ADCARE HEALTH SYSTEMS, INC
Form 10-K
July 08, 2013

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

(Mark One)

ý **ANNUAL REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the fiscal year ended December 31, 2012

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

For the transition period from to
Commission file number 001-33135

AdCare Health Systems, Inc.

(Exact name of registrant as specified in its charter)

Ohio	**31-1332119**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
1145 Hembree Road, Roswell, GA	**30076-1122**
(Address of principal executive offices)	(Zip Code)

Registrant's telephone number including area code **(678) 869-5116**

Securities registered pursuant to Section 12(b) of the Exchange Act:

Title of each class	**Name of each exchange on which registered**
Common Stock, no par value	NYSE MKT
Preferred Stock, no par value	NYSE MKT

Securities registered under Section 12(g) of the Exchange Act: **None**

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes o No ý

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or 15(d) of the Exchange Act. Yes o No ý

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes o No ý

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

Indicate by check mark if disclosure of delinquent filers in response to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. o

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

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

The aggregate market value of AdCare Health Systems, Inc., common stock held by non-affiliates as of June 29, 2012, the last business day of the registrant's most recently completed second fiscal quarter, was $42,035,226. The number of shares of AdCare Health Systems, Inc., common stock, no par value, outstanding as of June 24, 2013 was 14,788,288.

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Special Note Regarding Forward Looking Statements

Certain statements contained in this Annual Report on Form 10-K (this "Annual Report") in Part II, Item 7., "Management's Discussion and Analysis of Financial Condition and Results of Operations," and elsewhere are "forward-looking statements" within the meaning of, and subject to the protections of, Section 27A of the Securities Act of 1933, as amended (the "Securities Act"), and Section 21E of the Securities Exchange Act of 1934, as amended (the "Exchange Act").

Forward-looking statements include statements with respect to our beliefs, plans, objectives, goals, expectations, anticipations, assumptions, estimates, intentions and future performance and involve known and unknown risks, uncertainties and other factors, many of which may be beyond our control and which may cause the actual results, performance, or achievements of AdCare Health Systems, Inc. to be materially different from future results, performance or achievements expressed or implied by such forward-looking statements.

All statements other than statements of historical fact are statements that could be forward-looking statements. You can identify these forward-looking statements through our use of words such as "may," "will," "anticipate," "assume," "should," "indicate," "would," "believe," "contemplate," "expect," "estimate," "continue," "plan," "point to," "project," "predict," "could," "intend," "target," "potential" and other similar words and expressions of the future. These forward-looking statements may not be realized due to a variety of factors, including, without limitation, those described in Part I, Item 1A., "Risk Factors," and elsewhere in this Annual Report and those described from time to time in our future reports filed with the Securities and Exchange Commission (the "SEC") under the Exchange Act.

All written or oral forward-looking statements that are made by or are attributable to us are expressly qualified in their entirety by this cautionary notice. Our forward-looking statements apply only as of the date of this Annual Report. We have no obligation and do not undertake to update, revise or correct any of the forward-looking statements after the date of this Annual Report, or after the respective dates on which such statements otherwise are made, whether as a result of new information, future events or otherwise.

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PART I.

Item 1. Business

Overview

AdCare Health Systems, Inc. ("AdCare") through its subsidiaries (together, the "Company" or "we"), own and manage skilled nursing facilities and assisted living facilities in the states of Alabama, Arkansas, Georgia, Missouri, North Carolina, Ohio, Oklahoma, and South Carolina. As of December 31, 2012, AdCare, through its wholly owned separate operating subsidiaries, owns, leases and manages 50 facilities consisting of 46 skilled nursing facilities, three assisted living facilities and one independent living/senior housing facility which total approximately 5,000 beds. Our facilities provide a range of health care services to patients and residents, including, but not limited to, skilled nursing and assisted living services, social services, various therapy services, and other rehabilitative and healthcare services for both long-term residents and short-stay patients. As of December 31, 2012, of the total 50 facilities, we owned and operated 26 facilities, leased and operated 11 facilities, and managed 13 facilities (including one consolidated variable interest entity).

The skilled nursing and assisted living facilities provide services to individuals needing long-term care in a nursing home or assisted living setting and management of those facilities. Through our subsidiaries, we provide a full complement of administrative services as well as consultative services that permit our local facility leadership teams to better focus on the delivery of healthcare services. We also provide these services to unaffiliated third party long term care operators and/or owners with whom we enter into management contracts. We currently provide these services to five unaffiliated facility owners. Each of our facilities is led by highly dedicated individuals who are responsible for key operational decisions at their facilities. Facility leaders and staff are trained and motivated to pursue superior clinical outcomes, high patient and family satisfaction, operating efficiencies and financial performance at their facilities. In addition, our facility leaders are enabled and motivated to share real-time operating data and otherwise benchmark clinical and operational performance against their peers in other facilities in order to improve clinical care, maximize patient satisfaction and augment operational efficiencies, promoting the sharing of best practices.

Much of our historical growth can be attributed to our expertise in acquiring under-performing facilities and transforming them into market leaders in clinical quality, staff competency, employee loyalty and financial performance. We intend to continue to grow our revenue and earnings by:

- focusing on efficiencies in our operations and internal growth;
- increasing the proportion of sub-acute patients within our skilled nursing facilities;
- expanding clinical programs within our existing facilities;
- continuing to acquire additional facilities in existing and new markets; and
- evaluating and potentially targeting the acquisition of complementary businesses which provide services to skilled nursing facilities.

Our principal executive offices are located at 1145 Hembree Road, Roswell, GA 30076, and our telephone number is (678) 869-5116. We maintain a website at www.adcarehealth.com.

Company History

AdCare is an Ohio corporation. We were incorporated on August 14, 1991 under the name Passport Retirement, Inc. In 1995, we acquired substantially all of the assets and liabilities of AdCare Health Systems, Inc. and changed our name to AdCare Health Systems, Inc.

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Acquisitions and Dispositions

We have embarked on a strategy to grow our business through acquisitions and leases of senior care facilities and businesses providing services to those facilities. During the year ended December 31, 2012, the Company acquired a total of 11 skilled nursing facilities and one assisted living facility described further below. The total purchase price for each acquisition is after final closing adjustments. The Company incurred a total of $2.0 million of acquisition costs related to these acquisitions in 2012 and has recorded the cost in the "Other Income (Expense)" section of the Consolidated Statements of Operations included in Part II, Item 8., "Financial Statements and Supplementary Data."

Acquisitions

Eaglewood Care Center and Eaglewood Village. On January 1, 2012, the Company acquired a 113-bed skilled nursing facility located in Springfield, Ohio, known as Eaglewood Care Center, and an 80-bed assisted living facility located in Springfield, Ohio known as Eaglewood Village. The total purchase price was $12.4 million.

Little Rock, Northridge and Woodland Hills. On April 1, 2012, the Company acquired a 154-bed skilled nursing facility located in Little Rock, Arkansas, known as Little Rock Health & Rehab, a 140-bed skilled nursing facility located in North Little Rock, Arkansas, known as Northridge Healthcare and Rehabilitation, and a 140-bed skilled nursing facility located in Little Rock, Arkansas, known as Woodland Hills Healthcare and Rehabilitation. The total purchase price was $27.2 million.

Abington Place. On April 30, 2012, the Company acquired a 120-bed skilled nursing facility located in Little Rock, Arkansas, known as Abington Place. The total purchase price was $3.6 million.

Glenvue Nursing Home. On July 2, 2012, the Company acquired a 160-bed skilled nursing facility located in Glennville, Georgia, known as Glenvue Nursing. The total purchase price was $8.2 million.

Quail Creek Health and Rehab. On July 3, 2012, the Company acquired a 118-bed skilled nursing facility located in Oklahoma City, Oklahoma, known as Quail Creek Health and Rehab. The total purchase price was $6.2 million including with assumed fair valued indebtedness of $3.2 million.

Companions Specialized Care Center. On August 17, 2012, the Company acquired a 121-bed skilled nursing facility located in Tulsa, Oklahoma, known as Companions Specialized Care Center. The total purchase price was $5.9 million.

Sumter Valley Nursing and Rehab. On December 31, 2012, the Company acquired a 96-bed skilled nursing facility located in Sumter, South Carolina, known as Sumter Valley Nursing and Rehab. The total purchase price was $5.6 million.

Georgetown Healthcare and Rehab. On December 31, 2012, the Company acquired an 84-bed skilled nursing facility located in Georgetown, South Carolina, known as Georgetown Healthcare and Rehab. The total purchase price was $4.2 million.

Northwest Nursing Center. On December 31, 2012, the Company acquired an 88-bed skilled nursing facility located in Oklahoma City, Oklahoma, known as Northwest Nursing Center. The total purchase price was $3.0 million.

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The following tables provide summary information regarding our acquisitions and facility composition (excluding discontinued operations) for the periods indicated:

	December 31,	
	2012	2011
Cumulative number of facilities	50	37
Cumulative number of operational beds	4,996	3,603

		Number of Facilities as of December 31, 2012				
State	Number of Operational Beds/Units	Owned	VIE	Leased	Managed for Third Parties	Total
Alabama	408	2	1			3
Arkansas	1,041	10				10
Georgia	1,514	4		9		13
Missouri	80			1		1
North Carolina	106	1				1
Ohio	785	4		1	4	9
Oklahoma	882	3			8	11
South Carolina	180	2				2
Total	4,996	26	1	11	12	50
Facility Type						
Skilled Nursing	4,697	24		11	11	46
Assisted Living	216	2	1			3
Independent Living	83				1	1
Total	4,996	26	1	11	12	50

During 2012, we acquired 12 facilities (eleven skilled nursing facilities and one assisted living facility), bringing our Company's then total bed count to 4,996 at December 31, 2012. During 2011, we acquired 11 facilities (ten skilled nursing facilities and one assisted living facility), bringing our Company's then total bed count to 3,603 at December 31, 2011.

We are currently evaluating acquisition opportunities in addition to those described above and we continue to seek new opportunities to further implement our growth strategy. No assurances are made that we will be able to complete any such acquisitions on terms acceptable to us, if at all.

Dispositions

As part of the Company's strategy to focus on the growth of skilled nursing facilities, the Company decided in the fourth quarter of 2011 to exit the home health business. In the fourth quarter of 2012, the Company continued this strategy and entered into an agreement to sell six assisted living facilities located in Ohio. The Company also entered into a sublease arrangement in the fourth quarter of 2012 to exit the operations of a skilled nursing facility in Jeffersonville, Georgia. The results of operations and cash flows for the home health business, the six Ohio assisted living facilities and the Jeffersonville, Georgia skilled nursing facility are reported as discontinued operations. Current assets and liabilities of the disposal groups are classified as such in the Consolidated Balance Sheets at December 31, 2012 and 2011 included in Part II, Item 8, "Financial Statements and Supplementary Data."

Growth Strategy

Our objective is to be the provider of choice for health care and related services to the elderly in the communities in which we operate. We intend to grow our business through numerous initiatives.

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We expect to continue to increase occupancy rates and revenue per occupied unit at our facilities. We believe that our current operations serve as the foundation on which we can build a large fully-integrated senior living company. We will target attractive geographic markets by using our existing infrastructure and operating model, to provide a broad range of high quality care in a cost-efficient manner.

Organic Growth. We intend to focus on improving our operating margins within all of our facilities. We continually seek to maintain and improve by:

increasing the proportion of higher revenue sub-acute health care services delivered at the Company's skilled nursing facilities;

attracting new residents through the on-site marketing programs focused on residents and family members;

actively seeking referrals from professional community outreach sources, including area religious organizations, senior social service programs, civic and business networks, as well as the medical community; and

continually refurbishing and renovating our communities.

Pursue Strategic Acquisitions. We believe that our current infrastructure and extensive contacts within the industry will continue to provide us with the opportunity to evaluate numerous acquisition opportunities. We believe there is a significant opportunity for growth with a private to public arbitrage and opportunity to increase our operating margins by evaluating and potentially targeting the acquisition of complementary businesses which provide services to skilled nursing facilities.

Fragmentation in the Industry Provides Acquisition and Consolidation Opportunities. The senior living industry is highly fragmented and we believe that this provides significant acquisition and consolidation opportunities. We believe that the limited capital resources available to many small, private operators impedes their growth and exit prospects. We believe that we are well positioned to approach strategic small private operators and offer to them exit strategies which are not currently available as well as the ability to grow their business.

Emphasize Employee Training and Retention. We devote special attention to the hiring, screening, training, supervising and retention of our employees and caregivers. We have adopted comprehensive recruiting and screening programs for management positions that utilize corporate office team interviews and background and reference checks. We believe our commitment to and emphasis on quality hiring practices, employee training and retention differentiates us from many of our competitors.

Positioned for Growth. Our strategy typically begins with the acquisition of an independently owned, often times family operated, skilled nursing facility. We then utilize our proven clinical management and marketing programs to increase the proportion of more clinically complex sub-acute patients. These patients generate higher revenue per patient day. In many situations these patients are also more profitable. Additionally we are able to leverage our enhanced purchasing power and increase operating profit by providing more cost effective supplies and ancillary services. These management practices also assist in providing quality care to our patients and residents..

Pursue Management Contracts. We intend to pursue management opportunities for senior living communities. We believe that our management infrastructure and proven operating track record will allow us to take advantage of increased opportunities in the senior living market for new management contracts for third-party operators.

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Operating Strategy

Our operating philosophy is to provide affordable, quality care to our patients and residents. We execute this strategy by empowering and supporting our local leadership teams at the facilities. These facility teams are supported by seasoned regional staff that provide consultative assistance from both a clinical and operations perspective. Additionally, we provide centralized back office administrative services to the facilities such as accounting, payroll and accounts payable processing, purchasing, and IT support. Centralizing these non-patient centric activities is more efficient and cost effective and frees up facility staff to focus on patient care.

Increase Revenues and Profitability at Existing Facilities. Our strategy includes increasing facility revenues and profitability levels through increasing occupancy levels, increasing the percentage of sub-acute patients, maximizing reimbursement rates as appropriate, providing additional services to our current residents, and containing costs. Ongoing initiatives to promote higher occupancy levels and appropriate payor and case mixes at our senior living facilities include corporate programs to promote specialized care and therapy services as well as initiatives to improve customer service and develop safety programs to improve worker compensation insurance rates.

Offer Services Based on Level of Care. Our range of products and services is continually expanding to meet the evolving needs of our patients and residents. We have developed a variety of special clinical programs and care offerings that are responsive to particular geographic markets.

Improve Operating Efficiencies. We actively monitor and manage our operating costs. By having an established portfolio of properties, we believe that we have a platform to achieve operating efficiencies through economies of scale in the purchase of bulk items, such as food, and in the spreading of fixed costs, such as corporate overhead, over a larger revenue base, and the ability to provide more effective management supervision and financial controls.

Increase Occupancy Through Emphasis on Marketing Efforts. We emphasize strong corporate support for the marketing of our various local facilities. At a local level, our sales and marketing efforts are designed to promote higher occupancy levels and optimal payor mix. Management believes that the long-term care industry is fundamentally a local industry in which both patients and residents and the referral sources for them are based in the immediate local geographic area of the facility.

Promote an Internally-Developed Marketing Program. We focus on the identification and provision of services needed by the community. We assist each facility administrator in analysis of local demographics and competition with a view toward complementary service development. Our belief is that this locally based marketing approach, coupled with strong corporate monitoring and support, provides an advantage over regional competitors.

Operate the Facility Based Management Model. We hire an administrator/manager and director of nursing for each of our skilled nursing facilities and provide them with autonomy, responsibility and accountability. We believe this allows us to attract and retain higher quality administrators and directors of nursing. This leadership team manages the day-to-day operations of each facility, including oversight of the quality of care, delivery of resident services, and monitoring of the financial performance and marketing functions. We actively recruit personnel to maintain adequate staffing levels at our existing facilities and provide financial and budgeting assistance for our administrators, directors of nursing and department managers.

Industry Trends

The skilled nursing industry has evolved to meet the growing demand for post-acute and custodial healthcare services generated by an aging population, increasing life expectancies and the trend toward shifting of patient care to lower cost settings. The growth of the senior population in the United States

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continues to increase healthcare costs, often faster than the available funding from government-sponsored healthcare programs. In response, federal and state governments have adopted cost-containment measures that encourage the treatment of patients in more cost-effective settings such as skilled nursing facilities, for which the staffing requirements and associated costs are often significantly lower than acute care hospitals, inpatient rehabilitation facilities and other post-acute care settings. As a result, skilled nursing facilities are generally serving a larger population of higher acuity patients than in the past.

