for rent | - | 9,000 |
| Gain on acquisition | - | (413,593) |
| Changes in certain assets and liabilities: | | |
| Accounts receivable | 135,085 | 78,627 |
| Prepaid expenses and other | (90,258) | 153,084 |
| Other assets | 106,071 | 780 |
| Accounts payable and accrued expenses | (365,211) | (114,350) |
| Income tax liability | 21,284 | 21,284 |
| Other liabilities | 395,915 | (97,485) |
| Net cash provided by operating activities | 981,574 | 57,803 |
| Cash flows from investing activities: | | |
| Proceeds from the sale of assets, net of associated costs | 892 | 2,500 |
| (Increase) decrease in restricted cash | (21,364) | 276,693 |
| Purchase of property plant and equipment | (131,630) | (226,160) |
| Net cash (used in) provided by investing activities | (152,102) | 53,033 |
| Cash flows from financing activities: | | |
| Amortization of bond issuance costs | - | 144,475 |
| Stock issuance | 30,000 | - |
| Repayment of notes payable to stockholder | (4,004) | - |
| Prepaid financing costs | - | 111,984 |

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| | | |
|--|--------------|--------------|
| Repayment of notes payable | (313,179) | (240,588) |
| Net cash (used in) provided by financing activities | (287,183) | 15,871 |
| Net Increase in Cash | 542,289 | 126,707 |
| Cash, Beginning | 1,266,315 | 926,625 |
| Cash, Ending | \$ 1,808,604 | \$ 1,053,332 |
| Supplemental Disclosure of Cash Flow Information: | | |
| Cash paid during the year for interest | \$ 292,528 | \$ 265,760 |
| Supplemental Disclosure of Non-Cash Activities: | | |
| Rent in exchange of note receivable repayment | \$ - | \$ 9,000 |
| Acquisition of assets in exchange for note forgiveness | \$ - | \$ 2,808,736 |

See notes to consolidated financial statements.

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ADCARE HEALTH SYSTEMS, INC. AND SUBSIDIARIES

Notes to Unaudited

Consolidated Financial Statements

NOTE 1.

SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation

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 Article 10 of Regulation S-X. Accordingly they do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. In the opinion of the management of AdCare Health Systems, Inc., all adjustments considered for a fair presentation are included and are of a normal recurring nature. Operating results for the six months ended June 30, 2009 are not necessarily indicative of the results that may be expected for the year ending December 31, 2009.

For further information, refer to the consolidated financial statements and footnotes thereto included in AdCare Health Systems, Inc.'s annual report on Form 10-K, filed March 31, 2009.

Principles of Consolidation

The consolidated financial statements are presented in accordance with accounting principles generally accepted in the United States. These statements include the accounts of AdCare and its controlled subsidiaries. All inter-company accounts and transactions were eliminated in the consolidation.

Arrangements with other business enterprises are evaluated, and those in which AdCare is determined to have controlling financial interest are consolidated. In January 2003, the Financial Accounting Standards Board (FASB)

issued FASB Interpretation No. 46, *Consolidation of Variable Interest Entities (FIN 46)*, and amended it by issuing FIN 46R in December 2003. FIN 46R addresses the consolidation of business enterprises to which the usual condition of consolidation (ownership of a majority voting interest) does not apply. This interpretation focuses on controlling financial interests that may be achieved through arrangements that do not involve voting interests. It concludes that, in absences of clear control through voting interests, a company's exposure (variable interest) to the economic risks and potential rewards from the variable interest entity's assets and activities are the best evidence of control. If an enterprise holds a majority of the variable interests of an entity, it would be considered the primary beneficiary. The primary beneficiary is required to consolidate the assets, liabilities and results of operations of the variable interest entity in its financial statements.

AdCare has evaluated its relationship with Community's Hearth & Home and Hearth & Home of Urbana and has determined that these entities are variable interest entities and that AdCare holds variable interests in these entities. Furthermore, the Company determined that it is the primary beneficiary of these variable interests and that the entities are required to be consolidated in accordance with FIN 46R.

The Company considered many factors in connection with the evaluation of the application of the criteria in FIN 46R in determining if it is appropriate to consolidate the entities. All the entities were organized by AdCare for the purpose of developing, owning and operating a long-term care facility, which would be managed by AdCare. With one exception, all the entities are controlled by stockholders of AdCare. AdCare was instrumental in securing and has guaranteed the financing used to develop the property and operate the business. AdCare manages all aspects of the operations. These entities are thinly capitalized, highly leveraged and have a history of operating losses. The Company considered all these factors and evaluated the Company's exposure to economic risks and potential rewards for all entities in which it had a potential variable interest.

Table of Contents**NOTE 1.****SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES** (continued)

Presented below are the carrying amount and classification of the assets and liabilities of our variable interest entities for the six months ended June 30, 2009 and for the year ended December 31, 2008.

| | June 30, 2009 | December 31, 2008 |
|---------------------------------------|---------------|----------------------|
| Current assets | \$ 739,480 | \$ 715,645 |
| Property and equipment, net | 3,830,061 | 3,859,247 |
| Other assets | 217,795 | 221,047 |
| Total assets | \$4,787,336 | \$4,795,939 |
| Current liabilities | \$ 305,068 | \$ 347,828 |
| Notes payable, net of current portion | 3,952,285 | 3,970,132 |
| Total liabilities | \$4,257,353 | \$4,317,960 |
| Owner s equity | 529,983 | 477,979 |
| Total liabilities and equity | \$4,787,336 | \$4,795,939 |

The assets of the variable interest entities are pledged as security towards a Department of Housing and Urban Development secured loan and consequently restricted as to use. The Department of Housing and Urban Development secured loan is a non-recourse loan. As the primary beneficiary of the variable interest entities, the Company could be required to provide financial support by providing additional operating cash for example if the need arises as a result of a significant downturn in performance.

Use of Estimates

The preparation of consolidated financial statements in conformity with accounting principles generally accepted in the United States requires management to make certain estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported results of operations during the reporting period. Actual results could differ materially from those estimates.

Patient Care Receivables and Revenues

Patient care accounts receivable and revenues for the Company are recorded in the month that services are provided. For private patients, accounts receivable with invoice dates greater than 30 days are considered delinquent and are charged interest of 1.5% per month.

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

Contractual adjustments for the Medicare and Medicaid programs are recognized in the month that the related revenues are recorded. These contractual adjustments represent the difference between established rates and the amounts estimated to be reimbursable by Medicare and Medicaid. Differences between these estimates and amounts subsequently determined are recorded as additions to or deductions from contractual adjustments in the period such determination is made. Laws and regulations governing the Medicare and Medicaid programs are complex and subject to interpretation. As a result, there is at least a reasonable possibility that recorded estimates could change by a material amount in the near term.

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NOTE 1.

SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

Management, Consulting and Development Fee Receivables and Revenue

Management, consulting and development fee receivables and revenue are recorded in the month that services are provided.

Earnings per Share

Financial Accounting Standards Board Statement No. 128, *Earnings per Share* (SFAS 128) requires the presentation of basic and diluted earnings per share. Basic earnings per share exclude any dilutive effects of options, warrants and convertible securities and is computed using the weighted average number of common shares outstanding. Diluted earnings per share reflects the potential dilution if securities or other contracts to issue common units were exercised or converted into common units. The total number of shares that could potentially dilute earnings per share was 3,095,866 and 2,544,425 for the six months ended June 30, 2009 and June 30, 2008 respectively. Of these 485,943 shares were in the money as of June 30, 2009 and were used to calculate diluted earnings per share. No additional shares were included in 2009 as their inclusion would have had an anti-dilutive effect.

Licenses

The Company has capitalized the cost of acquiring operating licenses in connection with the acquisitions of its two skilled nursing facilities The Pavilion and Hearth & Care of Greenfield. In accordance with Statement of Financial Accounting Standards No. 142, *Goodwill and Other Intangible Assets* (SFAS 142), the licenses are tested for impairment annually.

Goodwill

The Company has capitalized the cost of goodwill acquired in the acquisition of Assured Health Care in January 2005. In accordance with Statement of Financial Accounting Standards No. 142, *Goodwill and Other Intangible Assets*

(SFAS 142), goodwill is tested for impairment annually.