The skilled nursing industry is large and highly fragmented, characterized predominantly by numerous local and regional providers. We believe this fragmentation provides significant acquisition and consolidation opportunities for us. Additionally, based on a decrease in the number of skilled nursing facilities over the past few years, we expect that the supply and demand balance in the skilled nursing industry will continue to improve due to the shift of patient care to lower cost settings, an aging population and increasing life expectancies.

We also anticipate that as life expectancy continues to increase in the United States, the overall demand for skilled nursing services will increase. At present, the primary market demographic for skilled nursing services is primarily individuals age 75 and older. According to the 2010 U.S. Census, there were over 40 million people in the United States in 2010 that are over 65 years old. The 2010 U.S. Census estimates this group is one of the fastest growing segments of the United States population and is expected to more than double between 2000 and 2030.

We believe the skilled nursing industry has been and will continue to be impacted by several other trends. The use of long-term care insurance is increasing among seniors as a means of planning for the costs of skilled nursing services. In addition, as a result of increased mobility in society, reduction of average family size, and the increased number of two-wage earner couples, more seniors are looking for alternatives outside the family for their care.

Medicare and Medicaid Reimbursement

Rising healthcare costs due to a variety of factors, including an aging population and increasing life expectancies, has generated growing demand for post-acute healthcare services in recent years. In an effort to mitigate the cost of providing healthcare benefits, third-party payors including Medicare, Medicaid, managed care providers, insurance companies and others have increasingly encouraged the treatment of patients in lower-cost care settings. As a result, in recent years skilled nursing facilities, which typically have significantly lower cost structures than acute care hospitals and certain other post-acute care settings, have generally been serving larger populations of higher-acuity patients than in the past. However, Medicare and Medicaid reimbursement rates are subject to change from time to time and reduction in rates could materially and adversely impact our revenue.

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

On July 29, 2011, the Centers for Medicare & Medicaid Services ("CMS") issued a final rule providing for, among other things, a net 11.1% reduction in PPS payments to skilled nursing facilities for CMS's fiscal year 2012 (which began October 1, 2011) as compared to PPS payments in CMS's fiscal year 2011 (which ended September 30, 2011). The 11.1% reduction is on a net basis, after the

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application of a 2.7% market basket increase, and reduced by a 1.0% multi-factor productivity adjustment required by the Patient Protection and Affordable Care Act of 2010 ("PPACA"). The final CMS rule also adjusted the method by which group therapy is counted for reimbursement purposes, and changed the timing in which patients who are receiving therapy must be reassessed for purposes of determining their RUG category.

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

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

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

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

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

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

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Historically, adjustments to reimbursement under Medicare and Medicaid have had a significant effect on our revenue and results of operations. Recently enacted, pending and proposed legislation and administrative rulemaking at the federal and state levels could have similar effects on our business. Efforts to impose reduced reimbursement rates, greater discounts and more stringent cost controls by government and other payors are expected to continue for the foreseeable future and could adversely affect our business, financial condition and results of operations. Additionally, any delay or default by the federal or state governments in making Medicare and/or Medicaid reimbursement payments could materially and adversely affect our business, financial condition and results of operations.

Revenue Sources

Total Revenue by Payor Sources. We derive revenue primarily from the Medicaid and Medicare programs, private pay patients and managed care payors. Medicaid typically covers patients that require standard room and board services, and provides reimbursement rates that are generally lower than rates earned from other sources. We monitor our patient mix, which is the percentage of non-Medicaid revenue from each of our facilities, to measure the level received from each payor across each of our business units. We intend to continue our focus on enhanced care offerings for high acuity patients.

Medicaid. Medicaid is a state-administered program financed by state funds and matching federal funds. Medicaid programs are administered by the states and their political subdivisions, and often go by state-specific names. Medicaid programs generally provide health benefits for qualifying individuals, and may supplement Medicare benefits for financially needy persons aged 65 and older. Medicaid reimbursement formulas are established by each state with the approval of the federal government in accordance with federal guidelines. Seniors who enter skilled nursing facilities as private pay clients can become eligible for Medicaid once they have substantially depleted their assets. Medicaid is the largest source of funding for nursing home facilities.

Private and Other Payors. Private and other payors consist primarily of individuals, family members or other third parties who directly pay for the services we provide.

Medicare. Medicare is a federal program that provides healthcare benefits to individuals who are 65 years of age or older or are disabled. To achieve and maintain Medicare certification, a skilled nursing facility must meet the CMS, "Conditions of Participation", on an ongoing basis, as determined in periodic facility inspections or surveys conducted primarily by the state licensing agency in the state where the facility is located. Medicare pays for inpatient skilled nursing facility services under the prospective payment system. The prospective payment for each beneficiary is based upon the medical condition of and care needed by the beneficiary. Medicare skilled nursing facility coverage is limited to 100 days per episode of illness for those beneficiaries who require daily care following discharge from an acute care hospital.

Managed Care and Private Insurance. Managed care patients consist of individuals who are insured by a third-party entity, typically a senior health maintenance organization ("HMO") plan, or who are Medicare beneficiaries who have assigned their Medicare benefits to a senior HMO plan. Another type of insurance, long-term care insurance, is also becoming more widely available to consumers, but is not expected to contribute significantly to industry revenues in the near term.

Billing and Reimbursement. Our revenue from government payors, including Medicare and state Medicaid agencies, is subject to retroactive adjustments in the form of claimed overpayments and underpayments based on rate adjustments and asserted billing and reimbursement errors. We believe billing and reimbursement errors, disagreements, overpayments and underpayments are common in our industry, and we are regularly engaged with government payors and their fiscal intermediaries in reviews, audits and appeals of our claims for reimbursement due to the subjectivity inherent in the processes related to patient diagnosis and care, recordkeeping, claims processing and other aspects of

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the patient service and reimbursement processes, and the errors and disagreements those subjectivities can produce.

We employ accounting, reimbursement and compliance specialists who train, mentor and assist our clerical, clinical and rehabilitation staffs in the preparation of claims and supporting documentation, regularly monitor billing and reimbursement practices within our facilities, and assist with the appeal of overpayment and recoupment claims generated by governmental, fiscal intermediary and other auditors and reviewers. In addition, due to the potentially serious consequences that could arise from any impropriety in our billing and reimbursement processes, we investigate all allegations of impropriety or irregularity relative thereto.

Whether information about our billing and reimbursement processes is obtained from external sources or activities such as Medicare and Medicaid audits or probe reviews or our regular day-to-day monitoring and training activities, we collect and utilize such information to improve our billing and reimbursement functions and the various processes related thereto. We continually strive to improve the efficiency and accuracy of all of our operational and business functions, including our billing and reimbursement processes. The table below sets forth our annual revenue by payor source during the year ended December 31, 2012 and 2011. Management fees of $2.2 million and $1.6 million in 2012 and 2011, respectively, are included in other.

	Year Ended December 31,	
Amounts in (000's)		
Annual Revenue by Payor	**2012**	**2011**
Medicaid	$ 108,459	$ 75,779
Medicare	58,181	42,524
Other	35,018	19,909
Total	$ 201,658	$ 138,212

Competition

Our ability to compete successfully varies from location to location and depends on a number of factors, including the number of competing facilities in the local market, the types of services available, our local reputation for quality care of patients, the commitment and expertise of our staff and physicians, our local service offerings and treatment programs, the cost of care in each locality, and the physical appearance, location, age and condition of our facilities. We are in a competitive, yet fragmented, industry. While there are several national and regional companies that provide retirement living alternatives, we anticipate that our primary source of competition will be the smaller regional and local development and management companies. There is limited, if any, price competition with respect to Medicaid and Medicare patients, since revenues for services to such patients are strictly controlled and are based on fixed rates and cost reimbursement principles. Although the degree of success with which our facilities compete varies from location to location, management believes that its facilities generally compete effectively with respect to these factors. Our competitors include assisted living communities and other retirement facilities and communities, home health care agencies, nursing homes, and convalescent centers, some of which operate on a not-for-profit or charitable basis. Our nursing homes and assisted living facilities compete with both national and local competitors. We also compete with other health care companies for facility acquisitions and management contracts. We give no assurance that additional facilities and management contracts can be acquired on favorable terms.

We seek to compete effectively in each market by establishing a reputation within the local community for quality of care, attractive and comfortable facilities, and providing specialized healthcare with an ability to care for high-acuity patients. We believe that the average cost to a third-party payor for the treatment of our typical high-acuity patient is lower if that patient is treated in one of our skilled nursing facilities than if that same patient were to be treated in an inpatient rehabilitation

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facility or long-term acute-care hospital. We face direct competition from alternative facilities in our markets for residents. The skilled nursing facilities operated by us compete with other facilities in their respective markets, including rehabilitation hospitals and other "skilled" and personal care residential facilities. Some of these providers are not-for-profit organizations with access to sources of funds not available to our centers. In addition, our facilities also face competition for employees.

Increased competition could limit our ability to expand our business. We believe that the most important competitive factors in the long-term care business are: a nursing center's local reputation with the local community and other healthcare providers, such as acute care hospitals, physicians, religious groups, other community organizations, managed care organizations, and a patient's family and friends; physical plant condition; the ability to identify and meet particular care needs in the community; the availability of qualified personnel to provide the requisite care; and the rates charged for services.

Increased competition could limit our ability to attract and retain patients, maintain or increase rates or to expand our business. Many of our competitors have greater financial and other resources than we have, may have greater brand recognition and may be more established in their respective communities than we are. Competing companies may also offer newer facilities or different programs or services than we do and may as a result be more attractive to our current patients, to potential patients and to referral sources. Some of our competitors may accept lower profit margins than we do, which could present significant price competition, particularly for managed care and private pay patients.

Government Regulation

The health care industry is subject to numerous laws and regulations of federal, state and local governments. These laws and regulations include, but are not necessarily limited to, matters such as licensure, accreditation, government health care program participation requirements, reimbursement for patient services, certificates of need, quality of patient care and Medicare and Medicaid fraud and abuse. Over the last several years, government activity has increased with respect to investigations and allegations concerning possible violations by health care providers of fraud and abuse statutes and regulations as well as laws and regulations governing quality of care issues in the skilled nursing profession in general. Violations of these laws and regulations could result in exclusion from government health care programs together with the imposition of significant fines and penalties, as well as significant repayments for patient services previously billed. Compliance with such laws and regulations is subject to ongoing government review and interpretation, as well as regulatory actions in which government agencies seek to impose fines and penalties.

Licensure and Certification. Certain states administer a certificate of need program, which applies to the incurrence of capital expenditures, the offering of certain new institutional health services, the cessation of certain services and the acquisition of major medical equipment. Such legislation also stipulates requirements for such programs, including that each program be consistent with the respective state health plan in effect pursuant to such legislation and provide for penalties to enforce program requirements. To the extent that certificates of need or other similar approvals are required for expansion of our operations, either through acquisitions, expansion or provision of new services or other changes, such expansion could be affected adversely by the failure or inability to obtain the necessary approvals, changes in the standards applicable to such approvals or possible delays and expenses associated with obtaining such approvals.

Skilled nursing homes and assisted living facilities are required to be individually licensed or certified under applicable state law and as a condition of participation under the Medicare program. In addition, healthcare professionals and practitioners are required to be licensed in most states. We believe that our operating companies and personnel that provide these services have all required

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regulatory approvals necessary for our current operations. The failure to obtain, retain or renew any required license could adversely affect our operations, including our financial results.

Health Reform Legislation. In recent years, there have been numerous initiatives on the federal and state levels for comprehensive reforms affecting the payment for, the availability of and reimbursement for healthcare services in the United States. These initiatives have ranged from proposals to fundamentally change federal and state healthcare reimbursement programs, including the provision of comprehensive healthcare coverage to the public under governmental funded programs, to minor modifications to existing programs. PPACA, which was passed in 2010 and has implementation timing and costs and regulatory implications that are still uncertain in many respects, is among the most comprehensive and notable of these legislative efforts, and its full effects on us and others in our industry are still in many ways difficult to predict. The content or timing of any future health reform legislation, and its impact on us, is impossible to predict. If significant reforms are made to the U.S. healthcare system, those reforms may have an adverse effect on our financial condition and results of operations.

While many of the provisions of PPACA will not take effect for several years or are subject to further refinement through the promulgation of regulations, some key provisions of PPACA are presently effective:

Enhanced CMPs and Escrow Provisions. PPACA includes expanded civil monetary penalty ("CMP") and related provisions applicable to all Medicare and Medicaid providers. CMS rules adopted to implement applicable provisions of PPACA also provide that assessed CMPs may be collected and placed in whole or in part into an escrow account pending final disposition of the applicable administrative and judicial appeals process. To the extent our businesses are assessed large CMPs that are collected and placed into an escrow account pending lengthy appeals, such actions could adversely affect our results of operations.

Nursing Home Transparency Requirements. In addition to expanded CMP provisions, PPACA imposes new transparency requirements for Medicare-participating nursing facilities. In addition to previously required disclosures regarding a facility's owners, management, and secured creditors, PPACA expanded the required disclosures to include information regarding the facility's organizational structure, additional information on officers, directors, trustees, and "managing employees" of the facility (including their names, titles, and start dates of services), and information regarding certain parties affiliated with the facility. The transparency provisions could result in the potential for greater government scrutiny and oversight of the ownership and investment structure for skilled nursing facilities, as well as more extensive disclosure of entities and individuals that comprise part of skilled nursing facilities' ownership and management structure.

Suspension of Payments During Pending Fraud Investigations. PPACA provides the federal government with expanded authority to suspend Medicare and Medicaid payments if a provider is investigated for allegations or issues of fraud. This suspension authority creates a new mechanism for the federal government to suspend both Medicare and Medicaid payments for allegations of fraud, independent of whether a state exercises its authority to suspend Medicaid payments pending a fraud investigation. To the extent the suspension of payment provision is applied to one of our businesses for allegations of fraud, such a suspension could adversely affect our results of operations.

Overpayment Reporting and Repayment; Expanded False Claims Act Liability. PPACA enacted several important changes that expand potential liability under the federal False Claims Act. Overpayments related to services provided to both Medicare and Medicaid beneficiaries must be reported and returned to the applicable payor within specified deadlines, or else they are considered obligations of the provider for purposes of the federal False Claims Act. This new

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provision substantially tightens the repayment and reporting requirements generally associated with the operations of health care providers to avoid False Claims Act exposure.

Home and Community Based Services. PPACA provides that states can provide home and community-based attendant services and support through the Community First Choice State plan option. States choosing to provide home and community-based services under this option must make them available to assist with activities of daily living, instrumental activities of daily living and health-related tasks under a plan of care agreed upon by the individual and his/her representative. For states that elect to make coverage of home and community-based services available through the community First Choice State plan option, the percentage of the state's Medicaid expenses paid by the federal government will increase by six percentage points. PPACA also includes additional measures related to the expansion of community and home-based services and authorizes states to expand coverage of community and home-based services to individuals who would not otherwise be eligible for them. The expansion of home and community-based services could reduce the demand for the facility-based services that we provide.

Health Care-Acquired Conditions. PPACA provides that the Secretary of Health and Human Services must prohibit payments to states for any amounts expended for providing medical assistance for certain medical conditions acquired during the patient's receipt of health care services. CMS adopted a final rule to implement this provision of PPACA in the third quarter of 2011. The rule prohibits states from making payments to providers under the Medicaid program for conditions that are deemed to be reasonably preventable. It uses Medicare's list of preventable conditions in inpatient hospital settings as the base (adjusted for the differences in the Medicare and Medicaid populations) and provides states the flexibility to identify additional preventable conditions and settings for which Medicaid payments will be denied.

Value-Based Purchasing. PPACA requires the Secretary of Health and Human Services to develop a plan to implement a value-based purchasing ("VBP") program for payments under the Medicare program for skilled nursing facilities and to submit a report containing the plan to Congress. The intent of the provision is to potentially reconfigure how Medicare pays for health care services, moving the program towards rewarding better value, outcomes, and innovations, instead of volume. According to the plan submitted to Congress in June 2012, the funding for the VBP program could come out of payment withholds from poor-performing skilled nursing facilities or by holding back a portion of the base payment rate or the annual update for all skilled nursing facilities. If a VBP program is ultimately implemented, it is uncertain what effect it would have upon skilled nursing facilities, but its funding or other provisions could negatively affect them.

Anti-Kickback Statute Amendments. PPACA amended the Anti-Kickback Statute so that (i) a claim that includes items or services violating the Anti-Kickback Statute also would constitute a false or fraudulent claim under the federal False Claims Act and (ii) the intent required to violate the Anti-Kickback Statute is lowered such that a person need not have actual knowledge or specific intent to violate the Anti-Kickback Statute in order for a violation to be deemed to have occurred. These modifications of the Anti-Kickback Statute could expose us to greater risk of inadvertent violations of the statute and to related liability under the federal False Claims Act.

Accountable Care Organizations. PPACA authorized CMS to enter into contracts with Accountable Care Organizations ("ACO"). ACOs are entities of providers and suppliers organized to deliver services to Medicare beneficiaries and eligible to receive a share of any cost savings the entity can achieve by delivering services to those beneficiaries at a cost below a set baseline and with sufficient quality of care. CMS recently finalized regulations to implement the ACO initiative. The widespread adoption of ACO payment methodologies in the Medicare program, and in other programs and payors, could impact our operations and reimbursement for our services.

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On June 28, 2012, the United States Supreme Court ruled that the enactment of PPACA did not violate the Constitution of the United States. This ruling permits the implementation of most of the provisions of PPACA to proceed. The provisions of PPACA discussed above are examples of recently enacted federal health reform provisions that we believe may have a material impact on the long-term care profession generally and on our business. However, the foregoing discussion is not intended to constitute, nor does it constitute, an exhaustive review and discussion of PPACA. It is possible that other provisions of PPACA may be interpreted, clarified, or applied to our businesses in ways that could have a material impact on our business, financial condition and results of operations. Similar federal and/or state legislation that may be adopted in the future could have similar effects.

In addition, we incur considerable administrative costs in monitoring the changes made within the various reimbursement programs in which we participate, determining the appropriate actions to be taken in response to those changes, and implementing the required actions to meet the new requirements and minimize the repercussions of the changes to our organization, reimbursement rates and costs.

Medicare and Medicaid. Medicare is a federally-funded and administered health insurance program for the aged and for certain chronically disabled individuals. Part A of the Medicare program covers inpatient hospital services and certain services furnished by other institutional providers such as skilled nursing facilities. Part B covers the services of doctors, suppliers of medical items, various types of outpatient services and certain ancillary services of the type provided by long-term and acute care facilities. Medicare payments under Part A and Part B are subject to certain caps and limitations, as provided in Medicare regulations. Medicare benefits are not available for intermediate and custodial levels of nursing center care or for assisted living center arrangements.

Medicaid is a medical assistance program for the indigent, operated by individual states with financial participation by the federal government. Criteria for medical indigence and available Medicaid benefits and rates of payment vary somewhat from state to state, subject to certain federal requirements. Basic long-term care services are provided to Medicaid beneficiaries, including nursing, dietary, housekeeping and laundry, restorative health care services, room and board and medications. Federal law requires that a state Medicaid program must provide for a public process for determination of Medicaid rates of payment for nursing center services. Under this process, proposed rates, the methodologies underlying the establishment of such rates and the justification for the proposed rates are published. This public process gives providers, beneficiaries and concerned state patients a reasonable opportunity for review and comment. Certain of the states in which we now operate are actively seeking ways to reduce Medicaid spending for nursing center care by such methods as capitated payments and substantial reductions in reimbursement rates.

As a component of CMS administration of the government's reimbursement programs, a new ratings system was implemented in December 2008 to assist the public in choosing a skilled care provider. The system is an attempt to simplify all the data for each nursing center to a "Star" ranking. The overall Star rating is determined by three components (three years survey results, quality measure calculations, and staffing data), with each of the components receiving star rankings as well. We will continue to strive to achieve high rankings for our facilities, as well as assuring that our rankings are correct and appropriately reflect our quality results.

Health Insurance Portability and Accountability Act of 1996 Compliance. There are numerous legislative and regulatory requirements at the federal and state levels addressing patient privacy and security of health information. The Health Insurance Portability and Accountability Act of 1996 ("HIPAA") contains provisions that require us to adopt and maintain business procedures designed to protect the privacy, security and integrity of patients' individual health information. States also have laws that apply to the privacy of healthcare information. We must comply with these state privacy laws to the extent that they are more protective of healthcare information or provide additional protections

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not afforded by HIPAA. HIPAA's security standards were designed to protect electronic information against reasonably anticipated threats or hazards to the security or integrity of the information and to protect the information against unauthorized use or disclosure. These standards have had and are expected to continue to have a significant impact on the health care industry because they impose extensive requirements and restrictions on the use and disclosure of identifiable patient information. In addition, HIPAA established uniform standards governing the conduct of certain electronic healthcare transactions and protecting the privacy and security of individually identifiable health information. The Health Information Technology for Clinical Health Act of 2009 expanded the requirements and noncompliance penalties under HIPAA and requires correspondingly intensive compliance efforts by companies such as ours, including self-disclosures of breaches of unsecured health information to affected patients, federal officials, and, in some cases, the media. On January 25, 2013, the Department of Health and Human Services promulgated new HIPAA privacy, security, and enforcement regulations, which increase significantly the penalties and enforcement practices of the Department regarding HIPAA violations. We implemented or upgraded computer and information systems as we believe necessary to comply with the new regulations. We believe that we are in substantial compliance with applicable state and federal regulations relating to privacy and security of patient information. However, if we fail to comply with the applicable regulations, we could be subject to significant penalties.

Employees

As of December 31, 2012, excluding discontinued operations, we had approximately 4,400 total employees of which 2,900 were full time employees.

Item 1A. Risk Factors

The following are certain risk factors that could affect our business, operations and financial condition. These risk factors should be considered in connection with evaluating the forward-looking statements contained in this Annual Report because these factors could cause the actual results and conditions to differ materially from those projected in forward-looking statements. This section does not describe all risks applicable to our business, and we intend it only as a summary of certain material factors. If any of the following risks actually occur, our business, financial condition or results of operations could be negatively affected. In that case, the trading price of our common stock and our Series A Preferred Stock could decline.

Health care reform may affect our profitability and may require us to change the way our business is conducted.

Health care is an area of extensive and frequent regulatory change. The manner and the extent to which health care is regulated at the federal and state level is evolving. Changes in the laws or new interpretations of existing laws may have a significant effect on our methods and costs of doing business. Our success will depend partially on our ability to satisfy the applicable regulations and requirements and to procure and maintain required licenses. Our operations could also be adversely affected by, among other things, regulatory developments such as mandatory increases in the scope and quality of care given to the residents and revisions in licensing and certification standards. We are and will continue to be subject to varying degrees of regulation and licensing by health or social service agencies. We believe that our operations do not presently violate any existing federal or state laws, but we make no assurances that federal, state, or local laws or regulatory procedures which might adversely affect our business, financial condition, results of operations or prospects will not be expanded or imposed. A failure to comply with applicable requirements could cause us to be fined or could cause the cessation of our business, which would have a material adverse effect on our Company.

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In March 2010, the PPACA and the Health Care and Education Reconciliation Act of 2010 were signed into law. Together, these two measures make the most sweeping changes to the U.S. health care system since the creation of Medicare and Medicaid. These new laws include a large number of health care related provisions scheduled to take effect over the next four years, including expanding Medicaid eligibility, requiring most individuals to have health insurance, establishing new regulations on health plans, establishing health insurance exchanges and modifying certain payment systems to encourage more cost-effective care and a reduction of inefficiencies and waste, including new tools to address fraud and abuse. As the implementation of, and rulemaking with respect to, these measures is ongoing, we are unable to accurately predict the effect these laws or any future legislation or regulation will have on us or our operations, including future reimbursement rates and occupancy in our inpatient facilities.

Our business depends on reimbursement under federal and state programs, and federal and state legislation or other changes to reimbursement and other aspects of Medicaid and Medicare may reduce or otherwise adversely affect reimbursement amounts.

A substantial portion of our revenue is derived from third-party payors, including Medicare and Medicaid programs. Our business, financial condition, results of operations and prospects would be adversely affected in the event that reimbursement rates under these programs are reduced or rise more slowly than the rate at which our costs increase or if there are changes in the way these programs pay for services. For example, services for which we are currently reimbursed by Medicaid and Medicare may not continue to be reimbursed at adequate levels or at all, or further limits on the scope of services being reimbursed, delays or reductions in reimbursement or changes in other aspects of reimbursement could occur, each of which could adversely impact our business, financial condition, results of operations and prospects.

The Medicaid and Medicare programs are subject to statutory and regulatory changes affecting, among other things, base rates or basis of payment, retroactive rate adjustments, annual caps that limit the amount that can be paid (including deductible and coinsurance amounts) for rehabilitation therapy services rendered to Medicare beneficiaries, administrative or executive orders and government funding restrictions, all of which may materially adversely affect the rates and frequency at which these programs reimburse us for our services.

For example, on July 29, 2011, CMS announced a final rule reducing Medicare skilled nursing facility PPS payments in fiscal year 2012 by $3.87 billion, or 11.1% lower than payments for fiscal year 2011. Moreover, CMS effectively reduced our Medicare reimbursement rates by nearly 11.7% by reducing rates as well as implementing changes to the RUG classification system. Similarly, in July 2011, Ohio Medicaid implemented reductions to the reimbursement rates of 6%.

On August 2, 2011, President Obama signed into law the Budget Control Act of 2011, which requires the federal budget to include automatic spending reductions beginning in 2012, including reduction of not more than 2% to Medicare providers, but exempting reductions to certain Medicaid and Medicare benefits. With respect to Medicare, these automatic reductions went into effect on April 1, 2013. Also, on March 15, 2013, the Medicare Payment Advisory Commission recommended that Congress eliminate the market basket update and revise the prospective payment system to result in 2014 in a 4% reduction in Medicare payments to skilled nursing facilities, with subsequent reductions to follow. We are unable to accurately predict the impact these automatic and potential reductions will have on our business, and those reductions could materially adversely affect our business, financial condition, results of operations and prospects.

Recent federal governmental proposals could limit the states' use of provider tax programs to generate revenue for their Medicaid expenditures, which could result in a reduction in our reimbursement rates under Medicaid. To generate funds to pay for the increasing costs of the Medicaid

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program, many states utilize financial arrangements commonly referred to as "provider taxes." Under provider tax arrangements, states collect taxes from healthcare providers and then use the revenue to pay the providers as a Medicaid expenditure, which allows the states to then claim additional federal matching funds on the additional reimbursements. Current federal law provides for a cap on the maximum allowable provider tax as a percentage of the provider's total revenue. There is no assurance that federal law will continue to provide matching federal funds on state Medicaid expenditures funded through provider taxes, or that the current caps on provider taxes will not be reduced. Any discontinuance or reduction in federal matching of provider tax-related Medicaid expenditures could have a significant and adverse effect on states' Medicaid expenditures and, as a result, could have a material and adverse effect on our business, financial condition, results of operations and prospects.

We cannot currently estimate the magnitude of the potential Medicare and Medicaid rate or payment reductions, the impact of the failure of these programs to increase rates to match increasing expenses or the impact on us of potential Medicare and Medicaid policy changes, but they may be material to our operations and affect our future results of operations. We are unable to accurately predict whether future Medicare and Medicaid rates and payments will be sufficient to cover our costs. Future Medicare and Medicaid rate declines or a failure of these rates or payments to cover our costs could result in our experiencing materially lower earnings or losses.

We conduct business in a heavily regulated industry, and changes in, or violations of, regulations may result in increased costs or sanctions that reduce our revenue and profitability.

As a result of our participation in the Medicaid and Medicare programs, we are subject to, in the ordinary course of business, various governmental reviews, inquiries, investigations and audits by federal and state agencies to verify our compliance with these programs and laws and regulations applicable to the operation of, and reimbursement for, skilled nursing and assisted living facilities and our other operating areas. These regulations include those relating to licensure, conduct of operations, ownership of facilities, construction of new facilities and additions to existing facilities, allowable costs, services and prices for services.

Recently, the federal government has imposed extensive enforcement policies resulting in a significant increase in the number of inspections, citations of regulatory deficiencies and other regulatory sanctions, including terminations from the Medicare and Medicaid programs, denials of payment for new Medicare and Medicaid admissions and civil monetary penalties. If we fail to comply, or are perceived as failing to comply, with the extensive laws and regulations applicable to our industry, then we may become ineligible to receive government program reimbursement, be required to refund amounts received from Medicare, Medicaid or private payors, suffer civil or criminal penalties, suffer damage to our reputation or be required to significantly change the way we operate our business.

We operate in multiple states and the applicable regulatory provisions in each state are subject to changes over time. We continue to monitor state regulatory provisions applicable to our business to facilitate compliance with any revised or newly issued rules and policies.

Federal and state healthcare fraud and abuse laws regulate both the provision of services to government program beneficiaries and the methods and requirements for submitting claims for services rendered to such beneficiaries. Under these laws, individuals and organizations can be penalized for submitting claims for services that are not provided, that have been inadequately provided, billed in an incorrect manner or other than as actually provided, not medically necessary, provided by an improper person, accompanied by an illegal inducement to utilize or refrain from utilizing a service or product, or billed or coded in a manner that does not otherwise comply with applicable governmental requirements. Penalties also may be imposed for violation of anti-kickback and patient referral laws.

Federal and state governments have a range of criminal, civil and administrative sanctions available to penalize and remediate healthcare fraud and abuse, including exclusion of the provider from

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participation in the Medicare and Medicaid programs, fines, criminal and civil monetary penalties and suspension of payments and, in the case of individuals, imprisonment. We also are subject to potential lawsuits under a federal whistleblower statute designed to combat fraud and abuse in the health care industry. These lawsuits can involve significant monetary awards to private plaintiffs who successfully bring these suits.

We believe that we maintain and follow policies and procedures that are sufficient to ensure that our facilities will operate in substantial compliance with these anti-fraud and abuse requirements and other Medicare and Medicaid program criteria. While we believe that our business practices are consistent with Medicare and Medicaid criteria, those criteria are often vague and subject to change and interpretation.

We are unable to accurately predict the future course of federal, state and local regulation or legislation, including Medicare and Medicaid statutes and regulations, or the intensity of federal and state enforcement actions. An adverse review, inquiry, investigation or audit could result in:

- an obligation to refund amounts previously paid to us pursuant to the Medicare or Medicaid programs or from private payors, in amounts that could be material to our business;
- state or federal agencies imposing fines, penalties and other sanctions on us;
- loss of our right to participate in the Medicare or Medicaid programs or one or more private payor networks;
- an increase in private litigation against us; and
- harm to our reputation in various markets.

An expanded federal program is underway to recover Medicare overpayments.

The Medicare Modernization Act of 2003 established a three year demonstration project to recover overpayments and identify underpayments on Medicare claims from hospitals, skilled nursing facilities and home health agencies through a review of claims previously paid by Medicare beginning in October, 2007. Medicare contracted nationwide with third parties known as Recovery Audit Contractors ("RAC") to conduct these reviews commonly referred to as RAC Audits. Due to the success of the program, the Tax Relief and Health Care Act of 2006 made the program permanent and mandated its expansion to all 50 states in 2010. We are also subject to other audits under various government programs, including Zone Program Integrity Contractors, Program Safeguard Contractors and Medicaid Integrity Contractors, in which third-party firms engaged by CMS conduct extensive reviews of claims data and medical and other records to identify potential improper government payments. We make no assurances that our claims will not be selected for any such audits in the future and, if they are selected for any such audit, the extent to which these audits may have a material adverse effect on our business, financial condition, results of operations and prospects.

We are subject to claims under the self-referral and anti-kickback legislation.

In the United States, various state and federal laws regulate the relationships between providers of health care services, physicians and other clinicians. In particular, various laws, including federal and state anti-kickback and anti-fraud statutes, prohibit certain business practices and relationships that might affect the provision and cost of health care services reimbursable under Medicare and Medicaid programs, including the payment or receipt of compensation for the referral of patients whose care will be paid by federal governmental programs. Sanctions for violating the anti-kickback and anti-fraud statutes include criminal penalties and civil sanctions, including fines and possible exclusion from governmental programs such as Medicare and Medicaid.