Income Taxes

The Company and its subsidiaries file a consolidated federal income tax return. The provision for income taxes included in the accompanying consolidated statements of income was computed by applying statutory rates to income before income taxes. Income taxes are allocated to each company based on earnings of each company.

Deferred income taxes are recognized for the tax consequences in future years of temporary differences between the financial reporting and tax basis of assets and liabilities of each period-end based on enacted tax laws and statutory tax rates. Valuation allowances are established when necessary to reduce deferred tax assets to the amount expected to be realized. Income tax expense represents the taxes currently payable and the net change during the period in deferred tax assets and liabilities. The Company's income tax expense differs from the expected tax expense due to changes in the valuation allowance recorded against its deferred taxes.

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NOTE 1.

SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

Recently Adopted or Issued Accounting Pronouncements

Effective January 1, 2009, we adopted Statement of Financial Accounting Standards (SFAS) No. 141(R), Business Combinations, and SFAS No. 160, Accounting and Reporting of Noncontrolling Interests in Consolidated Financial Statements. These new standards significantly change the financial accounting and reporting of business combination transactions and noncontrolling (or minority) interests in consolidated financial statements.

SFAS 141(R), among other things, requires companies to recognize, with certain exceptions, all assets acquired and liabilities assumed and noncontrolling interests in acquisitions of less than a 100 percent controlling interest at their acquisition-date fair value; recognize contingent consideration at the acquisition-date fair value, with subsequent changes in fair value recorded in earnings; recognize preacquisition loss and gain contingencies at their acquisition-date fair values; capitalize in-process research and development acquired at fair value; expense as incurred, acquisition-related transaction costs; generally expense acquisition-related restructuring costs; and recognize changes in existing income tax valuation allowances and tax uncertainty accruals that result from a business combination transaction as adjustments to income tax expense.

SFAS 160 establishes new accounting and reporting requirements for the noncontrolling interest in a subsidiary and for the deconsolidation of a subsidiary. The new standard requires that a noncontrolling interest in a consolidated subsidiary be recorded as a separate component of equity. Gains or losses are not recognized on sales; they are recorded as increases or decreases in paid-in-capital, unless there is a loss control.

We have not entered into any business combination transactions during 2009; and therefore, the effect of implementing these standards will be dependent upon the nature and extent of future business combination transactions.

The Company has adopted the provisions of SFAS 157, Fair Value Measurements. Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. SFAS 157 provides guidance on various methods used to measure fair value including market, income and cost approaches. These approaches require the Company to utilize certain assumptions about risk. These inputs can be readily observable, market corroborated, or generally unobservable inputs. The Company attempts to utilize valuation techniques that maximize the use of observable inputs and minimize the use of

unobservable inputs. Based on the inputs used in the valuation techniques, SFAS 157 requires the Company to classify the inputs under a fair value hierarchy that ranks the inputs based on their quality and reliability. Financial instruments carried at fair value will be classified and disclosed in one of the following three categories:

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

Level 2 Observable market based inputs or unobservable inputs that are corroborated by market data.

Level 3 Unobservable inputs that are not corroborated by market data.

The estimated fair values of the Company's short-term financial instruments, including cash and cash equivalents, receivables and payables arising in the ordinary course of business, and current portions of debt, approximate their individual carrying amounts due to the relatively short period of time between their origination and expected realization. The Company does not have any other financial instruments measured at fair value on a recurring basis that require further disclosure.

The Company does not have any financial instruments that required a cumulative-effect adjustment to beginning accumulated deficit upon adoption. There was no material impact to the Company's consolidated financial position, results of operations, or cash flows as a result of the adoption of SFAS 157.

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NOTE 1.

SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

Recently Adopted or Issued Accounting Pronouncements (continued)

In May 2009, the FASB issued SFAS 165, *Subsequent Events*. The objective of this Statement is to establish general standards of accounting for and disclosure of events that occur after the balance sheet date but before financial statements are issued or are available to be issued. In particular, this Statement sets forth: 1) the period after the balance sheet date during which management of a reporting entity should evaluate events or transactions that may occur for potential recognition or disclosure in the financial statements, 2) the circumstances under which an entity should recognize events or transactions occurring after the balance sheet date in its financial statements and 3) the disclosures that an entity should make about events or transactions that occurred after the balance sheet date. In accordance with this Statement, an entity should apply the requirements to interim or annual financial periods ending after June 15, 2009. The adoption of SFAS 165 did not have a material impact on the Company's financial statements or condition.

Effective for the quarterly period ended June 30, 2009; we adopted the FASB's Staff Position on FAS 107-1 and APB 28-1, *Interim Disclosures about Fair Value of Financial Instruments*. The FSP amends SFAS 107 and APB 28 to require disclosures about the fair value of financial instruments for interim reporting periods in addition to annual financial statements. The adoption of this standard does not have a material effect on our consolidated results of operations, financial position, or cash flows.

In June 2009, the FASB approved the *FASB Accounting Standards Codification* (Codification) as the single source of authoritative nongovernmental U.S. GAAP. The Codification, which became available July 1, 2009, does not change current U.S. GAAP, but is intended to simplify user access to all authoritative U.S. GAAP by providing all the authoritative literature related to a particular topic in one place. All existing accounting standard documents were superseded and all other accounting literature not included in the Codification is considered nonauthoritative. The Codification will be effective for our quarterly reporting period ended September 30, 2009 and will not have a material effect on our consolidated results of operations, financial position, or cash flows. We are currently evaluating the impact to our financial reporting process of providing Codification references in our public filings.

In January 2009, the Securities and Exchange Commission (SEC) issued Release No. 33-9002, *Interactive Data to Improve Financial Reporting*. The final rule requires us to provide our financial statements and schedules to the SEC and our website in interactive data format using the eXtensible Business Reporting Language (XBRL). The rule was adopted to improve the ability of financial statement users to access and analyze financial data. The SEC adopted a phase-in schedule under which we will be required to submit filings using XBRL beginning with our quarterly report

for the second quarter of 2011. Compliance with this rule will have no impact upon our consolidated results of operation, financial position, or cash flows.

In June 2009, the FASB issued FASB No. 167, Amendments to FASB Interpretation No. 46(R) (FASB 167). FASB 167 amends Interpretation No. 46(R) to require ongoing reassessments of whether an enterprise is the primary beneficiary of a variable interest entity. Additionally, FASB 167 requires enhanced disclosures that will provide users of financial statements with more transparent information about an enterprise s involvement in variable interest entities. FASB 167 is effective for fiscal years beginning after November 15, 2009. We are currently evaluating the impact that the adoption of FASB 167 will have on our consolidated results of operation financial position, cash flows or disclosures.

Reclassification

Certain reclassifications have been made to the 2008 financial information to conform to the 2009 presentation.

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NOTE 2.

LIQUIDITY AND PROFITABILITY

The Company had a net income (loss) of approximately \$243,000 and \$(116,000) for the six months ended June 30, 2009 and 2008, respectively, and has working capital of approximately \$275,000 at June 30, 2009. The Company's ability to achieve sustained profitable operations is dependent on continued growth in revenue and controlling costs.

Management's plans with the objective of improving liquidity and profitability in future years encompass the following:

- .
increase facility occupancy.
- .
add additional management contracts.
- .
acquire existing cash flowing operations to expand our operations and branch out into other related areas of business.

Management believes that the actions that will be taken by the Company provide the opportunity for the Company to improve liquidity and achieve profitability. However, there can be no assurance that such events will occur.

NOTE 3.

SEGMENTS

For the six months ended June 30, 2009 and 2008, the Company operated in two segments: management and facility based care and home based care. The management and facility based care segment provides services to individuals needing long term care in a nursing home or assisted living setting and management of those facilities. The home based care segment provides home health care services to patients while they are living in their own homes. All the Company's revenues and assets are within the State of Ohio.