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These laws and regulations are complex, and limited judicial or regulatory interpretation exists. While we make every effort to ensure compliance, we make no assurances that governmental officials charged with responsibility for enforcing the provisions of these laws and regulations will not assert that one or more of our arrangements are in violation of the provisions of such laws and regulations. Violations of these laws may result in substantial civil or criminal penalties for individuals or entities, including large civil monetary penalties and exclusion from participation in the Medicare or Medicaid programs. Such exclusion or penalties, if applied to us, could have a material adverse effect on our business, financial condition, results of operations and prospects.

We are required to comply with laws governing the transmission and privacy of health information.

HIPAA requires us to comply with standards for the exchange of health information within our Company and with third parties, such as payors, business associates and patients. These include standards for common health care transactions, such as claims information, plan eligibility, payment information and the use of electronic signatures, unique identifiers for providers, employers, health plans and individuals, and security, privacy and enforcement. If we are found to be in violation of the privacy or security rules under HIPAA or other federal or state laws protecting the confidentiality of patient health information, we could be subject to criminal penalties and civil sanctions, which could increase our liabilities, harm our reputation and have a material adverse effect on our business, financial condition, results of operations and prospects.

We rely on information technology in our operations, and any material failure, inadequacy, interruption or security failure of that technology could harm our business, financial condition, results of operations and prospects.

We rely on information technology networks and systems, including the Internet, to process, transmit and store electronic information, and manage or support a variety of business processes, including medical records, financial transactions and records, personal identifying information, payroll data and workforce scheduling information. We purchase some of our information technology from vendors, on whom our systems depend. We rely on commercially available systems, software, tools and monitoring to provide security for processing, transmission and storage of confidential patient, resident and other customer information, such as individually identifiable information, including information relating to health protected by HIPAA. Although we have taken steps to protect the security of our information systems and the data maintained in those systems, it is possible that our safety and security measures will not prevent the systems' improper functioning or damage or the improper access or disclosure of personally identifiable information such as in the event of cyber-attacks. Security breaches, including physical or electronic break-ins, computer viruses, attacks by hackers and similar breaches can create system disruptions or shutdowns or the unauthorized disclosure of confidential information. If personal or otherwise protected information of our patients is improperly accessed, tampered with or distributed, we may incur significant costs to remediate possible injury to the affected patients and we may be subject to sanctions and civil or criminal penalties if we are found to be in violation of the privacy or security rules under HIPAA or other similar federal or state laws protecting confidential patient health information. Any failure to maintain proper functionality and security of our information systems could interrupt our operations, damage our reputation, subject us to liability claims or regulatory penalties and could have a material adverse effect on our business, financial condition, results of operations and prospects.

We intend to continue to expand our business through acquisitions.

Our business model calls for seeking to acquire existing cash flowing operations and to expand our operations by pursuing an acquisition growth strategy to acquire and lease long-term care facilities, primarily skilled nursing facilities. Our success will largely depend on our ability to finance the new

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acquisitions and implement and integrate the new acquisitions into our management systems. As a result, we expect to experience all of the risks that generally occur with rapid expansion such as:

- adapting our management systems and personnel into the new acquisition;
- integrating the new acquisition and businesses into our structure;
- acquiring and operating new acquisitions and businesses in geographic regions in which we have not historically operated;
- obtaining adequate financing under reasonable and acceptable terms;
- retaining key personnel, customers and vendors of the acquired business and the hiring of new personnel;
- obtaining all necessary state and federal regulatory approvals to authorize acquisitions;
- impairments of goodwill and other intangible assets; and
- contingent and latent risks associated with the past operations of, and other unanticipated costs and problems arising in, an acquired business.

If we are unable to successfully integrate the operations of an acquired property or business into our operations, we could be required to undertake unanticipated changes. These changes could increase our operating costs and have a material adverse effect on our business, financial condition, results of operations and prospects.

We continue to seek acquisitions and other strategic opportunities that may require a significant amount of management resources and costs.

We continue to seek acquisitions and other strategic opportunities. Accordingly, we are often engaged in evaluating potential transactions and other strategic alternatives. In addition, from time to time, we engage in preliminary discussions that may result in one or more transactions. Although there is uncertainty that any of these discussions will result in definitive agreements or the completion of any transaction, we may devote a significant amount of our management resources to such transactions, which could negatively impact our existing and continuing operations. In addition, we may incur significant costs in connection with exploring and targeting acquisitions, regardless of whether these acquisitions are completed. In the event that we consummate an acquisition or strategic alternative in the future, there is no assurance that we would complete the acquisition or fully realize the potential benefit of such a transaction even if it is completed.

We will require additional financing in order to fund future acquisitions.

The pursuit of our growth strategy and the acquisition of new skilled nursing facilities may involve significant cash expenditures, debt incurrence, capital expenditures, additional operating losses, amortization of the intangible assets of acquired companies, dilutive issuances of equity securities and other expenses that could have a material adverse effect on our business, financial condition, results of operations and prospects.

During 2013, we will need to obtain additional financing to implement our expansion strategy and fund our acquisitions. We are currently exploring several financing alternatives and may seek to raise additional capital through the sale of additional debt or equity securities. As of December 31, 2012, we had an accumulated deficit of $25.8 million and a working capital deficit of approximately $5.9 million. Our cumulative losses have, in the past, made it difficult for us to borrow adequate funds on what management believed to be commercially reasonable terms. There is no assurance that we will succeed in obtaining financing or will be able to raise additional capital through the issuance of debt or equity securities on terms acceptable to us, or at all, or that any financing obtained will not contain restrictive

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covenants that limit our operating flexibility. If we are unable to secure such additional financing, then we may be required to delay or modify our expansion plans. If we raise capital for new acquisitions through the sale of equity securities, then our shareholders may experience dilution.

We may be unable to complete future facility or business acquisitions at attractive prices or at all, which may adversely affect our revenue and financial condition.

The profitability of our operations relies on acquiring existing cash flowing operations and expanding our operations by acquiring and leasing long-term care facilities, primarily skilled nursing facilities.

We face competition for the acquisition of these facilities and related businesses and expect this competition to increase. Based upon factors such as our ability to identify suitable acquisition candidates, the purchase price of the facilities, prevailing market conditions, the availability of leadership to manage new facilities and our willingness to take on new operations, the rate at which we have historically acquired facilities has fluctuated significantly. In the future, we anticipate the rate at which we may acquire facilities will continue to fluctuate, which may affect our revenue and financial condition.

In undertaking acquisitions, we may be adversely impacted by costs, liabilities and regulatory issues that may adversely affect our operations.

In acquiring new facilities, we may be adversely impacted by unforeseen liabilities attributable to prior providers who operated those facilities, against whom we may have little or no recourse. Even if we improve operations and patient care at facilities that we have acquired, we still may face post-acquisition regulatory issues related to pre-acquisition events. These may include, without limitation, payment recoupment related to our predecessors' prior noncompliance, the imposition of fines, penalties, operational restrictions or special regulatory status. Further, we may incur post-acquisition compliance risk due to the difficulty or impossibility of immediately or quickly bringing non-compliant facilities into full compliance. Diligence materials pertaining to acquisition targets, especially the underperforming facilities that often represent the greatest opportunity for return, are often inadequate, inaccurate or impossible to obtain, sometimes requiring us to make acquisition decisions with incomplete information. Despite our due diligence procedures, facilities that we have acquired or may acquire in the future may generate unexpectedly low returns, may cause us to incur substantial losses, may require unexpected levels of management time, expenditures or other resources or may otherwise not meet a risk profile that our investors find acceptable.

In addition, we might encounter unanticipated difficulties and expenditures relating to any of the acquired facilities, including contingent liabilities. For example, when we acquire a facility, we may assume the facility's existing Medicare provider number for purposes of billing Medicare for services. If CMS later determined that the prior owner of the facility had received overpayments from Medicare for the period of time during which it operated the facility, or had incurred fines in connection with the operation of the facility, CMS could hold us liable for repayment of the overpayments or fines. If the prior operator is defunct or otherwise unable to reimburse us, we may be unable to recover these funds. We may be unable to improve every facility that we acquire. In addition, operation of these facilities may divert management time and attention from other operations and priorities, negatively impact cash flows, result in adverse or unanticipated accounting charges or otherwise damage other areas of our Company if they are not timely and adequately improved.

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We may not be able to successfully integrate acquired facilities and businesses into our operations, and we may not achieve the benefits we expect from any of our facility acquisitions.

We may not be able to efficiently or effectively integrate newly acquired facilities with our existing operations, culture and systems. The process of integrating acquired facilities into our existing operations may result in unforeseen operating difficulties, divert management's attention from existing operations or require an unexpected commitment of staff, financial or other resources, and the integration process may ultimately be unsuccessful. We recognize the importance of maintaining adequate staffing and supervision in our facilities at all times to ensure a high quality of care for our patients and residents. The financial benefits we expect to realize from many of our acquisitions rely largely upon our ability to improve performance, overcome regulatory deficiencies, increase and maintain occupancy and control costs. If we are unable to accomplish any of these objectives at facilities we acquire, we may not realize the expected benefits, which may have a material adverse effect on our business, financial condition, results of operations and prospects.

State efforts to regulate the construction or expansion of health care providers could impair our ability to expand our operations or make acquisitions.

Some states require health care providers (including skilled nursing facilities, hospices and assisted living facilities) to obtain prior approval, in the form of a Certificate of Need ("CON"), for the purchase, construction or expansion of health care facilities, capital expenditures exceeding a prescribed amount or changes in services or bed capacity. To the extent that we are unable to obtain any required CON or other similar approvals, our expansion could be materially adversely affected. Additionally, failure to obtain the necessary state approvals can also result in sanctions or adverse action on the facility's license and adverse reimbursement action. No assurances are given that we will be able to obtain a CON or other similar approval for any future projects requiring this approval or that such approvals will be timely.

Circumstances that adversely affect the ability of seniors, or their families, to pay for our services could have material adverse effects on our business, financial condition, results of operations and prospects.

Approximately 6% of our skilled nursing occupants and nearly all of the occupants of our assisted living facilities rely on their personal investments and wealth to pay for their stay in our facilities. We expect to continue to rely on the ability of our residents to pay for our services from their own financial resources. Inflation, continued high levels of unemployment, declines in market values of investments and home prices, or other circumstances that may adversely affect the ability of the elderly or their families to pay for our services could have a material adverse effect on our business, financial condition, results of operations and prospects.

We depend largely upon reimbursement from third-party payors, and our business, financial condition, results of operations and prospects could be adversely affected by any changes in the mix of patients in our facilities as well as payor mix and payment methodologies.

Our revenue is affected by the percentage of our patients who require a high level of skilled nursing and rehabilitative care, whom we refer to as high acuity patients, and by our mix of payment sources. Changes in our patient mix, as well as our payor mix among Medicaid, Medicare, private payors and managed care companies, may significantly affect our profitability because we generally receive higher reimbursement rates for certain patients, such as rehabilitation patients, and because the payors reimburse us at different rates. As a result, changes in the case mix of patients as well as the payor mix may significantly affect our profitability. Particularly, a significant increase in Medicaid patients will have a material adverse effect on our business, financial condition, results of operations and prospects, especially if states operating Medicaid programs continue to limit, or more aggressively seek limits on, reimbursement rates.

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We operate in an industry that is highly competitive.

The long-term care industry is highly competitive and we believe that it will become even more competitive in the future. We face direct competition for the acquisition of facilities, and in turn, we face competition for employees and patients. Our assisted living facilities and nursing homes face competition from skilled nursing, assisted living, independent living facilities, homecare services, community-based service programs, retirement communities and other operations that provide services comparable to those offered by us.

We compete with national companies with respect to both our skilled nursing and assisted living facilities. Additionally, we also compete with local and regional based entities. Many of these competing companies have greater financial and other resources than we have. Failure to effectively compete with these companies may have a material adverse effect on our business, financial condition, results of operations and prospects.

Our ability to compete is based on several factors, including, without limitation, building age, appearance, reputation, availability of patients, survey history and CMS rankings. We make no assurances that increases in competition in the future will not adversely affect our business, financial condition, results of operations and prospects.

The cost to replace or retain qualified personnel may affect our business, financial condition, results of operations and prospects, and we may not be able to comply with the staffing requirements of certain states.

We could experience significant increases in our costs due to shortages in qualified nurses, health care professionals and other key personnel. We compete with other providers of home health care, nursing home care, and assisted living with respect to attracting and retaining qualified personnel, and the market is competitive. Because of the small markets in which we operate, shortages of nurses and trained personnel may require us to enhance our wage and benefit package in order to compete and attract qualified employees from more metropolitan areas. Further, acquisitions of new facilities may require us to pay increased compensation or offer other incentives to retain key personnel and other employees in any newly acquired facilities. Increased competition in the future with respect to attracting and maintaining key personnel could limit our ability to attract and retain residents or to expand our business.

Certain states in which we currently operate, or may operate in the future, may have adopted minimum staffing standards, and additional states may also establish similar requirements in the future. Our ability to satisfy these requirements will depend upon our ability to attract and retain qualified, nurses, certified nurses' assistants and other personnel. Failure to comply with these requirements may result in the imposition of fines or other sanctions. If states do not appropriate sufficient additional funding, through Medicaid appropriations or otherwise, to pay for any additional operating costs resulting from minimum staffing requirements, then our business, financial condition, results of operations and prospects may be adversely affected.

To date, we have been able to adequately staff all of our operations and future operations following an acquisition. However, we make no assurances that the ability to adequately staff all of our operations will continue in the future. Additionally, increasing employee health and workers' compensation insurance costs may materially and negatively affect our profitability. We provide no assurances that our labor costs will not increase or that any increase will be matched by corresponding increases in rates we charge to facility residents. Our ability to control labor costs will significantly effect on our business, financial condition and results of operation in the future.

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Successful union organization of our employees may adversely affect our business, financial condition, results of operations and prospects.

Periodically, labor unions attempt to organize our employees. Although we currently have no collective bargaining agreements with unions with respect to our employees or our facilities, there is no assurance that this will continue to be the case in the future. If future federal legislation makes it easier for employee groups to unionize, then groups of our employees may seek union representation. If more of our employees unionize, we could experience business interruptions, work stoppages, declines in service levels due to union specific rules or increased operating expenses that may adversely affect our business, financial condition, results of operations and prospects.

If we lose our key management personnel, we may not be able to successfully manage our business or achieve our objectives, which could have a material adverse effect on our business, financial condition, results of operations and prospects.

We are dependent on our management team, and our future success depends largely upon the management experience, skill, and contacts of our management, and the loss of any of our key management team could harm our business. If we lose the services of any or all of our management team, we may not be able to replace them with similarly qualified personnel, which could have a material adverse effect on our business, financial condition, results of operations and prospects.

Termination of assisted living resident agreements and resident attrition could adversely affect our revenues and earnings.

State regulations governing assisted living facilities typically require a written resident agreement with each resident. Most of these regulations also require that each resident have the right to terminate our assisted living resident agreement for any reason on reasonable notice. Consistent with these regulations, most resident agreements allow residents to terminate their agreements on 30 days' notice. Unlike typical leasing relationships which require a commitment of one year or more, we cannot contract with our residents for longer periods of time. In event that a substantial number of residents elect to terminate their resident agreements at or around the same time, our revenues and earnings could be materially and adversely affected.

Environmental compliance costs and liabilities associated with our facilities may have a material adverse effect on our business, financial condition, results of operations and prospects.

We are subject to various federal, state and local environmental and health and safety laws and regulations with respect to our facilities. These laws and regulations address various matters, including asbestos, fuel oil management, wastewater discharges, air emissions, medical wastes and hazardous wastes. The costs of complying with these laws and regulations and the penalties for non-compliance can be substantial. For example, with respect to our owned and leased property, we may be held liable for costs relating to the investigation and cleanup of any of our owned or leased properties from which there has been a release or threatened release of a regulated material as well as other properties affected by the release. In addition to these costs, which are typically not limited by law or regulation and could exceed the property's value, we could be liable for certain other costs, including, without limitation, governmental fines and injuries to persons, property or natural resources. Further, some environmental laws create a lien on the contaminated site in favor of the government for damages and the costs it incurs in connection with the contamination. While we are not aware of any potential environmental problems, no assurances are made that such problems and the costs associated with them will not arise in the future. If any of our properties were found to violate environmental laws, we may be required to expend significant amounts of time and money to rehabilitate the property, and we may be subject to significant liability. Any environmental compliance costs and liabilities incurred may have a material adverse effect on our business, financial condition, results of operations and prospects.

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Disasters and other adverse events may seriously harm our business.

Our facilities and residents may suffer harm as a result of natural or man-made disasters such as storms, earthquakes, hurricanes, tornadoes, floods, fires, terrorist attacks and other conditions. Such events may disrupt our operations, harm our patients and employees, severely damage or destroy one more of our facilities, harm our business, reputation and financial performance, or otherwise cause our business to suffer in ways that cannot currently be predicted.

The nature of business exposes us to certain litigation risks.

The provision of health care services entails an inherent risk of liability. In recent years, participants in the long-term care industry have become subject to an increasing number of lawsuits alleging malpractice, negligence, product liability or other related legal theories. In several well publicized instances, private litigation by residents of senior living facilities for alleged abuses has resulted in large damage awards against other operating companies. Certain lawyers and firms specialize in bringing litigation against companies such as ours. As a result of this litigation, our cost of liability insurance has increased during the past few years.

We currently maintain liability insurance. This insurance is intended to cover malpractice and other lawsuits. Although we believe that it is in keeping with industry standards, no assurances are made that claims in excess of our limits will not arise. Any such successful claims could have a material adverse effect upon our business, financial condition, results of operations and prospects. Claims against us, regardless of their merit or eventual outcome, may also have a material adverse effect upon our ability to attract and retain patients and key personnel. In addition, our insurance policies must be renewed annually, and no assurances are made that we will be able to retain coverage in the future or, if coverage is available, that it will be available on acceptable terms.

We are subject to possible conflicts of interest; we have engaged in, and expect to continue to engage in, transactions with parties that may be considered related parties.

From time to time, we have engaged in various transactions with Christopher Brogdon, Vice Chairman of the Board of Directors, owner of greater than 10% of our outstanding common stock and former Chief Acquisition Officer of the Company. These transactions, along with other related party transactions, are described in Note 22 to our Consolidated Financial Statements included in Part II, Item 8., "Financial Statements and Supplementary Data."

We believe that our affiliations with Mr. Brogdon, and other related parties have been, and will be, beneficial to us. Although we do not believe the potential conflicts have adversely affected, or will adversely affect, our business, others may disagree with this position. In the past, in particular following periods of financial instability, shareholder litigation and dissident shareholder director nominations and shareholder proposals have often been instituted against companies alleging conflicts of interest in business dealings with officers, directors and other affiliates. Our relationships with Mr. Brogdon and other related parties may give rise to such litigation, nominations or proposals which could result in substantial costs to us and a diversion of our resources and our management's attention, whether or not any allegations made are substantiated.

The costs of being publicly owned may strain our resources and impact our business, financial condition, results of operations and prospects.

As a public company, we are subject to the reporting requirements of the Exchange Act and the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley Act"). The Exchange Act requires that we file annual, quarterly and current reports with respect to our business and financial condition. The Sarbanes-Oxley Act requires that we maintain effective disclosure controls and procedures and internal controls for financial reporting. We are required to document and test our internal control procedures in order to

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satisfy the requirements of Section 404 of the Sarbanes-Oxley Act, which requires annual management assessments of the effectiveness of our internal controls over financial reporting.

These requirements may place a strain on our systems and resources and have required us, and may in the future require us, to hire additional accounting and financial resources with appropriate public company experience and technical accounting knowledge. In addition, failure to maintain such internal controls could result in us being unable to provide timely and reliable financial information which could potentially subject us to sanctions or investigations by the SEC or other regulatory authorities or cause us to be late in the filing of required reports or financial results. Any of the foregoing events could have an adverse effect on our business, financial condition, results of operations and prospects.

We have a history of operating losses and may incur losses in the future.

For the year ended December 31, 2012, for amounts attributable to the Company, we had a net loss of $6.9 million compared to a net loss of $6.2 million for the year ended December 31, 2011. We make no assurances that we will be able to operate profitably. As of December 31, 2012, we have a working capital deficit of approximately $5.9 million.

We intend to seek to improve our liquidity and profitability in future years by:

refinancing debt where possible to obtain more favorable terms;

increasing facility occupancy and the proportion of sub-acute patients within our skilled nursing facilities;

continuing our cost optimization and efficiency strategies;

acquiring additional long-term care facilities with existing cash flowing operations to expand our operations; and

adding additional management contracts.

We believe the foregoing actions, if taken, will provide the opportunity for the Company to improve liquidity and achieve profitability. No assurances are made that such improvements or achievements will occur.

Our business requires us to make capital expenditures to maintain and improve our facilities.

Our facilities sometimes require capital expenditures to address ongoing required maintenance and to make them attractive to residents. Physical characteristics of senior living facilities and rehabilitation centers are mandated by various governmental authorities; and changes in these regulations may require us to make significant expenditures. In addition, we often are required to make significant capital expenditures when we acquire new facilities in pursuit of our growth strategy. Our available financial resources may be insufficient to fund these expenditures.

Our substantial debt could adversely affect our cash flow and impair our ability to raise additional capital.

As of December 31, 2012, we had approximately $171.9 million in indebtedness, including current maturities and discontinued operations. We may also obtain additional short-term and long-term debt to meet future capital needs, including to fund acquisitions, subject to certain restrictions under our existing indebtedness, which would increase our total debt. Our substantial amount of debt could have negative consequences to our business. For example, it could:

increase our vulnerability to general adverse economic and industry conditions;

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require us to dedicate a substantial portion of cash flows from operations to interest and principal payments on outstanding debt, thereby limiting the availability of cash flow to fund acquisitions, capital expenditures, working capital and other general corporate requirements;

limit our flexibility in planning for, or reacting to, changes in our business and industry;

place us at a competitive disadvantage compared with our competitors that have less debt; and

limit our ability to borrow additional funds, even when necessary to maintain adequate liquidity.

In addition, our ability to borrow funds in the future will depend in part on the satisfaction of the covenants in our credit facilities and other debt agreements. If we are unable to satisfy the financial covenants contained in those agreements, or are unable to generate cash sufficient to make required debt payments, the lenders and other parties to those arrangements could accelerate the maturity of some or all of our outstanding indebtedness.

We may not have sufficient liquidity to meet our capital needs.

For the year ended and as of December 31, 2012, we had a net loss of $7.5 million and negative working capital of $5.9 million. At December 31, 2012, we had $15.9 million in cash and cash equivalents and $171.9 million in indebtedness, including current maturities and discontinued operations, of which $23.0 million is current debt (including the Company's outstanding convertible promissory notes with a principal amount in the aggregate of $11.7 million which mature in October 2013 and approximately $3.7 million of mortgage notes included in liabilities of disposal group).

Based on existing cash balances, anticipated cash flows for the year ending December 31, 2013, and new sources of capital, we believe there will be sufficient funds for our operations, scheduled debt service, and capital expenditures at least through the next 12 months. On a longer term basis, we have approximately $80.4 million of debt payments and maturities due between 2014 and 2016, excluding convertible promissory notes which are convertible into shares of common stock. We believe our long-term liquidity needs will be satisfied by these same sources, as well as borrowings as required to refinance indebtedness.

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

An increase in market interest rates could increase our interest costs on existing and future debt.

We have incurred and expect in the future to incur floating rate indebtedness in connection with our acquisition of new facilities, as well as for other purposes. Accordingly, increases in interest rates

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would increase the Company's interest costs. These increased costs could make the financing of any acquisition more costly and could limit our ability to refinance existing debt when it matures.

We do not currently pay cash dividends on our common stock and do not anticipate doing so in the future.

We have never declared or paid any cash dividends on our common stock. We intend to retain any future earnings after payment of dividends on our Series A Preferred Stock to fund our operations and, therefore, we currently do not anticipate paying any cash dividends on our common stock in the foreseeable future. In addition, no cash dividends may be declared or paid on our common stock unless full cumulative dividends on our Series A Preferred Stock have been, or contemporaneously are, declared and paid, or declared and a sum sufficient for the payment thereof is set apart for payment, for all past dividend periods.

We could be prevented from paying dividends on our Series A Preferred Stock and our common stock.

We are a holding company, and we have no significant operations. We rely primarily on dividends and other distributions from our subsidiaries to us so we may, among other things, pay dividends on our stock, if and to the extent declared by the Board of Directors. The ability of our subsidiaries to pay dividends and other distributions to us depends on their earnings and is restricted by the terms of certain agreements governing their indebtedness. If our subsidiaries are in default under such agreements, then they may not pay dividends or other distributions to us.

In addition, we may only pay dividends on our stock if we have funds legally available for the payment of dividends and such payment is not restricted or prohibited by law, the terms of any shares with higher priority with respect to dividends or any documents governing our indebtedness. Our loan agreement with KeyBank National Association ("KeyBank") prohibits the payment of dividends on our stock if we fail to comply with certain financial covenants or if a default or event of default under the loan agreement has occurred. As such, we could become unable, on a temporary or permanent basis, to pay dividends on our stock, including our Series A Preferred Stock. In addition, future debt, contractual covenants or arrangements we or our subsidiaries enter into may restrict or prevent future dividend payments.

The payment of any future dividends on our stock will be at the discretion of the Board of Directors and will depend, among other things, the earnings and results of operations of our subsidiaries, their ability to pay dividends and other distributions to AdCare under agreements governing their indebtedness, our financial condition and capital requirements, any debt service requirements and any other factors the Board of Directors deems relevant.

The price of our stock, in particular our common stock, has fluctuated, and a number of factors may cause the price of our stock to decline.

The market price of our stock has fluctuated and could fluctuate significantly in the future as a result of various factors and events, many of which are beyond our control. These factors may include:

variations in our operating results;

changes in our financial condition, performance and prospects;

changes in general economic and market conditions;

the departure of any of our key executive officers and directors;

announcements by us or our competitors of significant acquisitions, strategic partnerships, or transactions;

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press releases or negative publicity relating to us or our competitors or relating to trends in health care;

government action or regulation, including changes in federal, state, and local health-care regulations to which we are subject;

the level and quality of securities analysts' coverage for our stock;

changes in financial estimates or recommendations by securities analysts with respect to us or our competitors; and

with respect to our common stock, future sales of our common stock.

In addition, the market price of our Series A Preferred Stock will also depend upon:

prevailing interest rates, increases in which may have an adverse effect on the market price of our Series A Preferred Stock;

trading prices of preferred equity securities issued by other companies in the industry;

the annual yield from distributions on our Series A Preferred Stock as compared to yields on other financial instruments; and

our issuance of additional preferred equity or debt securities.

Furthermore, the stock market in recent years has experienced sweeping price and volume fluctuations that often have been unrelated to the operating performance of affected companies. These market fluctuations may also cause the price of our stock to decline.

In the event of fluctuations in the price of our stock, shareholders may be unable to resell shares of our stock at or above the price at which they purchased such shares. Additionally, due to fluctuations in the price of our stock, comparing our operating results on a period-to-period basis may not be meaningful, and you should not rely on past results as an indication of future performance.

Our directors and officers substantially control all major decisions.

Our directors and officers beneficially own approximately 22.4% of our outstanding common stock. Therefore, our directors and officers will be able to influence major corporate actions required to be voted on by shareholders, such as the election of directors, the amendment of our charter documents and the approval of significant corporate transactions such as mergers, reorganizations, sales of substantially all of our assets and liquidation. Furthermore, our directors will be able to make decisions affecting our capital structure, including decisions to issue additional capital stock, implement stock repurchase programs and incur indebtedness. This control may have the effect of deterring hostile takeovers, delaying or preventing changes in control or changes in management, or limiting the ability of our other shareholders to approve transactions that they may deem to be in their best interest.

No assurance is made that Brogdon Family, LLC will commence a tender offer for the common stock or that, if commenced, such tender offer will be completed on terms acceptable to our shareholders or at all.

On April 17, 2013, Brogdon Family, LLC ("Brogdon Family"), an affiliate of Christopher Brogdon, our Vice Chairman and beneficial owner of greater than 10% of the common stock, informed the Board of Directors of Brogdon Family's interest in commencing an unsolicited tender offer to acquire, at a price of $8.00 per share, such number of shares of common stock that would result in Mr. Brogdon beneficially owning at least 55%, but no more than 75%, of the outstanding shares of common stock (the "Tender Offer"). Brogdon Family also informed the Board of Directors, or otherwise disclosed, that the Tender Offer will be subject to certain conditions, including, but not limited to: (i) the valid tender of shares of common stock totaling at least 55% of the issued and

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outstanding common stock when added to the shares of common stock held by Brogdon Family and its affiliates; (ii) the absence of litigation regarding the Tender Offer; (iii) the absence of any governmental order being entered enjoining the Tender Offer (and that such order is not anticipated being entered); (iv) the receipt of any required governmental approvals; and (v) Brogdon Family obtaining appropriate financing.

We do not control if or when Brogdon Family commences the Tender Offer or, if commenced, the ultimate terms of the Tender Offer, including the price offered for the common stock. No assurance is made that Brogdon Family will commence the Tender Offer or that, if commenced, it will be completed on terms acceptable to our shareholders or at all.

If and when the Tender Offer is commenced, then, consistent with its fiduciary duties and as required by applicable law, the Board of Directors, in consultation with our independent financial and legal advisors (a) will review the Tender Offer to determine the course of action that it believes is in the best interests of us and our shareholders and (b) will advise shareholders of its formal position regarding the Tender Offer within ten business days after its commencement by making available to our shareholders and filing with the SEC a solicitation/recommendation statement on Schedule 14D-9.

If the Tender Offer is commenced, then we will file a solicitation/recommendation statement with the SEC. INVESTORS AND ALL OF OUR SECURITY HOLDERS ARE URGED TO READ SUCH STATEMENT AND ANY OTHER DOCUMENTS FILED WITH THE SEC CAREFULLY IN THEIR ENTIRETY WHEN THEY BECOME AVAILABLE BECAUSE THEY WILL CONTAIN IMPORTANT INFORMATION. INVESTORS AND SECURITY HOLDERS WILL BE ABLE TO OBTAIN FREE COPIES OF THESE DOCUMENTS (WHEN AVAILABLE) AND OTHER DOCUMENTS FILED WITH THE SEC BY US THROUGH THE WEBSITE MAINTAINED BY THE SEC AT http://www.sec.gov.

Takeover defense provisions in Ohio law and our charter documents may delay or prevent takeover attempts thereby preventing our shareholders from realizing a premium on their common stock.

Various provisions of Ohio corporation law and of our charter documents may inhibit changes in control not approved by our Board of Directors and may have the effect of depriving our investors of an opportunity to receive a premium over the prevailing market price of our common stock in the event of an attempted hostile takeover. In addition, the existence of these provisions may adversely affect the market price of our common stock. These provisions include:

- a requirement that special meetings of shareholders be called by our Board of Directors, the Chairman, the President, or the holders of shares with voting power of at least 25%;
- staggered terms among our directors with three classes of directors and only one class to be elected each year;
- advance notice requirements for shareholder proposals and nominations; and
- availability of "blank check" preferred stock.

Our Board of Directors can use these and other provisions to prevent, delay or discourage a change in control of the Company or a change in our management. Any such delay or prevention of a change in control or management could deter potential acquirers or prevent the completion of a takeover transaction pursuant to which our shareholders could receive a substantial premium over the current market price of our common stock, which in turn may limit the price investors might be willing to pay for our common stock.

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Provisions in our charter documents provide for indemnification of officers and directors, which could require us to direct funds away from our business and future operations.

Our charter documents provide for the indemnification of our officers and directors. We may be required to advance costs incurred by an officer or director and to pay judgments, fines and expenses incurred by an officer or director, including reasonable attorneys' fees, as a result of actions or proceedings in which our officers and directors are involved by reason of being or having been an officer or director of our Company. Funds paid in satisfaction of judgments, fines and expenses may be funds we need for the operation and growth of our business.

Item 1B. Unresolved Staff Comments

Disclosure pursuant to Item 1B of Form 10-K is not required to be provided by smaller reporting companies.

Item 2. Properties

Facilities

As of December 31, 2012, we operated 50 facilities in eight states with the operational capacity to serve approximately 4,996 residents. Of the facilities, we owned and operated 26 facilities, leased and operated 11 facilities, and managed 13 facilities (including one consolidated variable interest entity.