(Amounts in 000 s)

| | Manage- ment and Facility <u>Based Care</u> | Home Based <u>Care</u> | Total <u>Segments</u> | Discon- tinued <u>operations</u> | Cor- porate <u>porate</u> | <u>Total</u> |
|-----------------------------------|--|------------------------------|--------------------------|--|---------------------------------|--------------|
| Three-months ended June 30, 2009: | | | | | | |
| Net Revenue | 6,746 | 795 | 7,542 | - | (1,390) | 6,151 |
| Net Income | 16 | 131 | 147 | - | - | 147 |
| Total Assets | 24,367 | 2,543 | 26,910 | - | - | 26,910 |
| Capital Spending | 61 | - | 61 | - | - | 61 |
| Three-months ended June 30, 2008: | | | | | | |
| Net Revenue | 5,819 | 648 | 6,467 | - | (451) | 6,016 |
| Net Income (Loss) | (18) | 41 | 23 | - | - | 23 |
| Total Assets | 24,316 | 2,390 | 26,706 | - | - | 26,706 |
| Capital Spending | 69 | - | 69 | - | - | 69 |
| Six-months ended June 30, 2009: | | | | | | |
| Net Revenue | 12,469 | 1,458 | 13,927 | - | (929) | 12,998 |
| Net Income | 94 | 149 | 243 | - | - | 243 |
| Total Assets | 24,367 | 2,543 | 26,910 | - | - | 26,910 |
| Capital Spending | 132 | - | 132 | - | - | 132 |
| Six-months ended June 30, 2008: | | | | | | |
| Net Revenue | 11,658 | 1,274 | 12,932 | - | (923) | 12,009 |
| Net Income (Loss) | (181) | 65 | (116) | - | - | (116) |
| Total Assets | 24,316 | 2,390 | 26,706 | - | - | 26,706 |
| Capital Spending | 226 | - | 226 | - | - | 226 |

Table of Contents**NOTE 4.****STOCK BASED COMPENSATION**

From time to time, as determined by the Board of Directors, the Company grants stock based compensation awards to officers, directors and employees. The Board of Directors administers the granting of awards, determines the persons to whom awards will be made, the amount of the awards, and the other terms and conditions of the awards. The Board currently has three separate grants of stock based compensation awards that have provided both incentive and nonqualified stock options.

In August 2004, the Company granted 114,200 options with a weighted-average fair value estimated at \$0.36 per share. The options have a term of 5 years and the exercise price per share was equal to the fair market value on the grant date. The stock options vested 40% on the date of grant and 20% for each of the three years from the date of grant. The options are exercisable until the term expires in August 2009.

In May 2007, the Company granted 199,000 options with a weighted-average fair value estimated at \$0.58 per share. The options have a term of 5 years and the exercise price per share was equal to the fair market value on the grant date. The stock options vested 20% on the date of grant and 20% for each of the 4 years from the date of grant. The options are exercisable until the term expires in May 2012.

In August 2008, the Company authorized 1,092,305 options. As of June 30, 2009, 436,920 options were vested with a weighted-average fair value estimated at \$1.35 per share. The remaining options will be granted once all terms including the share price are known. The options have a term of 10 years and the options were at an exercise price per share less than the fair market value on the grant date. Half of the stock options granted vest on January 1, 2009 with the remainder on January 1, 2010. The options are exercisable until the term expires in August 2018.

The weighted-average of significant assumptions used to estimate the fair value of options granted using the Black Scholes option-pricing model is as follows:

| | |
|-------------------------|-------|
| | 2009 |
| Dividend Yield | 0.0% |
| Expected Volatility | 43.0% |
| Risk-Free Interest Rate | 3.13% |

Expected Term

4.5 years

Dividend Yield: The Company has not historically paid dividends and does not expect to pay dividends in the near future. As such, there is no expected dividend yield.

Expected Volatility: Because the Company is a relatively new public company, estimates of expected volatility are based on the weighted-average historical volatility of similar companies within the industry whose stock prices are publicly available.

Risk-Free Interest Rate: The Company bases the risk-free interest rate on the implied yield currently available on U.S. Treasury zero-coupon issues with a remaining term equivalent to the expected term of the options being valued.

Expected Term: The Company currently uses a simplified method for calculating the expected term based on the vesting and contractual expiration dates.

Table of Contents**NOTE 4. STOCK BASED COMPENSATION** (continued)

A summary of the status of the Company's employee stock options as of June 30, 2009 is presented below:

| | Number of Shares | Weighted Average Exercise Price | Weighted Average Remaining Contract Life |
|--------------------------------|------------------------|--|--|
| Outstanding at January 1, 2009 | 715,920 | \$1.77 | |
| Options granted | - | - | |
| Options exercised | - | - | |
| Options forfeited | (20,600) | - | - |
| Outstanding at June 30, 2009 | 695,320 | _\$1.77 | 6.6 years |
| Exercisable at June 30, 2009 | 628,080 | _\$1.80 | 6.6 years |

The weighted-average remaining contractual term of stock options outstanding and stock options exercisable at June 30, 2009 was approximately 6.6 years. The options outstanding and stock options exercisable had no aggregate intrinsic value at June 30, 2009. Compensation expense was approximately \$22,000.

There was no recorded tax effect on the recognition of stock-based compensation expense due to the Company's significant net operating loss carry forward and valuation reserve. In addition, there was no effect on the presentation of the statement of cash flows as excess tax benefits from the exercise of stock options have not been recorded as the Company does not expect to be able to realize current period deductions of taxable income.

NOTE 5.**PROPERTY AND EQUIPMENT**

| <u>Estimated Useful Lives (Years)</u> | <u>June 30, 2009</u> | <u>December 31, 2008</u> |
|---|----------------------|------------------------------|
|---|----------------------|------------------------------|

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| | | | |
|--------------------------------|---------|--------------|--------------|
| Buildings and improvements | 5 to 40 | \$15,798,884 | \$15,729,206 |
| Equipment | 2-10 | 2,814,703 | 2,776,998 |
| Land | - | 2,922,712 | 2,922,712 |
| Furniture and fixtures | 2-5 | 652,078 | 642,196 |
| Construction in process | - | 151,806 | 143,863 |
| | | 22, 340,183 | 22,214,975 |
| Less: accumulated depreciation | | 5,877,823 | 5,442,315 |
| | | \$16,462,360 | \$16,772,660 |

For the period ended June 30, 2009 and 2008 depreciation expense was approximately \$451,000 and \$433,000, respectively.

NOTE 6.

CONTINGENCIES

Certain claims and suits arising in the ordinary course of business in managing certain nursing facilities were filed or are pending against the Company. Management provides for loss contingencies where the possibility of a loss is probable. As of June 30, 2009, no estimated loss liabilities due to litigation were recorded. Management believes that the liability, if any, which may result would not have a material adverse effect on the financial position or results of operations of the Company. The Company carries liability insurance that is available to fund certain defined losses, should any arise, net of a deductible amount.

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NOTE 7. DEBT

On June 26, 2008, financing was obtained to replace the bonds in place at Community's Hearth & Home. The new financing is through HUD with the following terms: principal amount of \$4,006,500, interest rate of 6.65%, and a repayment term of 35 years.

On July 24, 2008 an existing loan for Assured Home Health was refinanced with Huntington National Bank with the following terms: principal amount \$760,000, interest rate of prime plus 1.5% (currently 6.5%), and a repayment term of 5 years.

On July 29, 2008, financing was obtained to replace the construction loan in place at Hearth & Care at Greenfield. The new financing is through HUD with the following terms: principal amount of \$2,524,800, interest rate of 6.5%, and a repayment term of 30 years.

On October 17, 2008, financing was obtained to replace the existing loan in place for the corporate office. The new financing is through Huntington National Bank with the following terms: principal amount of \$300,000, variable interest rate of 7.36%, and a repayment term of 8 years.

The Company has accounted for these refinance transactions in accordance with APB Opinion Number 26, *Early Extinguishment of Debt* as amended by Statement of Financial Accounting Standard 140 *Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities* and Emerging Issues Task Force Issue 96-19 *Debtors Accounting for a Modification or Exchange of Debt Instruments*. The transactions did not result in the recognition of a material gain or loss as a result of debt extinguishment.

NOTE 8. SENIOR LIVING FACILITY ACQUISITION

On March 7, 2008, the Company entered into an agreement to acquire 100% of The New Lincoln, Ltd. (NLL) effective April 1, 2008. The sole asset of The New Lincoln, Ltd. is the New Lincoln Lodge Retirement Residence which is a 49 unit senior living residence located in Columbus, Ohio. The Company completed the transaction on May 15, 2008. The Company accounted for the transaction under guidance issued in EITF 04-01, *Accounting for Preexisting Relationships between the Parties to a Business Combination*. The Company's preexisting relationship consisted primarily of a note receivable.