The following table provides summary information regarding the number of operational beds at our facilities as of December 31 (excluding discontinued operations):

	December 31,	
	2012	2011
Cumulative number of facilities	50	37
Cumulative number of operational beds	4,996	3,603

		Number of Facilities				
State	Number of Operational Beds/Units	Owned	VIE	Leased	Managed for Third Parties	Total
Alabama	408	2	1			3
Arkansas	1,041	10				10
Georgia	1,514	4		9		13
Missouri	80			1		1
North Carolina	106	1				1
Ohio	785	4		1	4	9
Oklahoma	882	3			8	11
South Carolina	180	2				2
Total	4,996	26	1	11	12	50
Facility Type						
Skilled Nursing	4,697	24		11	11	46
Assisted Living	216	2	1			3
Independent Living	83				1	1
Total	4,996	26	1	11	12	50

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Corporate Office

Our corporate office is located in Roswell, Georgia. We own the office building which contains approximately 10,000 square feet of office space. In addition, we have a month-to-month lease for a total of approximately 2,000 square feet of office space in the Atlanta, Georgia area.

Item 3. Legal Proceedings

We are party to various legal actions and administrative proceedings and are subject to various claims arising in the ordinary course of business, including claims that our services have resulted in injury or death to the residents of our facilities and claims related to employment, staffing requirements and commercial matters. Although we intend to vigorously defend ourselves in these matters, there is no assurance that the outcomes of these matters will not have a material adverse effect on our business, results of operations and financial condition.

We operate in an industry that is extremely regulated. As such, in the ordinary course of business, we are continuously subject to state and federal regulatory scrutiny, supervision and control. Such regulatory scrutiny often includes inquiries, investigations, examinations, audits, site visits and surveys, some of which are non-routine. In addition to being subject to direct regulatory oversight of state and federal regulatory agencies, our industry is frequently subject to the regulatory practices, which could subject us to civil, administrative or criminal fines, penalties or restitutionary relief, and reimbursement authorities could also seek the suspension or exclusion of the provider or individual from participation in their program. We believe that there has been, and will continue to be, an increase in governmental investigations of long-term care providers, particularly in the area of Medicare/Medicaid false claims, as well as an increase in enforcement actions resulting from these investigations. Adverse determinations in legal proceedings or governmental investigations against or involving us, whether currently asserted or arising in the future, could have a material adverse effect on our business results of operations and financial condition.

Item 4. Mine Safety Disclosures

Not applicable.

PART II

Item 5. Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities

Our common stock is listed for trading on the NYSE MKT LLC under the symbol "ADK". The high and low sales prices of our common stock during the quarters listed below were as follows:

		High	Low
"ADK"			
2012	First Quarter	$ 4.89	$ 3.68
	Second Quarter	$ 3.96	$ 3.32
	Third Quarter	$ 4.70	$ 3.47
	Fourth Quarter	$ 5.35	$ 3.89

		High	Low
2011	First Quarter	$ 5.09	$ 3.90
	Second Quarter	$ 6.31	$ 4.66
	Third Quarter	$ 6.69	$ 4.15
	Fourth Quarter	$ 4.71	$ 3.70

Based on information supplied from our transfer agent, there were approximately 500 shareholders of record of our common stock as of June 24, 2013.

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We have never declared or paid any cash dividends with respect to our common stock. Our ability to pay dividends will depend upon our future earnings and net worth. We are restricted by Ohio law from paying dividends on our common stock while insolvent or if such payment would result in a reduction of our stated capital below the required amount. In addition, no cash dividends may be declared or paid on our common stock unless full cumulative dividends on our Series A Preferred Stock have been, or contemporaneously are, declared and paid, or declared and a sum sufficient for the payment thereof is set apart for payment, for all past dividend periods. Furthermore, our loan agreement with KeyBank prohibits the payment of dividends on our stock if we fail to comply with certain financial covenants or if a default or event of default under the loan agreement has occurred.

Except for payment of dividends on our Series A Preferred Stock, we currently intend to retain any future earnings to fund the operation and growth of our business. We do not anticipate paying cash dividends in the foreseeable future.

Equity Compensation Plan Information

The following table sets forth additional information as of December 31, 2012, concerning shares of our common stock that may be issued upon the exercise of options and other rights under our existing equity compensation plans and arrangements, divided between plans approved by our shareholders and plans or arrangements not submitted to the shareholders for approval. The information includes the number of shares covered by and the weighted average exercise price of, outstanding options and other rights and the number of shares remaining available for future grants excluding the shares to be issued upon exercise of outstanding options, warrants, and other rights.

Plan Category	(a) Number of Securities to be Issued Upon Exercise of Outstanding Options, Warrants and Rights	(b) Weighted-Average Exercise Price of Outstanding Options, Warrants and Rights	(c) Number of Securities Remaining Available for Future Issuance Under Equity Compensation Plans (Excluding Securities Reflected in Column (a))
Equity compensation plans approved by security holders(1)	1,350,861	$ 4.57	1,675,239
Equity compensation plan not approved by security holders(2)	3,767,481	$ 3.40	

(1) Represents options issued pursuant to the: (i) AdCare Health Systems, Inc. 2011 Stock Incentive Plan, (ii) 2005 Stock Option Plan of AdCare Health Systems, Inc., and (iii) 2004 Stock Option Plan of AdCare Health Systems, Inc., which were all approved by our shareholders.

(2) Represents warrants issued outside of our shareholder approved plans to certain of our executive officers as an inducement to their employment with us and to certain non-employees for services provided by them:

On January 10, 2011, we issued to Boyd Gentry, as an inducement to become our Chief Executive Officer, a ten-year warrant to purchase 250,000 shares of our common stock at an exercise price of $4.13, which vests as to one-third of the underlying shares on the issue date and as to one-third of the underlying shares on each of the successive two anniversaries of the issue date. This warrant is subject to certain anti-dilution adjustments and, therefore, was adjusted on September 30, 2011 and October 22, 2012 for a 5% stock dividend. As a result, the warrant now represents the right to purchase 275,625 shares at an exercise price of $3.75 per share.

On March 31, 2011, we issued to Cantone Research, Inc., as partial consideration for serving as placement agent for the sale of certain promissory notes of the Company, a three-year warrant

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to purchase 250,000 shares of our common stock at an exercise price of $5.30 per share. This warrant is subject to certain anti-dilution adjustments, and, therefore, was adjusted on October 1, 2011 and October 22, 2012 for a 5% stock dividend. As a result, the warrant now represents the right to purchase 275,625 shares at an exercise price of $4.81 per share.

On December 19, 2011, we issued to David Rubenstein, as an inducement to become our Chief Operating Officer: (i) a ten-year warrant to purchase 100,000 shares of our common stock at an exercise price of $4.13 per share and (ii) a ten-year warrant to purchase 100,000 shares of our common stock at an exercise price of $4.97 per share. The first warrant vests as to one-third of the underlying shares on each of the first, second and third anniversaries of the issue date and the second warrant vests as to one-third of the underlying shares on each of the second, third and fourth anniversaries of the issue date. The warrants are subject to certain anti-dilution adjustments, and, therefore, were adjusted on October 22, 2012 for a 5% stock dividend. As a result, the warrants now represent the right to purchase: (i) 105,000 shares at an exercise price of $3.93 per share; and (ii) 105,000 shares at an exercise price of $4.58 per share.

On March 30, 2012, we issued to Cantone Asset Management LLC, as partial consideration for providing certain financing to the Company, a three-year warrant to purchase 300,000 shares of our common stock at an exercise price of $4.00. This warrant is subject to certain anti-dilution adjustments, and, therefore, was adjusted on October 22, 2012 for a 5% stock dividend. As a result, the warrant now represents the right to purchase 315,000 shares at an exercise price of $3.81 per share.

On April 1, 2012, we issued to Strome Alpha Offshore Ltd., as partial consideration for providing certain financing to the Company, a three-year warrant to purchase 312,500 shares of our common stock at an exercise price of $4.00. This warrant is subject to certain anti-dilution, adjustments, and, therefore, was adjusted on October 22, 2012 for a 5% stock dividend. As a result, the warrant now represents the right to purchase 328,125 shares at an exercise price of $3.81 per share.

On July 2, 2012, we issued to Cantone Research, Inc., as partial consideration for serving as placement agent for the sale of certain promissory notes of the Company, a three-year warrant to purchase 100,000 shares of our common stock at an exercise price of $4.00. This warrant is subject to certain anti-dilution adjustments, and, therefore, was adjusted on October 22, 2012 for a 5% stock dividend. As a result, the warrant now represents the right to purchase 105,000 shares at an exercise price of $3.81 per share.

On August 31, 2012, we issued to an investor relations firm, as partial consideration for providing certain investor relations services to the Company, a three-year warrant to purchase 15,000 shares of our common stock at an exercise price of $4.59. This warrant is subject to certain anti-dilution adjustments, and, therefore, was adjusted on October 22, 2012 for a 5% stock dividend. As a result, the warrant now represents the right to purchase 15,750 shares at an exercise price of $4.37 per share.

On October 1, 2012 we agreed to issue to an investor relations firm, as partial consideration for providing certain investor relations services to the Company, three-year warrants to purchase, in the aggregate, 120,000 shares of our common stock at exercise prices ranging from $5.75 to $7.00.

On December 28, 2012, we issued to Strome Alpha Offshore, Ltd., as partial consideration for providing certain financing to the Company, a ten-year warrant to purchase 50,000 shares of our common stock at an exercise price of $3.80. This warrant is subject to certain anti-dilution adjustments.

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Item 6. Selected Financial Data

Disclosure pursuant to Item 6 of Form 10-K is not required to be provided by smaller reporting companies.

Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations

Overview

We own and operate skilled nursing and assisted living facilities in the states of Alabama, Arkansas, Georgia, Missouri, North Carolina, Ohio, Oklahoma, and South Carolina. As of December 31, 2012, through our wholly owned separate operating subsidiaries, we operate 50 facilities comprised of 46 skilled nursing facilities, three assisted living facilities and one independent living/senior housing facility totaling approximately 5,000 beds. Our facilities provide a range of health care services to their patients and residents including, but not limited to, skilled nursing and assisted living services, social services, various therapy services, and other rehabilitative and healthcare services for both long-term residents and short-stay patients. As of December 31, 2012, of the total 50 facilities, we owned and operated 26 facilities, leased and operated 11 facilities, and managed 13 facilities (including one consolidated variable interest entity). As part of our strategy to focus on the growth of skilled nursing facilities, we decided in the fourth quarter of 2011 to exit the home health business; and accordingly, this business is reported as discontinued operations. We sold the assets of the home health business in 2012. Additionally, in the fourth quarter of 2012 we entered into an agreement to sell six assisted living facilities located in Ohio and executed a sublease arrangement to exit the skilled nursing business in Jeffersonville, Georgia. The six Ohio assisted living facilities and the Jeffersonville, Georgia skilled nursing facility have an aggregate of 313 units in service. These seven facilities are also reported as discontinued operations. We sold the assets of four of the six Ohio assisted living facilities in December 2012, one in February 2013, and the other in May 2013.

As further discussed in the footnotes to the Consolidated Financial Statements included in this Annual Report (see Note 20, *Variable Interest Entities*, and Note 22, *Related Party Transactions*), effective August 1, 2011 entities (the "Oklahoma Owners") controlled by Christopher Brogdon (Vice Chairman of the Board of Directors, owner of greater than 10% of the outstanding common stock and former Chief Acquisition Officer of the Company) and his spouse, Connie Brogdon, (related parties to the Company), acquired five skilled nursing facilities located in Oklahoma (the "Oklahoma Facilities"). The Company entered into a Management Agreement with the Oklahoma Owners pursuant to which a wholly-owned subsidiary of the Company supervises the management of the Oklahoma Facilities for a monthly fee equal to 5% of the monthly gross revenues of the Oklahoma Facilities. Upon acquisition, the Company concluded it was the primary beneficiary of the Oklahoma Owners and pursuant to Financial Accounting Standards Board ("FASB") Accounting Standards Codification ("ASC") Topic 810-10, *Consolidation Overall*, consolidated the Oklahoma Owners in its 2011 consolidated financial statements.

During the process of finalizing the 2012 financial statements, the Company reassessed its prior conclusion that it should consolidate the Oklahoma Owners. In the reassessment process, the Company concluded that it should not have consolidated the Oklahoma Owners. The Company has deconsolidated the Oklahoma Owners effective January 1, 2012 and the balance sheet, operations and cash flows of the Oklahoma Owners are not included in the Company's 2012 consolidated financial statements. The Company further concluded that including the Oklahoma Owners in its 2011 financial statements was not material to such consolidated financial statements and therefore no adjustments have been made to the previously issued 2011 financial statements. Note 20, *Variable Interest Entities*, in the Consolidated Financial Statements included in Part II, Item 8., "Financial Statements and Supplementary Data," includes summarized financial statements of the Oklahoma Owners for 2011 that are included in the Company's 2011 consolidated financial statements.

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Liquidity

For the year ended and as of December 31, 2012, we had a net loss of $7.5 million and negative working capital of $5.9 million. At December 31, 2012, we had $15.9 million in cash and cash equivalents and $171.9 million in indebtedness, including current maturities and discontinued operations, of which $23.0 million is current debt (including the Company's outstanding convertible promissory notes with a principal amount in the aggregate of $11.7 million which mature in October 2013 and approximately $3.7 million of mortgage notes included in liabilities of disposal group). Our ability to achieve profitable operations is dependent on continued growth in revenue and controlling costs.

We anticipate that scheduled debt service (excluding outstanding convertible promissory notes but including principal, interest, collateral and capital improvement fund or other escrow deposits) will total approximately $17.2 million and cash outlays for acquisition costs, maintenance capital expenditures, dividends on our Series A Preferred Stock and income taxes will total approximately $4.7 million for the year ending December 31, 2013. Debt service requirements for the year ending December 31, 2013 include approximately $1.9 million of bullet maturities that the Company believes could be refinanced on a longer term basis. In recent periods, we have refinanced shorter term acquisition debt, including seller notes, with traditional longer term mortgage notes, some of which have been executed under government guaranteed lending programs. Although, we anticipate the conversion to common stock of the Company's outstanding convertible promissory notes with a principal amount in the aggregate of $11.7 million which mature in October 2013, we believe that our anticipated cash flow and committed funding sources would allow us to pay these notes in cash. These promissory notes are convertible into shares of common stock of the Company at $3.73 per share. The closing price of the common stock exceeded $4.00 per share from January 1, 2013 through July 5, 2013, except for the last three trading days in March 2013. As discussed further below, if we were required to pay these notes in cash, then the Company may be required to restructure its outstanding indebtedness, implement further cost reduction initiatives, sell assets, or delay, modify, or abandon its expansion plans due to our limited liquidity in such an event.

We estimate that cash flow from operations, including approximately $2.0 million cash outlay for costs with respect to the Audit Committee review and inquiry discussed in Part II, Item 9A. "Controls and Procedures," and other working capital changes will be approximately $17.8 million for the year ending December 31, 2013. The Company expanded its existing credit facility with Gemino Healthcare Finance, LLC ("Gemino"): (i) in May 2013, to refinance and include one of the facilities the Company acquired in December 2012; and (ii) in June 2013, to refinance and include two additional facilities the Company also acquired in December 2012. We routinely have ongoing discussions with existing and potential new lenders to refinance current debt on a longer term basis. We have been successful in recent years in raising new equity capital and believe, based on recent discussions that these markets will continue to be available to us for raising capital in 2013.

Based on existing cash balances, anticipated cash flows for the year ending December 31, 2013, and new sources of capital, we believe there will be sufficient funds for our operations, scheduled debt service, and capital expenditures at least through the next 12 months. On a longer term basis, we have approximately $80.4 million of debt payments and maturities due between 2014 and 2016, excluding convertible promissory notes which are convertible into shares of common stock. We believe our long-term liquidity needs will be satisfied by these same sources, as well as borrowings as required to refinance indebtedness.

In order to satisfy these capital needs, we intend to: (i) improve our operating results by increasing facility occupancy, optimizing our payor mix by increasing the proportion of sub-acute patients within our skilled nursing facilities, continuing our cost optimization and efficiency strategies and acquiring additional long-term care facilities with existing operating cash flow; (ii) expand our borrowing

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arrangements with certain existing lenders; (iii) refinance current debt where possible to obtain more favorable terms; and (iv) raise capital through the issuance of debt or equity securities. We anticipate that these actions, if successful, will provide the opportunity for us to maintain liquidity on a short and long term basis, thereby permitting us to meet our operating and financing obligations for the next 12 months and provide for the continuance of our acquisition strategy. However, there is no guarantee that such actions will be successful or that anticipated operating results will be achieved. We currently have limited borrowing availability under our existing revolving credit facilities. If the Company is unable to improve operating results, expand existing borrowing agreements, refinance current debt, or raise capital through the issuance of securities, or the convertible promissory notes due October 2013 are not converted into common stock and are required to be repaid by us in cash, then the Company may be required to restructure its outstanding indebtedness, implement further cost reduction initiatives, sell assets, or delay, modify, or abandon its expansion plans.