The consideration paid by the Company to NLL was approximately \$2,392,000 consisting of \$12,500 in cash, the residual value of the Company's note receivable of approximately \$218,000, 1% ownership of NLL which the Company has valued at approximately \$6,600, liabilities assumed of approximately \$2,144,000 and 25,000 warrants to purchase the Company's stock at a price equal to the stock price of \$1.21. Preliminarily, the Company has estimated the value of these warrants to be approximately \$10,500 using the Black-Scholes option-pricing model.

Additionally, the Company granted an option and right of first refusal to the seller. The terms of the agreement include an option to purchase the NLL for a period of two years ending on April 1, 2010 at a price equal to \$2,750,000 plus any capital expenditures, cash loans, and refinancing charges made to refinance the property. The Company also granted a right of first refusal for an additional three years ending on April 1, 2013 in the event the seller does not exercise its option to purchase by April 1, 2010. The right of first refusal grants the seller the opportunity to meet any offer to purchase the property for a period of sixty days from the time the offer is made.

Table of Contents**NOTE 8. SENIOR LIVING FACILITY ACQUISITION** (continued)

Following is a condensed balance sheet showing assets acquired and liabilities assumed as of the date of acquisition:

| | April 1, 2008 |
|--|----------------|
| Cash | \$ 19,813 |
| Prepaid expenses and other | 12,246 |
| Restricted cash | 36,677 |
| Property, Plant & Equipment | 2,740,000 |
| Assets Acquired | 2,808,736 |
| Current portion of notes payable and other debt | \$ (86,499) |
| Accounts payable and accrued expenses | (88,740) |
| Notes payable and other debt, net of current portion | (1,968,343) |
| Liabilities Assumed | \$ (2,143,582) |
| Net assets acquired | \$ 665,154 |

The following unaudited pro forma summary presents consolidated financial information for the year ended December 31, 2007 as if the acquisition had occurred on January 1, 2007. The unaudited pro forma summary presents consolidated financial information for the three months ended March 31, 2008 as if the acquisition had occurred on January 1, 2008.

| | March 31, 2008 | December 31, 2007 |
|--|----------------|----------------------|
| Revenue | \$ 6,151,710 | \$ 24,245,000 |
| Expenses | 6,304,851 | 25,200,655 |
| Income Before Discontinued Operations, Income Taxes and Gain | (153,141) | (955,655) |
| Income Tax Benefit | - | 178,415 |
| Income Tax Expense | (10,642) | - |
| Gain on Acquisition | 413,593 | 419,552 |
| Income (Loss) from continuing operations | 249,810 | (357,688) |
| Discontinued Operations: | | |
| Income from discontinued operations (including gain on disposal) | - | 587,039 |

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| | | |
|---|------------|-----------|
| Provision for income taxes | - | (178,415) |
| | - | 408,624 |
| Net Income | \$ 249,810 | \$ 50,936 |
| Net Income Per Share, Basic and Diluted: | | |
| Continuing operations | \$ 0.07 | \$ (0.09) |
| Discontinued operations | - | 0.11 |
| | \$ 0.07 | \$ 0.02 |
| Weighted Average Common Shares Outstanding, | | |
| Basic | 3,786,129 | 3,786,129 |
| Diluted | 3,786,129 | 3,786,129 |

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NOTE 8. SENIOR LIVING FACILITY ACQUISITION (continued)

In November, 2008, the Company acquired the remaining 50.8% ownership interest in Hearth & Home of Van Wert, LLC as required by our forward purchase contract (see Note 7). Through October 2008, the Company owned 49.2% of the limited liability company with the remaining 50.8% owned by individual investors. The total cost of the acquisition was \$941,289 of which \$800,664 was satisfied in cash while the remaining \$140,625 was satisfied in the form of sellers' notes payable which mature in 2010. Approximately \$41,000 was allocated to goodwill with the balance treated as an additional equity investment by the Company for the purpose of eliminating the liability for the forward purchase contract.

NOTE 9. SUBSEQUENT EVENTS

In May 2009, the FASB issued SFAS No. 165, Subsequent Events, which is effective for interim or annual financial periods ending after June 15, 2009. Subsequent events are events or transactions that occur after the balance sheet date, but before financial statements are issued. In conformity with the disclosure requirements of SFAS No. 165, the Company evaluated subsequent events through August 13, 2009, which was the issue date of the Company's financial statements for the period ended June 30, 2009. No events requiring financial statement recognition or disclosure were noted.

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

Special Note Regarding Forward Looking Statements

Certain statements in this 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 AdCare to be materially different from any future results, performance or achievements expressed or implied by the forward-looking statements. Specifically, the actions of competitors and customers and our ability to execute our business plan, and our ability to increase revenues is dependent upon our ability to continue to expand our current business and to expand into new markets, general economic conditions, and other factors. You can identify forward-looking statements by terminology such as may, will, should, expects, intends, plans, anticipate, 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 cannot guarantee future results, levels of activity, performance or achievements. We undertake no obligation to publicly update or review any forward-looking statements, whether as a result of new information, future developments or otherwise.

Overview

We are a Springfield, Ohio based developer, owner and manager of retirement communities, assisted living facilities, nursing homes, and provide home health care services in the state of Ohio. We currently manage fourteen facilities, comprised of six skilled nursing centers, six assisted living residences and two independent living/senior housing facilities, totaling over 800 units.

We have an ownership interest in eight of the facilities we manage, comprised of 100% ownership of two of the skilled nursing centers and two assisted living facility, 99% ownership in one independent living facility as well as a 50% ownership of three of the assisted living facilities. The assisted living facilities that we own operate under the name Hearth & Home, with the tag line Home is where the hearth is... We also maintain a development/consulting initiative which is strategic in providing potential management opportunities to our core long-term care business. AdCare Health Systems, Inc.® and Hearth & Home® are registered trademarks. All of our properties are located within the State of Ohio.

On May 15, 2008, we completed our acquisition of the New Lincoln Lodge. This acquisition was effective April 1, 2008. Consequently, many of the expense areas in our income statement have increased. The New Lincoln Lodge is a senior living facility located in Columbus, Ohio. For further information on this acquisition, please review our 8-K filed on May 19, 2008 and amended on July 29, 2008.

On June 26, 2008 we completed the refinancing of our three assisted living properties known as Community's Hearth & Home. This refinancing replaced our adjustable rate demand taxable notes, series 2002 Bonds in the original principal amount of \$4,200,000 obtained in 2002. Interest on the note was indexed at the seven day LIBOR rate. We refinanced this debt with two HUD insured loans at a fixed interest rate of 6.65% with a 35 year amortization. The new financing consists of two loans, one for the two Springfield, Ohio properties and one for the Urbana, Ohio property. The loans are in the amount of \$1,863,800 and \$2,142,700, respectively, and total \$4,006,500.

Segments

Our business operates in two segments: (1) management and facility-based care and (2) home-based care. In our management and facility-based care segment, we derive revenues from three primary sources. We operate and have ownership interests in eight facilities for which we collect fees from the residents of those facilities. Profits/losses are generated to the extent that the monthly patient fees exceed the costs associated with operating those facilities. We also manage assisted living facilities and nursing homes owned by third parties. With respect to these facilities, we receive a management fee based on the revenue generated by the facilities. Within our management facility-based care segment, we provide development, consulting and accounting services to third parties. In these instances, we receive a fee for providing those services. These fees vary from project to project, with the development fee in most cases being based on a percentage of the total cost to develop the project.

Table of Contents*Management and Facility Based Care Segment*

We have implemented changes at our skilled nursing facilities to improve occupancy and revenue and these changes appear to be working as occupancy rates have been increasing. We own two of our skilled nursing facilities and lease a third. We have recently completed renovations at all three facilities with additional renovations in process. We continue our work towards maximizing the number of patients covered by Medicare where our profit margins are typically higher. For the quarter ended June 30, 2009, compared to the quarter ended June 30, 2008, the percentage of residents in our skilled nursing facilities covered by Medicare was unchanged. For the six months ended June 30, 2009, compared to the six months ended June 30, 2008, overall occupancy in our skilled nursing centers increased nearly 1% and occupancy in our assisted living centers increased 2.4%.

In July, 2009, the Governor of the State of Ohio signed into law the state Biennial Budget 2009-2010. Certain provisions of this budget contain modifications to Medicaid reimbursement that could reduce our reimbursement beginning July 1, 2009. We are currently evaluating the implication of the reimbursement changes and developing management strategies to limit or eliminate the potential negative impact. For the three months ended June 30, 2009, Medicaid covered residents of our skilled nursing facilities comprised approximately 67% of our total residents.

Home Based Care Segment

Our home health division has reduced and, in most cases, eliminated services to patients where our reimbursement provided very small margins. This has resulted in a lower number of patient visits and lower revenue but increased profit margins. The majority of the reduced revenue has been offset by lower payroll and related expenses. We are utilizing our home health services in our assisted living and independent living properties creating cross selling opportunities thereby further enhancing our revenue. The percentage of our home health patients covered by Medicare has increased from 10.1% for the six months ended June 30, 2008, to 28.9% for the six months ended June 30, 2009.

Consolidated Results of Operations**Three months ended June 30, 2009 and June 30, 2008*****Revenue***

| | <u>June 30, 2009</u> | <u>June 30, 2008</u> | <u>Increase</u> | <u>%</u> | <u>Change</u> |
|----------------------|----------------------|----------------------|-----------------|----------|---------------|
| Patient care revenue | \$6,162,746 | \$5,574,114 | \$588,632 | | 10.6% |
| | 450,381 | 442,422 | 7,959 | | 1.8% |

Management, consulting and development fee revenue

| | | | |
|-------------|-------------|-----------|------|
| \$6,613,127 | \$6,016,536 | \$596,591 | 9.9% |
|-------------|-------------|-----------|------|

For the periods compared, patient care revenue increased approximately \$589,000 or 10.6%. Average occupancy in our skilled nursing centers increased by 2.3% but was somewhat offset by a decrease in the number of residents covered by Medicare resulting in a net increase in skilled nursing facility revenue of approximately \$371,000. Occupancy in our assisted living centers was nearly unchanged with \$71,000 of additional revenue. Charges for private paying residents at our assisted living and skilled nursing facilities increased approximately 5% beginning January 1, 2009 which further enhanced our revenue growth. Home health revenue increased approximately \$147,000 as a result of services provided to assisted living residents as well as an increase in the number of patients covered by Medicare. Management, consulting and development fee revenue increased approximately \$8,000 or 1.8% as a result of higher management fees on our managed only properties offset by the loss of two third part management agreements and their related management fee revenue.

Table of Contents***Operating Expenses***

| | <u>June 30, 2009</u> | <u>June 30, 2008</u> | <u>Increase</u> | <u>% Change</u> |
|-----------------------------------|----------------------|----------------------|-----------------|---------------------|
| Payroll and related payroll costs | \$3,709,728 | \$3,697,477 | \$12,251 | .3% |
| Other operating expenses | 2,150,161 | 2,113,128 | 37,033 | 1.8% |
| Depreciation and amortization | 225,878 | 206,324 | 19,554 | 9.5% |
| | \$6,085,767 | \$6,016,929 | \$68,838 | 1.1% |

Operating expenses for the three months ended June 30, 2009 increased by approximately \$69,000 or 1.1%. Payroll and related payroll costs for the three months ended June 30, 2009 increased by approximately \$12,000 or .3%. The increase was due primarily to annual employee wage increases of approximately 3% offset by staffing adjustments to compensate for fluctuations in facility occupancy.

Other operating expenses increased approximately \$37,000 or 1.8% due primarily to increased occupancy at our skilled nursing facilities resulting in increased supplies and services usage required to provide care for the additional residents.

Depreciation and amortization expense increased by approximately \$20,000 or 9.5% primarily as a result of the acquisition of the Lincoln Lodge.

Income from Operations

Income from operations for the three months ended June 30, 2009 was approximately \$527,000. When compared to the three months ended June 30, 2008 loss from operations of approximately \$393, this represents an increase of approximately \$527,000 primarily as a result of increasing revenue and controlling expenses as described above.

Other Income and Expense

For the three months ended June 30, 2009 compared to the three months ended June 30, 2008, interest income decreased approximately \$4,000 as a result of less interest earned on bank accounts. Interest expense for the three months ended June 30, 2009 compared to the three months ended June 30, 2008, decreased \$94,000 or 23.8%. During June, 2008, we expensed the balance of the unamortized financing costs of \$106,000 associated with our 2002 financing of Community s Hearth which was a result of refinancing the related debt. This resulted in higher interest expense for the three months ended June 30, 2008.

Other expense for the three months ended June 30, 2009 was approximately \$54,000. This is a result of approximately \$58,000 in expenses associated with due diligence activity for a potential acquisition. The expenses have been recognized in accordance with Statement of Financial Accounting Standards (SFAS) No. 141(R), Business

Combinations . These expenses were somewhat offset by rental income of \$4,200 for commercial space at the Lincoln Lodge.

Summary

Income before income taxes for the three months ended June 30, 2009 was approximately \$175,000 compared to a net income of approximately \$12,000 for the three months ended June 30, 2008, an increase of approximately \$163,000 primarily as a result of increased revenue and controlled expenses. Net income for the three months ended June 30, 2008, was primarily the result of the gain we recognized upon our acquisition of the New Lincoln Lodge of approximately \$414,000.

Income tax expense of approximately \$10,600 for three months ended June 30, 2009, is related to the amortization of purchased goodwill under Internal Revenue Code section 197. However, as a result of existing loss carry forwards no tax will actually be paid by the Company.

Net income for the three months ended June 30, 2009, was approximately \$147,000 compared to a net income for the three months ended June 30, 2008, of approximately \$23,000, an improvement of \$124,000 or 539.1%.

Table of Contents**Consolidated Results of Operations****Six months ended June 30, 2009 and June 30, 2008*****Revenue***

| | <u>June 30, 2009</u> | <u>June 30, 2008</u> | <u>Increase</u> | <u>%</u> | <u>Change</u> |
|--|----------------------|----------------------|-----------------|----------|---------------|
| Patient care revenue | \$12,079,581 | \$11,142,175 | \$937,406 | | 8.4% |
| Management, consulting and development fee revenue | 918,435 | 866,903 | 51,532 | | 5.9% |
| | \$12,998,016 | \$12,009,078 | \$988,938 | | 8.2% |

For the period ended June 30, 2009, patient care revenue increased approximately \$937,000 or 8.4%. Average occupancy in our skilled nursing centers increased by .7% but was somewhat offset by a small decrease in the number of residents covered by Medicare resulting in a net increase in skilled nursing facility revenue of approximately \$493,000. Occupancy in our assisted living centers increased 2.4% with approximately \$260,000 of additional revenue. Charges for private paying residents at our assisted living and skilled nursing facilities increased approximately 5% beginning January 1, 2009 which further enhanced our revenue growth. Home health revenue increased approximately \$184,000 as a result of services provided to assisted living residents as well as an increase in the number of patients covered by Medicare. Management, consulting and development fee revenue increased approximately \$52,000 or 5.9% as a result of higher management fees on our managed only properties offset by the loss of two third party management agreements and their related management fee revenue.

Operating Expenses

| | <u>June 30, 2009</u> | <u>June 30, 2008</u> | <u>Increase</u> | <u>%</u> | <u>Change</u> |
|-----------------------------------|----------------------|----------------------|-----------------|----------|---------------|
| Payroll and related payroll costs | \$ 7,447,457 | \$ 7,284,874 | \$162,583 | | 2.2% |
| Other operating expenses | 4,168,087 | 4,136,385 | 31,702 | | 0.8% |
| Depreciation and amortization | 451,186 | 433,018 | 18,168 | | 4.2% |
| | \$12,066,730 | \$11,854,277 | \$212,453 | | 1.8% |

Operating expenses for the six months ended June 30, 2009 increased by approximately \$213,000 or 1.8%. Payroll and related payroll costs increased by approximately \$163,000 or 2.2%. The increase due primarily to annual employee wage increases of approximately 3% offset by staffing adjustments to compensate for fluctuations in facility occupancy.