Acquisitions

We have embarked on a strategy to grow our business through acquisitions and leases of senior care facilities and businesses providing services to those facilities. During the year ended December 31, 2012, the Company acquired a total of eleven skilled nursing facilities and one assisted living facility described further below. The total purchase price for each acquisition is after final closing adjustments. The Company has incurred a total of $2.0 million of acquisition costs related to these acquisitions and has recorded the cost in the "Other Income (Expense)" section of the Consolidated Statements of Operations included in Part II, Item 8, "Financial Statements and Supplementary Data."

Eaglewood Care Center and Eaglewood Village

On January 1, 2012, the Company acquired a 113-bed skilled nursing facility located in Springfield, Ohio, known as Eaglewood Care Center, and an 80-bed assisted living facility located in Springfield, Ohio, known as Eaglewood Village. The total purchase price was $12.4 million.

Little Rock, Northridge and Woodland Hills

On April 1, 2012, the Company acquired a 154-bed skilled nursing facility located in Little Rock, Arkansas, known as Little Rock Health & Rehab, a 140-bed skilled nursing facility located in North Little Rock, Arkansas, known as Northridge Healthcare and Rehabilitation, and a 140-bed skilled nursing facility located in Little Rock, Arkansas, known as Woodland Hills Healthcare and Rehabilitation. The total purchase price was $27.2 million.

Abington Place

On April 30, 2012, the Company acquired a 120-bed skilled nursing facility located in Little Rock, Arkansas, known as Abington Place. The total purchase price was $3.6 million after final closing adjustments.

Glenvue Nursing Home

On July 2, 2012, the Company acquired a 160-bed skilled nursing facility located in Glennville, Georgia, known as Glenvue Nursing. The total purchase price was $8.2 million.

Quail Creek Health and Rehab

On July 3, 2012, the Company acquired a 118-bed skilled nursing facility located in Oklahoma City, Oklahoma, known as Quail Creek Health and Rehab. The total purchase price was $6.2 million including assumed fair valued indebtedness of $3.2 million.

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Companions Specialized Care Center

On August 17, 2012, the Company acquired a 121-bed skilled nursing facility located in Tulsa, Oklahoma, known as Companions Specialized Care Center. The total purchase price was $5.9 million.

Sumter Valley Nursing and Rehab

On December 31, 2012, the Company acquired a 96-bed skilled nursing facility located in Sumter, South Carolina, known as Sumter Valley Nursing and Rehab. The total purchase price was $5.6 million.

Georgetown Healthcare and Rehab

On December 31, 2012, the Company acquired an 84-bed skilled nursing facility located in Georgetown, South Carolina, known as Georgetown Healthcare and Rehab. The total purchase price was $4.2 million.

Northwest Nursing Center

On December 31, 2012, the Company acquired an 88-bed skilled nursing facility located in Oklahoma City, Oklahoma, known as Northwest Nursing Center. The total purchase price was $3.0 million.

Segments

Consistent with our strategy to focus on the growth of our skilled nursing facilities and in light of our sale of the majority of our assisted living facilities (the completed sale of four of our assisted living facilities located in Ohio in fourth quarter of 2012), beginning in the fourth quarter of 2012, we only evaluate operating performance for our 46 skilled nursing facilities, our remaining three assisted living facilities and one independent living facility on a combined basis. Through the third quarter of 2012, we previously evaluated our operations under three segments: skilled nursing facilities ("SNF"), assisted living facilities ("ALF"), and Corporate & Other. Accordingly, management discussion and analysis on a segment basis is not included herein.

Primary Performance Indicators

We focus on two primary indicators in evaluating our financial performance. Those indicators are facility occupancy and patient mix. Facility occupancy is important as higher occupancy generally leads to higher revenues. In addition, concentrating on increasing the number of Medicare covered admissions ("the patient mix") helps in increasing revenues. We include commercial insurance covered admissions that are reimbursed at the same level as those covered by Medicare in our Medicare utilization percentages and analysis. We also evaluate "Same Facilities" and "Recently Acquired Facilities" results. Same Facilities represent those owned and leased facilities we began to operate prior to January 1, 2011. Recently Acquired Facilities results represents those owned and leased facilities we began to operate subsequent to January 1, 2012.

The tables below reflect our 2012 and 2011 patient care revenue key performance indicators for our skilled nursing facilities excluding discontinued operations. Excluding discontinued operations, our assisted living facilities represent approximately 2% and 1% of our total consolidated revenues in 2012 and 2011, respectively.

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SNF Average Occupancy

	Year Ended December 31,	
	2012	2011
Same Facilities	85.9%	88.4%
Recently Acquired Facilities	71.2%	78.2%
Total	78.8%	86.0%

We continue our work towards maximizing the number of patients covered by Medicare where our operating margins are higher.

SNF Patient Mix

	Same Facilities	Recently Acquired Facilities	Total	Same Facilities	Recently Acquired Facilities	Total
	2012	2012	2012	2011	2011	2011
Medicare	15.4%	12.7%	14.4%	15.0%	10.6%	14.1%
Medicaid	72.6%	72.6%	72.4%	74.8%	78.9%	75.6%
Other	12.0%	14.7%	13.2%	10.2%	10.5%	10.3%
Total	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%

SNF Analysis by State For the Year Ended December 31, 2012:

State	Operational Beds at Period End	Period's Average Operational Beds	Occupancy (Operational Beds)	Medicare Utilization (Skilled %ADC)	2012 Total Revenues	Medicare (Skilled) $PPD	Medicaid $PPD
Alabama	304	304	79.4%	11.4%	$ 18,341	$ 384.68	$ 178.26
Arkansas	1,009	869	63.3%	13.2%	41,929	389.72	172.79
Georgia	1,514	1,448	87.8%	14.9%	97,957	457.08	155.78
Missouri	80	80	65.4%	17.0%	3,560	407.05	133.34
North Carolina	106	106	83.7%	18.6%	7,353	456.49	160.74
Ohio	293	293	83.7%	15.8%	20,989	461.20	162.91
Oklahoma	318	100	72.6%	13.9%	5,053	432.60	134.85
South Carolina	180						
Total	3,804	3,200	78.8%	14.4%	$ 195,182	$ 436.66	$ 161.57

SNF Analysis by State For the Year Ended December 31, 2011:

State	Operational Beds at Period End	Period's Average Operational Beds	Occupancy (Operational Beds)	Medicare Utilization (Skilled %ADC)	2011 Total Revenues	Medicare (Skilled) $PPD	Medicaid $PPD
Arkansas	498	143	72.2%	14.1%	$ 7,565	$ 388.00	$ 168.35
Alabama	304	304	83.6%	11.1%	18,452	385.54	172.74
Georgia	1,380	1,263	89.6%	14.7%	81,849	477.17	141.72
Missouri	80	13	55.8%	16.9%	512	441.19	119.92
North Carolina	106	106	93.1%	18.6%	7,986	448.88	156.09
Ohio	293	194	83.5%	15.5%	13,670	357.19	154.00
Oklahoma	314	132	73.1%	7.3%	5,103	371.11	123.55
Total	2,975	2,155	86.0%	14.1%	$ 135,137	$ 445.80	$ 148.13

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Medicare reimbursement rates and procedures are subject to change from time to time, which could materially impact our revenues. Medicare reimburses our skilled nursing facilities under PPS for certain inpatient-covered services. Under the PPS, facilities are paid a predetermined amount per patient, per day, based on the anticipated costs of treating patients. The amount to be paid is determined by classifying each patient into a RUG category that is based upon each patient's acuity level. On July 29, 2011, CMS announced a final rule reducing Medicare skilled nursing facility PPS payments in fiscal year 2012 by $3.87 billion, or 11.1% lower than payments for fiscal year 2011. CMS announced it is recalibrating the case-mix indexes ("CMI") for fiscal year 2012 to restore overall payments to their intended levels on a prospective basis. Each RUG group consists of CMIs that reflect a patient's severity of illness and the services that a patient requires in the skilled nursing facility. In transitioning from the previous classification system to the new RUG-IV, CMS adjusted the CMIs for fiscal year 2011 based on forecasted utilization under this new classification system to establish parity in overall payments. The fiscal year 2011 recalibration of the CMIs will result in a reduction to skilled nursing facility payments of $4.47 billion, or 12.6%. However, this reduction would be partially offset by the fiscal year 2012 update to Medicare payments to skilled nursing facilities. The update, a 1.7% or $600 million increase, reflects a 2.7% market basket increase, reduced by a 1.0% multi-factor productivity ("MFP") adjustment mandated by the PPACA. The combined MFP-adjusted market basket increase and the fiscal year 2012 recalibration will yield a net reduction of $3.87 billion, or 11.1%.

Divestitures

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

Total revenues from discontinued operations were $14.3 million and $14.9 million, respectively; in 2012 and 2011. Net income (loss) from discontinued operations was $7.2 million and ($1.2) million, respectively, in 2012 and 2011. Interest expense included in discontinued operations was $0.6 million and $0.8 million in 2012 and 2011, respectively. Income tax benefit included in discontinued operations was ($0.02) million and ($0.2) million in 2012 and 2011, respectively. The 2012 net income from discontinued operations includes a gain on sale of $6.7 million which includes a $6.9 million gain on the sale of four of the six Ohio assisted living facilities sold for $16.1 million in December 2012 and a $0.2 million loss on the exit of the Jeffersonville, Georgia leased business operation. The 2011 net loss from discontinued operations includes a $1.8 million goodwill impairment charge pertaining to the home health segment business.

Critical Accounting Policies

We prepare our financial statements in accordance with accounting principles generally accepted in the United States ("GAAP"). The preparation of these financial statements requires us to make estimates and judgments that affect the reported amount of assets, liabilities, revenues and expenses. We base our estimates on historical experience, business knowledge and on various other assumptions that we believe to be reasonable under the circumstances at the time. Actual results may vary from our

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estimates. These estimates are evaluated by management and revised as circumstances change. We believe that the following represents our critical accounting policies:

Consolidation with Entities in Which We Have Determined to Have a Controlling Financial Interest

Arrangements with other business enterprises are evaluated, and those in which AdCare is determined to have controlling financial interest are consolidated. Guidance is provided by FASB ASC Topic 810-10, *Consolidation Overall,* which 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.

We have evaluated and concluded that as of December 31, 2012, we have one relationship with a variable interest entity in which we have determined that we are the primary beneficiary required to consolidate the entity. See Note 20 to our consolidated financial statements included in Part II, Item 8., "Financial Statements and Supplementary Data."

As further discussed in the footnotes to the Consolidated Financial Statements included in Part II, Item 8., "Financial Statements and Supplementary Data." (see Note 20, Variable Interest Entities, and Note 22, Related Party Transactions), effective August 1, 2011 entities (the "Oklahoma Owners") controlled by Mr. Brogdon and his spouse, Connie Brogdon, (related parties to the Company), acquired five skilled nursing facilities located in Oklahoma (the "Oklahoma Facilities"). The Company entered into a Management Agreement with the Oklahoma Owners pursuant to which a wholly-owned subsidiary of the Company supervises the management of the Oklahoma Facilities for a monthly fee equal to 5% of the monthly gross revenues of the Oklahoma Facilities. Upon acquisition, the Company concluded it was the primary beneficiary of the Oklahoma Owners and pursuant to FAS Topic 810-10, *Consolidation Overall*, consolidated the Oklahoma Owners in its 2011 consolidated financial statements.

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

Revenue Recognition

Our revenue recognition policies involve judgments about Medicare and Medicaid rate calculations. These judgments are based principally upon our experience with these programs and our knowledge of current rules and regulations applicable to these programs. We recognize revenues when services are provided and these amounts are reported at their estimated net realizable amounts. Some Medicare and Medicaid revenues are subject to audit and retroactive adjustment and sometimes retroactive legislative changes.

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Patient Care Receivables

Patient care receivables are reported net of allowances for doubtful accounts. The administrators and managers of our properties evaluate the adequacy of the allowance for doubtful accounts on a monthly basis, and adjustments are made if necessary. Approximately 87% of our revenue in our nursing facilities is derived from Medicare and Medicaid qualifying residents. Charges to these payers are evaluated monthly to insure that revenue is recorded properly and that any adjustments necessitated by our contractual arrangement with these payers are recorded in the month incurred.

Asset Impairment

We evaluate our property and equipment and other long-lived assets, other than goodwill and other indefinite lived intangibles, on an annual basis to determine if facts and circumstances suggest that the assets may be impaired or that the estimated depreciable life of the asset may need to be changed such as significant physical changes in the property, significant adverse changes in general economic conditions, and significant deteriorations of the underlying cash flows or fair values of the property. The need to recognize impairment is based on estimated future cash flows from a property compared to the carrying value of that property. If recognition of impairment is necessary, it is measured as the amount by which the carrying amount of the property exceeds the fair value of the property.

For goodwill and other indefinite lived intangibles, we perform an annual impairment test in the fourth quarter of each year or earlier if there are indications of potential impairment.

Our asset impairment analysis is consistent with the fair value measurements described in ASC Topic 820, *Fair Value Measurements and Disclosures*. We recorded an impairment to goodwill of $1.8 million in 2011 due to our discontinuation of the home health segment. In 2012, the Company recognized impairment charges totaling $0.5 million related to its former corporate office building in Springfield, Ohio and an administrative office building in Rogers, Arkansas. Both of these office buildings are held for sale at December 31, 2012 with the planned sale to occur in 2013.

If our estimates or assumptions with respect to a property change in the future, we may be required to record additional impairment charges for our assets.

Self-Insurance Accruals

As of October 1, 2012, the Company is self-insured for employee medical claims and has a large deductible workers' compensation plan (in all states except for Ohio, where workers' compensation is covered under a premium-only policy provided by the Ohio Bureau of Worker's Compensation, a state funded program required by Ohio's monopolistic workers' compensation system). Determining reserves for healthcare losses and costs that we have incurred as of the end of a reporting period involves significant judgments based upon our experience and our expectations of future events, including projected settlements for pending claims, known incidents which we expect may result in claims, estimates of incurred but not yet reported claims, expected changes in premiums for insurance provided by insurers whose policies provide for retroactive adjustments, estimated litigation costs and other factors. Since these reserves are based on estimates, the actual expenses we incur may differ from the amount reserved. We regularly adjust these estimates to reflect changes in the foregoing factors, our actual claims experience, recommendations from our professional consultants, changes in market conditions and other factors; it is possible that such adjustments may be material.

Business Combinations

The Company follows ASC Topic 805, *Business Combinations ("ASC 805")*, which establishes principles and requirements for how an acquirer recognizes and measures in its financial statements the

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identifiable assets acquired, the liabilities assumed, any non-controlling interest in the acquiree as well as the goodwill acquired or gain recognized in a bargain purchase. The guidance also establishes disclosure requirements to enable the evaluation of the nature and financial effects of the business combination. During 2012, we expensed approximately $2.0 million in acquisition costs related to the transactions discussed in Note 19 of the Consolidated Financial Statements included in Part II, Item 8., "Financial Statements and Supplementary Data." ASC 805 requires that we make certain valuations to determine the fair value of assets acquired and the liabilities assumed. Such valuations require us to make significant estimates, judgments and assumptions, including projections of future events and operating performance.

Stock-Based Compensation

We recognize compensation cost for all share-based payments granted after January 1, 2006 based on various vesting criteria over the requisite service period. We calculate the recognized and unrecognized stock-based compensation using the Black-Scholes-Merton option valuation method, which requires us to use certain key assumptions to develop the fair value estimates. These key assumptions include expected volatility, risk-free interest rate, expected dividends and expected term. During the years ended December 31, 2012 and 2011, we recorded share-based compensation charges for various employee and non-employee services totaling approximately $1.0 million and $1.0 million, respectively. Stock-based compensation expense is a non-cash expense and such amounts are included as a component of general and administrative expenses.