Other operating expenses increased approximately \$32,000 or .8% due primarily to increased occupancy at our skilled nursing facilities resulting in increased supplies and services usage required to provide care for the additional

residents.

Depreciation and amortization expense increased by approximately \$18,000 or 4.2% primarily as a result of the acquisition of the Lincoln Lodge.

Income from Operations

Income from operations for the six months ended June 30, 2009 was approximately \$931,000. When compared to the six months ended June 30, 2008 income from operations of approximately \$155,000, this represents an increase of approximately \$776,000 primarily as a result of increasing revenue and controlling expenses as described above.

Other Income and Expense

For the three months ended June 30, 2009 compared to the three months ended June 30, 2008, interest income decreased approximately \$12,000 as a result of less interest earned on bank accounts. Interest expense for the six months ended June 30, 2009 compared to the six months ended June 30, 2008, decreased approximately \$26,000 or 4.2%. During June, 2008, we expensed the balance of the unamortized financing costs of \$106,000 associated with our 2002 financing of Community's Hearth which was a result of refinancing the related debt. This resulted in higher interest expense for the six months ended June 30, 2008.

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Other expense for the six months ended June 30, 2009 was approximately \$49,000. This is a result of approximately \$58,000 in expenses associated with due diligence activity for a potential acquisition. The expenses have been recognized in accordance with Statement of Financial Accounting Standards (SFAS) No. 141(R), Business Combinations . These expenses were somewhat offset by rental income of \$8,400 for commercial space at the Lincoln Lodge.

Summary

Income before income taxes for the six months ended June 30, 2009 was approximately \$289,000 compared to a net loss of approximately \$65,000 for the six months ended June 30, 2008, an increase of approximately \$354,000 primarily as a result of increased revenue and controlled expenses. The net loss for the six months ended June 30, 2008, included the gain we recognized upon our acquisition of the New Lincoln Lodge of approximately \$414,000.

Income tax expense of approximately \$21,000 for six months ended June 30, 2009, is related to the amortization of purchased goodwill under Internal Revenue Code section 197. However, as a result of existing loss carry forwards no tax will actually be paid by the Company.

Net income for the six months ended June 30, 2009, was approximately \$243,000 compared to a net loss for the six months ended June 30, 2008, of approximately \$116,000, an increase of \$359,000 or 309.5%.

Liquidity and Capital Resources

Overview

We had net working capital as of June 30, 2009 of approximately \$275,000 as compared to negative net working capital of approximately \$540,000 for the year ended December 31, 2008, an improvement of approximately \$815,000 or 150.9%. This improvement is a result of net income enhanced by cash provided by operating activities. We have reduced accounts payable by approximately \$134,000 and accrued expenses by approximately \$232,000 and at the same time increased cash by nearly \$542,000.

On November 14, 2008, we established a \$100,000 line of credit with Huntington National Bank to assist with cash flow. We anticipate that our cash flow from our subsidiaries will continue to be sufficient to fund their operating cash needs. We have established a \$150,000 line of credit using funds from our non-qualified deferred compensation plan. Members of this plan, which is only available to a select group of senior management, authorized the transfer of funds to establish the line of credit with interest accruing at 8%.

We plan to improve liquidity by 1) refinancing debt where possible to obtain more favorable terms, 2) increasing facility occupancy, add additional management contracts and expand our home health operations and 3) engaged financial advisors to assist the Company in identifying, evaluating and securing alternative capital, financing and investment sources to fund the Company's strategic business plan.

Notes Payable and Other Debt

On June 26, 2008, we completed the refinancing of three assisted living properties known as Community's Hearth & Home. This refinancing replaced our adjustable rate demand taxable notes, series 2002 Bonds in the original principal amount of \$4,200,000 obtained in 2002. Interest on the note was indexed at the LIBOR rate. We refinanced this debt with two HUD insured loans at a fixed interest rate of 6.65% with a 35 year amortization. The new financing consists of two loans, one for the two Springfield, Ohio properties and one for the Urbana, Ohio property. The loans are in the amount of \$1,863,800 and \$2,142,700, respectively, and total \$4,006,500.

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On July 24, 2008, we completed refinancing our Assured Health Care loan in the original amount of approximately \$820,000. This refinancing reduced \$760,000 of our note payable to a stockholder leaving a balance of \$60,000. Payments began at \$8,000 per month until our loan from the previous owner of Assured Health Care was completely repaid in January, 2009, at which time the payments increased to \$17,000 per month. Interest on the loan accrues at the Lender's Prime Commercial Rate plus 1.5% or 6.5% at the time of the loan closing. The loan matures in 2013.

On July 29, 2008, we completed refinancing our Hearth & Care of Greenfield skilled nursing facility. This refinancing replaced our existing note payable in the amount of \$1,412,000 and returned over \$800,000 to the Company for cash utilized to complete the room additions and renovations of the property. Our new financing is a HUD insured loan at a fixed interest rate of 6.5% with a 30 year amortization.

On October 17, 2008, we completed refinancing our corporate office building located in Springfield, Ohio. This refinancing replaced two loans totaling approximately \$230,000 at the time of the refinancing. Our new financing is traditional bank mortgage debt in the amount of \$300,000. Repayment terms include level principal payments with a nine year amortization and variable interest indexed to the LIBOR rate plus 3% or 7.359% at the time of the loan closing. Approximately \$70,000 in loan proceeds were used for renovations to the office building.

Cash Flow

Our cash requirements are satisfied primarily with cash generated from operating activities, financing activities and additional indebtedness. Our cash flow is dependent on our ability to collect accounts receivable in a timely manner. The majority of our revenue is from Medicaid and Medicare programs. These are reliable payment sources which make our likelihood of collection very high. However, the time it takes to receive payment on a claim from these sources can take up to several months. On average, accounts receivable were outstanding nearly 30 days before collection as of June 30, 2009 and nearly 34 days as of December 31, 2008 which has helped improve cash flow. The status of accounts receivable collections is monitored very closely by our senior management.

Six months ended June 30, 2009

Net cash provided by operating activities for the six months ended June 30, 2009 was approximately \$982,000 consisting primarily of decreases in accounts receivable as a result of improved collections, an increase in accounts payable offset by increased other liabilities; all primarily the result of routine operating activity.

Net cash used in investing activities for the three months ended June 30, 2009 was approximately \$152,000. This is primarily the result of purchases of additional equipment and an increase in restricted cash due to routine payment into HUD required escrow accounts.

Net cash used in financing activities was approximately \$287,000 for the six months ended June 30, 2009, primarily as a result of routine principal payments on existing loans.

Six months ended June 30, 2008

Net cash provided by operating activities for the six months ended June 30, 2008 was approximately \$58,000 consisting primarily of decreases in accounts receivable and prepaid expenses offset by reductions in accounts payable and accrued expenses and other liabilities.

Net cash provided by investing activities for the six months ended June 30, 2008 was approximately \$53,000. This is a result of purchases of additional equipment offset by a decrease in restricted cash as a result of cash released by our bank. In June 2008, as a result of refinancing the Community's Hearth & Home note, Huntington National Bank released the balance of restricted cash held as security collateral for a letter of credit.

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Net cash provided by financing activities was approximately \$16,000 for the six months ended June 30, 2008 as a result of routine repayments on notes payable offset by prepaid financing and amortization of bond issuance costs as a result of the new loan for Community's Hearth & Home.

Item 4. 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 Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in the rules and forms of the Securities and Exchange Commission (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.

As required by Rule 13a-15(b) of the Securities Exchange Act of 1934, we carried out an evaluation, under the supervision and with the participation of our management, including our chief executive officer and chief financial officer, of the effectiveness of the design and operation of our disclosure controls and procedures as of the end of the period covered by this report. Based on the foregoing, our chief executive officer and chief financial officer concluded that our disclosure controls and procedures were effective at the reasonable assurance level.

There has been no change in our internal controls over financial reporting during our most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, our internal controls over financial reporting.

Part II. Other Information

Item 1. Legal Proceedings

There are no material pending legal proceedings to which AdCare Health Systems, Inc and Subsidiaries is a party or to which any property is subject.

Item 6. Exhibits and Reports on Form 8-K

a.

The following Exhibits are attached:

| Exhibit Number | Description |
|-----------------------|--|
| 31.1 | Certification of CEO pursuant to Section 302 of the Sarbanes-Oxley Act |
| 31.2 | Certification of CFO pursuant to Section 302 of the Sarbanes-Oxley Act |
| 32.1 | Certification of CEO pursuant to Section 906 of the Sarbanes-Oxley Act |
| 32.2 | Certification of CFO pursuant to Section 906 of the Sarbanes-Oxley Act |
| 99.1 | Press release dated August 13, 2009 |

b.

The Company filed the following Reports on Form 8-K during the three months ended June 30, 2009:

| Date | Description |
|---------------|--|
| April 2, 2009 | Financial Statements and Exhibits, Departure of Directors or Officers. |
| May 18, 2009 | Financial Statements and Exhibits |

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SIGNATURES

In accordance with the requirements of the Exchange Act, the registrant has duly caused the report to be signed on its behalf by the undersigned, thereunto duly authorized.

AdCare Health Systems, Inc.

(Registrant)

Date: August 13, 2009

/s/ Gary L. Wade

Chief Executive Officer

Date: August 13, 2009

/s/ Scott Cunningham

Chief Financial Officer

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Exhibit 31.1

CERTIFICATIONS

I, Gary L. Wade certify, that:

1.

I have reviewed this quarterly report on Form 10-Q of AdCare Health Systems, Inc.;

2.

Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3.

Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4.

The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15 d-15(f)) for the registrant and have:

a.

Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

b.

Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, 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;

c.

Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

d.

Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting.

5.

The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):

a.

All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

b.

Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: August 13, 2009

By /s/Gary L. Wade
President and Chief Executive Officer

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Exhibit 31.2

CERTIFICATIONS

I, Scott Cunningham, certify, that:

1.

I have reviewed this quarterly report on Form 10-Q of AdCare Health Systems, Inc.;

2.

Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3.

Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4.

The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15 d-15(f)) for the registrant and have:

a.

Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

b.

Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, 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;

c.

Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

d.

Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting.

5.

The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):

a.

All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

b.

Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: August 13, 2009

By /s/Scott Cunningham
Chief Financial Officer

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Exhibit 32.1

CERTIFICATION PURSUANT TO

18 U.S.C. SECTION 1350,

AS ADDED BY

SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

In connection with the Quarterly Report of AdCare Health Systems, Inc. (the Company) on Form 10-Q for the period ended June 30, 2009 as filed with the Securities and Exchange Commission (the Report), I, Gary L. Wade, Chief Executive Officer of the Company, certify, pursuant to 18 U.S.C. § 1350, as added by § 906 of the Sarbanes-Oxley Act of 2002, that:

1. The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
2. To my knowledge, the information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company as of and for the period covered by the Report.

Date: August 13, 2009

By: /s/ Gary L. Wade

Gary L. Wade, Chief Executive Officer

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Exhibit 32.2

CERTIFICATION PURSUANT TO

18 U.S.C. SECTION 1350,

AS ADDED BY

SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

In connection with the Quarterly Report of AdCare Health Systems, Inc. (the Company) on Form 10-Q for the period ended June 30, 2009 as filed with the Securities and Exchange Commission (the Report), I, Scott Cunningham, Chief Financial Officer of the Company, certify, pursuant to 18 U.S.C. § 1350, as added by § 906 of the Sarbanes-Oxley Act of 2002, that:

1. The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
2. To my knowledge, the information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company as of and for the period covered by the Report.

Date: August 13, 2009

By: /s/ Scott Cunningham
Scott Cunningham, Chief Financial Officer

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Exhibit 99.1

For Immediate Release

**AdCare Health Systems, Inc. Continues To Be Profitable;
Reports 2009 Second Quarter Earning Results**

SPRINGFIELD, Ohio, August 13, 2009 /PRNewswire-FirstCall/ AdCare Health Systems, Inc. (NYSE AMEX: ADK), an Ohio based long term care, home care and management company, today reported financial results for its second quarter of 2009.

Revenues for the quarter ended June 30, 2009 were \$6,613,127 as compared to \$6,016,536 for the same quarter in 2008, an increase of \$596,591. The increase was mostly due to improved occupancy in our skilled nursing centers and enhanced revenues in our home health care division. Management will continue to focus on expanding the revenue base at its home health care operations.

The net income for the quarter ended June 30, 2009 was \$147,101 as compared to \$22,963 for the second quarter ended June 30, 2008, an improvement of \$124,138. The improvement in net income would have been significantly higher without the \$413,593 gain on the acquisition of the Lincoln Lodge in the second quarter of last year. Basic and diluted net income per share for the quarter ended June 30, 2009 was \$0.04 as compared to a basic and diluted net income per share of \$0.01 for the same quarter ended June 30, 2008.

Revenues for the six-months ended June 30, 2009 were \$12,998,016 as compared to \$12,009,078 for the same period in 2008, an increase of \$988,938. Net income for the six-months ended June 30, 2009 was \$242,915 as compared to a loss of \$116,507 for the same period in 2007, an improvement of \$359,422. Again, the increase was due mostly to improved occupancy in our skilled nursing centers and assisted living facilities as well as improved revenues in our home health care division. Basic and diluted net income per share for the six-months ended June 30, 2009 was \$0.07 as compared to a basic and diluted net loss per share of (\$0.02) for the same six-months period ended June 30, 2008.

David A. Tenwick, Chairman of AdCare, stated that I am extremely encouraged that the Company is moving in the right direction and profitability continues to improve despite the challenging economic environment. He continued,

The Company has made great strides in improving its financial performance. I am especially pleased with the improvement in income from Operations for the first six months of 2009, increasing to \$931,286 from \$154,801 for the same period last year. In addition, we continued to improve our working capital position by \$815,324, since the end of last year with current assets now \$275,302 more than current liabilities. He added that AdCare is still seeking attractive acquisitions and business opportunities in the health care field that have the potential to expand our operations.

About AdCare Health Systems, Inc.

AdCare Health Systems, Inc. (Amex: ADK) develops, owns and manages assisted living facilities, nursing homes and retirement communities and provides home health care services. Prior to becoming a publicly traded company in November of 2006, AdCare operated as a private company for 18 years. AdCare's 900 employees provide high-quality care for patients and residents residing in the 14 facilities that they manage, six of which are assisted living facilities, six skilled nursing centers and two independent senior living communities. The Company has ownership interests in eight of those facilities. In the ever expanding marketplace of long term care, AdCare's mission is to provide quality healthcare services to the elderly.

Safe Harbor Statement

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Statements contained in this press release that are not historical facts may be forward-looking statements within the meaning of federal law. Such forward-looking statements reflect management's beliefs and assumptions and are based on information currently available to management. The forward-looking statements involve known and unknown risks, results, performance or achievements of the Company to differ materially from those expressed or implied in such statements. Such factors are identified in the public filings made by the Company with the Securities and Exchange Commission and include the Company's ability to secure lines of credit and/or an acquisition credit facility, find suitable acquisition properties at favorable terms, changes in the health care industry because of political and economic influences, changes in regulations governing the industry, changes in reimbursement levels including those under the Medicare and Medicaid programs and changes in the competitive marketplace. There can be no assurance that such factors or other factors will not affect the accuracy of such forward-looking statements.

Contact:

April Spittle

Manager of Corporate Communications

1-703-893-0021 ext. 108

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www.adcarehealth.com

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ADCARE HEALTH SYSTEMS, INC. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEET

| | June 30, 2009 (Unaudited) | December 31, 2008 |
|---|---------------------------------|----------------------|
| <u>ASSETS</u> | | |
| Current Assets: | | |
| Cash | \$ 1,808,604 | \$ 1,266,315 |
| Accounts receivable: | | |
| Long-term care resident receivables, net | 1,965,901 | 2,008,847 |
| Management, consulting and development receivables, net | 167,900 | 258,811 |
| Advances and receivables from affiliates | 16,407 | 17,635 |
| Prepaid expenses and other | 537,277 | 478,534 |
| Total current assets | 4,496,089 | 4,030,142 |
| Restricted cash | 1,176,960 | 1,155,596 |
| Property and equipment, net | 16,462,360 | 16,772,660 |
| License, net | 1,189,307 | 1,189,307 |
| Goodwill | 2,679,482 | 2,679,482 |
| Other assets | 906,269 | 1,012,340 |
| Total assets | \$ 26,910,467 | \$ 26,839,527 |
| <u>LIABILITIES AND STOCKHOLDERS EQUITY</u> | | |
| Current Liabilities: | | |
| Current portion of notes payable and other debt | \$ 729,157 | \$ 713,323 |
| Current portion of notes payable to stockholder | 9,432 | 9,432 |
| Accounts payable | 875,325 | 1,009,002 |
| Accrued expenses | 2,606,873 | 2,838,407 |
| Total current liabilities | 4,220,787 | 4,570,164 |
| Notes payable and other debt, net of current portion | 16,645,776 | 16,974,788 |
| Notes payable to stockholder, net of current portion | 30,623 | 34,626 |
| Other liabilities | 695,229 | 299,314 |
| Income tax payable | 191,291 | 170,007 |
| Total liabilities | 21,783,705 | 22,048,899 |

Stockholders' equity:

| | | |
|--|---------------|---------------|
| Preferred stock, no par value; 500,000 shares authorized; no shares issued or outstanding | - | - |
| Common stock and additional paid-in capital, no par value; 14,500,000 shares authorized; 3,786,129 shares issued and outstanding | 14,835,191 | 14,766,967 |
| Accumulated deficit | (10,002,617) | (10,245,532) |
| Total stockholders' equity | 4,832,574 | 4,521,435 |
| Noncontrolling interest in subsidiaries | 294,188 | 269,193 |
| Total equity | 5,126,762 | 4,790,628 |
| Total liabilities and stockholders' equity | \$ 26,910,467 | \$ 26,839,527 |

See notes to consolidated financial statements

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ADCARE HEALTH SYSTEMS, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF OPERATIONS
(Unaudited)

| | Three-Months Ended | | Six-Months Ended | |
|--|--------------------|-----------|------------------|--------------|
| | June 30, | | June 30, | |
| | 2009 | 2008 | 2009 | 2008 |
| Revenues: | | | | |
| | | | | \$ |
| Patient care revenues | \$ 6,162,746 | 5,574,114 | \$12,079,581 | \$11,142,175 |
| Management, consulting and development fee revenue | 450,381 | 442,422 | 918,435 | 866,903 |
| Total revenue | 6,613,127 | 6,016,536 | 12,998,016 | 12,009,078 |
| Expenses: | | | | |
| Payroll and related payroll costs | 3,709,728 | 3,697,477 | 7,447,457 | 7,284,874 |
| Other operating expenses | 2,150,161 | 2,113,128 | 4,168,087 | 4,136,385 |
| Depreciation and amortization | 225,878 | 206,324 | 451,186 | 433,018 |
| Total expenses | 6,085,767 | 6,016,929 | 12,066,730 | 11,854,277 |
| Income (Loss) from Operations | 527,360 | (393) | 931,286 | 154,801 |
| Other Income (Expense): | | | | |
| Interest income | 1,098 | 5,096 | 2,406 | 14,228 |
| Interest expense, others | (299,804) | (393,358) | (593,947) | (619,710) |
| Interest expense, related parties | (510) | (13,574) | (1,228) | (28,446) |
| Other expense | (53,524) | - | (49,324) | - |
| | (352,740) | (401,836) | (642,092) | (633,928) |
| Gain on Acquisition | - | 413,593 | - | 413,593 |
| Income (Loss) Before Income Taxes | 174,620 | 11,364 | 289,194 | (65,534) |
| Income Tax Expense | (10,642) | (10,642) | (21,284) | (21,284) |
| Net Income (Loss) | 163,978 | 722 | 267,910 | (86,818) |
| Net Income (Loss) Attributable to Noncontrolling Interests | (16,877) | 22,241 | (24,995) | (29,689) |
| Net Income (Loss) Attributable to AdCare Health Systems | \$ 147,101 | 22,963 | \$ 242,915 | \$ (116,507) |

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| | | | | |
|---------------------------------------|---------|---------|---------|-----------|
| Net Income (Loss) Per Share, Basic: | \$ 0.04 | \$ 0.01 | \$ 0.07 | \$ (0.02) |
| Net Income (Loss) Per Share, Diluted: | \$ 0.04 | \$ 0.01 | \$ 0.07 | \$ (0.02) |

Weighted Average Common Shares
Outstanding,

| | | | | |
|---------|-----------|-----------|-----------|-----------|
| Basic | 3,786,129 | 3,786,129 | 3,786,129 | 3,786,129 |
| Diluted | 3,890,681 | 3,786,129 | 3,890,681 | 3,786,129 |

See notes to consolidated financial statements.

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ADCARE HEALTH SYSTEMS, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENT OF STOCKHOLDERS EQUITY
(Unaudited)

| | Total | Accumulated Deficit | Common Stock and Additional Paid-in Capital | Noncontrolling Interest |
|---|-------------|------------------------|--|----------------------------|
| Balance, December 31, 2008: | \$4,790,628 | \$(10,245,532) | \$14,766,967 | \$269,193 |
| Warrants issued in connection with consulting agreement | 15,908 | - | 15,908 | - |
| Stock option compensation expense | 22,316 | - | 22,316 | - |
| Stock issuance | 30,000 | - | 30,000 | - |
| Net income | 242,915 | 242,915 | - | - |
| Net income attributable to noncontrolling interest | 24,995 | - | - | 24,995 |
| Balance, June 30, 2009 | \$5,126,762 | \$(10,002,617) | \$14,835,191 | \$294,188 |

See notes to consolidated financial statements

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ADCARE HEALTH SYSTEMS, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited)

| | Six-Months Ended June 30, | |
|---|---------------------------|-------------|
| | 2009 | 2008 |
| Cash flows from operating activities: | | |
| Net income (loss) inclusive of noncontrolling interest | \$ 267,910 | \$ (86,818) |
| Adjustments to reconcile net income (loss) to net cash | | |
| Provided by operating activities: | | |
| Depreciation and amortization | 451,186 | 433,018 |
| Warrants issued for services | 37,276 | 55,105 |
| Stock option compensation expense | 22,316 | 19,151 |
| Note receivable forgiveness exchanged for rent | - | 9,000 |
| Gain on acquisition | - | (413,593) |
| Changes in certain assets and liabilities: | | |
| Accounts receivable | 135,085 | 78,627 |
| Prepaid expenses and other | (90,258) | 153,084 |
| Other assets | 106,071 | 780 |
| Accounts payable and accrued expenses | (365,211) | (114,350) |
| Income tax liability | 21,284 | 21,284 |
| Other liabilities | 395,915 | (97,485) |
| Net cash provided by operating activities | 981,574 | 57,803 |
| Cash flows from investing activities: | | |
| Proceeds from the sale of assets, net of associated costs | 892 | 2,500 |
| (Increase) decrease in restricted cash | (21,364) | 276,693 |
| Purchase of property plant and equipment | (131,630) | (226,160) |
| Net cash (used in) provided by investing activities | (152,102) | 53,033 |
| Cash flows from financing activities: | | |
| Amortization of bond issuance costs | - | 144,475 |
| Stock issuance | 30,000 | - |
| Repayment of notes payable to stockholder | (4,004) | - |
| Prepaid financing costs | - | 111,984 |

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| | | |
|--|--------------|--------------|
| Repayment of notes payable | (313,179) | (240,588) |
| Net cash (used in) provided by financing activities | (287,183) | 15,871 |
| Net Increase in Cash | 542,289 | 126,707 |
| Cash, Beginning | 1,266,315 | 926,625 |
| Cash, Ending | \$ 1,808,604 | \$ 1,053,332 |
| Supplemental Disclosure of Cash Flow Information: | | |
| Cash paid during the year for interest | \$ 292,528 | \$ 265,760 |
| Supplemental Disclosure of Non-Cash Activities: | | |
| Rent in exchange of note receivable repayment | \$ - | \$ 9,000 |
| Acquisition of assets in exchange for note forgiveness | \$ - | \$ 2,808,736 |

See notes to consolidated financial statements.