Income Taxes

As required by ASC Topic 740, *Income Taxes ("ASC 740"),* we determine deferred tax assets and liabilities based upon differences between financial reporting and tax bases of assets and liabilities and measure them using the enacted tax laws that will be in effect when the differences are expected to reverse. At December 31, 2012 we maintain a valuation allowance of approximately $8.0 million to reduce the deferred tax assets by the amount we believe is more likely than not to not be utilized through the turnaround of existing temporary differences, future earnings, or a combination thereof. In future periods, we will continue to assess the need for and adequacy of the remaining valuation allowance. We follow the relevant ASC 740 guidance when accounting for uncertainty in income taxes. The guidance provides information and procedures for financial statement recognition and measurement of tax positions taken, or expected to be taken, in tax returns.

Results of Operations

Same and Recently Acquired Facility Patient Care Revenue Analysis:

Amounts in (000's)	Total Patient Care Revenues Year Ended December 31, 2012	2011
Same Facilities	$ 112,811	$ 111,682
Recently Acquired Facilities	86,691	24,910
Total	$ 199,502	$ 136,592

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Continuing Operations:

(Amounts in 000's, except per share data)	Year Ended December 31, 2012	2011	Change	Percent Change
Revenues:				
Patient care revenues	$ 199,502	$ 136,592	$ 62,910	46%
Management revenues	2,156	1,620	536	33%
Total revenues	201,658	138,212	63,446	46%
Expenses:				
Cost of services (exclusive of facility rent, depreciation and amortization)	168,207	111,819	56,888	50%
General and administrative expenses	17,005	13,281	3,724	28%
Facility rent expense	7,689	7,193	496	7%
Depreciation and amortization	6,805	3,359	3,446	103%
Salary retirement and continuation costs	43	1,451	(1,408)	(97)%
Total expenses	199,749	137,103	62,646	46%
Income from Operations	1,909	1,109	800	72%
Other Income (Expense):				
Interest expense, net	(13,224)	(7,381)	(5,843)	(79)%
Acquisition costs, net of gains	(1,962)	(1,163)	(799)	(69)%
Derivative (loss) gain	(1,741)	957	(2,698)	(282)%
Gain (Loss) on extinguishment of debt	500	(141)	641	(455)%
Gain (Loss) on disposal of assets	2	(111)	113	102%
Other income	(124)	551	(675)	(122)%
Total other expense, net	(16,549)	(7,288)	(9,261)	(127)%
Loss from Continuing Operations Before Income Taxes	(14,640)	(6,179)	(8,461)	(137)%
Income tax (expense)	(97)	(215)	118	55%
Loss from Continuing Operations	$ (14,737)	$ (6,394	$ (8,343)	(130)%

Patient Care Revenues Total patient care revenues increased by $62.9 million, or 46.1% from 2011 to 2012, primarily as a result of the facilities acquired in 2012, full year of operations in 2012 for facilities acquired in 2011 and the optimization of resident mix.

Management Revenues Management revenues (net of eliminations) increased by $0.5 million, or 33.1%. In 2011 the management fee charged to the Oklahoma Owners was eliminated in the process of consolidating the Oklahoma Owners as a consolidated variable interest entity. Upon deconsolidation of the Oklahoma Owners in 2012, the management fee is recognized as a third party transaction.

Cost of Services Cost of services increased by $56.4 million, or 50.4%, in 2012 as compared to 2011 primarily from the acquisitions in both years. Cost of services as a percentage of patient care revenue increased slightly from 81.9% in 2011 to 84.3% in 2012. The increase in cost of services as a percentage of patient care revenue is primarily due to the effect in 2012 from the operations of certain 2012 acquired facilities prior to the Company achieving completion of its cost reduction optimization strategy for acquired facilities.

General and Administrative General and administrative costs increased by $3.7 million to $17.0 million in 2012 from $13.3 million in 2011. We increased our corporate overhead structure throughout 2012 in response to the growth needs and opened an accounting service center located in Roswell, Georgia during the second quarter of 2011. As a percentage of revenue, general and administrative costs declined to 8.4% in 2012 compared to 9.5% in 2011 reflecting increased leverage of our fixed costs over the scale of expanding operations from acquisitions.

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Facility Rent Expense Facility rent expenses increased by $0.5 million, or 6.9% from 2011 to 2012. The increase in facility rent expense is due to annual increases in lease rates and the addition of one new leased facility in the fourth quarter of 2011.

Depreciation and Amortization Depreciation and amortization increased $3.4 million in 2012 compared to 2011. The depreciation increase is directly related to acquisition activity that was not included in the 2011 results and the impairment charges of $0.4 million to write down the carrying value of an office building located in Rogers, Arkansas and $0.1 million to reduce the net book value of the Company's former Springfield, Ohio office to net realizable value. In addition, the acquisitions resulted in intangibles that are being amortized during the period.

Salary Retirement and Continuation Costs In 2011, we incurred certain retirement and salary continuation costs of approximately $1.5 million related to separation agreements with prior officers of the Company.

Interest Expense, net Interest expense, net increased $5.8 million, or 79.1% from 2011 to 2012. We have entered into numerous debt instruments in relation to our growth strategy for the acquisition of the facilities which began in the third quarter of 2010.

Acquisition Costs, net of Gains For 2012, acquisition costs were $2.0 million, compared to $1.2 million for 2011. In 2011 we recognized bargain purchase gains of $1.1 million partially offset by $2.3 million of acquisition costs related to the 2011 acquisitions. No bargain purchase gains were recognized in 2012.

Derivative Gain/Loss For 2012, the derivative loss was $1.7 million compared to a gain of $1.0 million in 2011. The derivative is a product of a convertible debt instrument entered into during the third quarter of 2010. The expense associated with the derivative is subject to volatility based on a number of factors including increases or decreases in our stock price. Increases in our stock price generally result in increases in expense. Conversely, a decrease in our stock price generally results in the recognition of a gain in our statements of operations. The expense or gain recognized in a period is based on the fair value of the derivative instrument at the end of the year in comparison to the beginning of the year. The fair value of the derivative instrument was $3.6 million at December 31, 2012 compared to $1.9 million at December 31, 2011.

(Gain) Loss on Debt Extinguishment In March 2011, we issued a promissory note in the amount of $1.4 million. Subsequent to March 31, 2011, we repaid this promissory note. In June 2011, we recorded a loss on debt extinguishment related to a conversion of debt. In August 2011, we refinanced our Southland Care Center resulting in a loss on debt extinguishment. The total loss recognized in 2011 related to the unamortized deferred financing costs written-off upon in these transactions totaled $0.1 million. In 2012, a non-cash gain of $0.6 million was recognized in connection with a litigation settlement.

Other Income/(Expense) For 2012, other income, net was $0.1 million compared to $0.6 million in 2011. In 2011, the collections of receivables purchased in the acquisitions of five leased facilities in 2010 was $0.6 million more than expected resulting in additional income for 2011.

Income Tax Expense Income tax expense in 2012 is comparable to 2011 with a decrease of $0.1 million in income tax expense from 2011 to 2012.

Discontinued Operations:

As part of the Company's strategy to focus on the growth of its skilled nursing segment, the Company decided in the fourth quarter of 2011 to exit the home health segment of the business. The 2011 net loss from discontinued operations of $1.2 million includes a $1.8 million goodwill impairment

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charge pertaining to the home health business. The 2012 net income from discontinued operations of $7.2 million includes a gain on sale of $6.7 million.

Liquidity and Capital Resources

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

For the year ended and as of December 31, 2012, we had a net loss of $7.5 million and negative working capital of $5.9 million. At December 31, 2012, we had $15.9 million in cash and cash equivalents and $171.9 million in indebtedness, including current maturities and discontinued operations, of which $23.0 million is current debt (including the Company's outstanding convertible promissory notes with a principal amount in the aggregate of $11.7 million which mature in October 2013 and approximately $3.7 million of mortgage notes included in liabilities of disposal group). Our ability to achieve profitable operations is dependent on continued growth in revenue and controlling costs.

We anticipate that scheduled debt service (excluding outstanding convertible promissory notes but including principal, interest, collateral and capital improvement fund or other escrow deposits) will total approximately $17.2 million and cash outlays for acquisition costs, maintenance capital expenditures, dividends on our Series A Preferred Stock and income taxes will total approximately $4.7 million for the year ending December 31, 2013. Debt service requirements for the year ending December 31, 2013 include approximately $1.9 million of bullet maturities that the Company believes could be refinanced on a longer term basis. In recent periods, we have refinanced shorter term acquisition debt, including seller notes, with traditional longer term mortgage notes, some of which have been executed under government guaranteed lending programs. Although, we anticipate the conversion to common stock of the Company's outstanding convertible promissory notes with a principal amount in the aggregate of $11.7 million which mature in October 2013, we believe that our anticipated cash flow and committed funding sources would allow us to pay these notes in cash. These promissory notes are convertible into shares of common stock of the Company at $3.73 per share. The closing price of the common stock exceeded $4.00 per share from January 1, 2013 through July 5, 2013, except for the last three trading days in March 2013. As discussed further below, if we were required to pay these notes in cash, then the Company may be required to restructure its outstanding indebtedness, implement further cost reduction initiatives, sell assets, or delay, modify, or abandon its expansion plans due to our limited liquidity in such an event.

We estimate that cash flow from operations, including approximately $2.0 million cash outlay for costs with respect to the Audit Committee review and inquiry discussed in Part II, Item 9A. "Controls and Procedures," and other working capital changes will be approximately $17.8 million for the year ending December 31, 2013. The Company expanded its existing credit facility with Gemino Healthcare Finance, LLC ("Gemino"): (i) in May 2013, to refinance and include one of the facilities the Company acquired in December 2012; and (ii) in June 2013, to refinance and include two additional facilities the Company also acquired in December 2012. We routinely have ongoing discussions with existing and potential new lenders to refinance current debt on a longer term basis. We have been successful in recent years in raising new equity capital and believe, based on recent discussions that these markets will continue to be available to us for raising capital in 2013.

Based on existing cash balances, anticipated cash flows for the year ending December 31, 2013, and new sources of capital, we believe there will be sufficient funds for our operations, scheduled debt service, and capital expenditures at least through the next 12 months. On a longer term basis, we have approximately $80.4 million of debt payments and maturities due between 2014 and 2016, excluding convertible promissory notes which are convertible into shares of common stock. We believe our

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long-term liquidity needs will be satisfied by these same sources, as well as borrowings as required to refinance indebtedness.

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

The following table presents selected data from our consolidated statement of cash flows for the periods presented:

	Year Ended December 31,	
Amounts in (000's)	**2012**	**2011**
Net cash provided by operating activities continuing operations	$ 1,124	$ 542
Net cash provided by operating activities discontinued operations	403	1,450
Net cash used in investing activities continuing operations	(70,853)	(60,772)
Net cash provided by (used in) investing activities discontinued operations	11,691	(218)
Net cash provided by financing activities continuing operations	72,609	62,722
Net cash used in financing activities discontinued operations	(6,221)	(271)
Net change in cash and cash equivalents	8,753	3,453
Cash and cash equivalents at beginning of period	7,364	3,911
Cash decrease due to deconsolidation of variable interest entity	(180)	
Cash and cash equivalents at end of period	$ 15,937	$ 7,364

Year Ended December 31, 2012

Net cash provided by operating activities continuing operations for the year ended December 31, 2012, was approximately $1.1 million consisting primarily of our income from operations less changes in working capital, and noncash charges (primarily depreciation and amortization, the derivative loss, share-based compensation, difference between straight-line rent and rent paid, and amortization of debt discounts and related deferred financing costs); all primarily the result of routine operating activity. The net cash provided by operating activities discontinued operations was approximately $0.4 million.

Net cash used in investing activities continuing operations for the year ended December 31, 2012, was approximately $70.9 million. This is primarily the result of funding our acquisitions, including making escrow deposits as well as capital expenditures throughout the facilities and new computer

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software. Net cash provided by investing activities discontinued operations was approximately $11.7 million.

Net cash provided by financing activities continuing operations was approximately $72.6 million for the year ended December 31, 2012. This is primarily the result of cash proceeds received from warrant exercises, increases in borrowings on the line of credit, and proceeds from debt financings to fund our acquisitions, partially offset by repayments of existing debt obligations. Net cash used in financing activities discontinued operations was approximately $6.2 million consisting of repayments of existing debt obligations.

Year Ended December 31, 2011

Net cash provided by operating activities continuing operations for the year ended December 31, 2011, was $0.5 million consisting primarily of our income from operations less changes in working capital, and noncash charges (primarily depreciation and amortization, the derivative loss, share-based compensation, difference between straight-line rent and rent paid, and amortization of debt discounts and related deferred financing costs); all primarily the result of routine operating activity. The net cash provided by operating activities discontinued operations was approximately $1.4 million.

Net cash used in investing activities continuing operations for the year ended December 31, 2011, was approximately $60.8 million. This is primarily the result of funding our acquisitions, including making escrow deposits as well as capital expenditures throughout the facilities and new computer software. Net cash used in investing activities discontinued operations was approximately $0.2 million for the year ended December 31, 2011.

Net cash provided by financing activities continuing operations was approximately $62.7 million for the year ended December 31, 2011. This is primarily the result of cash proceeds received from warrant exercises, increases in borrowings on the line of credit, and proceeds from debt financings to fund our acquisitions, partially offset by repayments of existing debt obligations. Net cash used in financing activities discontinued operations was approximately $0.3 million consisting of repayments of existing debt obligations.

Total notes payable and other debt obligations as of December 31, 2012 and 2011 were as follows:

	December 31,	
Amounts in (000's)	**2012**	**2011**
Revolving credit facilities and lines of credit	$ 9,204	$ 8,651
Senior debt guaranteed by HUD	9,699	15,738
Senior debt guaranteed by USDA	28,370	38,717
Senior debt guaranteed by SBA	6,189	5,087
Senior debt bonds, net of discount	16,265	6,176
Senior debt other mortgage indebtedness	75,188	24,063
Other debt	4,004	4,196
Convertible debt issued in 2010, net of discount	10,948	10,105
Convertible debt issued in 2011	4,509	4,509
Convertible debt issued in 2012	7,500	
Total	171,876	117,242
Less current portion	19,387	11,909
Less portion included in liabilities of disposal group held for sale	3,662	240
Notes payable and other debt, net of current portion	$ 148,827	$ 105,093

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Scheduled Maturities

The schedule below summarizes the scheduled maturities as of December 31, 2012 for each of the next five years and thereafter. The 2013 maturities include $3.7 million related to the Vandalia HUD mortgage note classified as liabilities of disposal group held for sale at December 31, 2012 that was assumed by the buyer of the Hearth & Home of Vandalia assisted living facility that the Company sold in a transaction that closed in May 2013 (see Note 3 and Note 23 to our Consolidated Financial Statements included in Part II, Item 8., "Financial Statements and Supplementary Data.").

	Amounts in (000's)
2013	$ 23,661
2014	20,561
2015	30,888
2016	41,000
2017	3,750
Thereafter	52,789
Subtotal	172,649
Less: unamortized discounts ($702 classified as current)	(1,131)
Plus: unamortized premiums ($90 classified as current)	358
Total notes and other debt	$ 171,876

Gemino Credit Facility

On September 20, 2012, AdCare terminated and paid off all amounts outstanding under that certain Credit Agreement, dated October 29, 2010, between Gemino and AdCare (the "Gemino Credit Facility"). The Gemino Credit Facility was a secured credit facility for borrowings up to $7.5 million, which was to mature on October 29, 2013. As of September 20, 2012, the amount outstanding in principal balance was approximately $4.2 million which was paid from funds made available to AdCare from a new credit facility entered into with The PrivateBank and Trust Company ("PrivateBank"). Interest accrued on the principal balance outstanding of the Gemino Credit Facility at an annual rate equal to LIBOR rate plus the applicable margin of 4.75% to 5.00%, depending on the principal amount outstanding. The Gemino Credit Facility contained various financial covenants and other restrictions, including a fixed charge cover ratio and maximum loan turn days, as well as borrowing base restrictions. No material early termination penalties were incurred by AdCare as a result of the termination.

At December 31, 2011, the outstanding balance of approximately $7.3 million for the Gemino Credit Facility was classified as current as a result of the required lockbox arrangement and subjective acceleration clauses.

Gemino-Bonterra Amendment

On September 20, 2012, ADK Bonterra/Parkview, LLC, a wholly owned subsidiary of AdCare ("Bonterra") entered into a Second Amendment to the Credit Agreement with Gemino ("Gemino-Bonterra Credit Facility"), which amended the original Credit Agreement dated April 27, 2011 between Bonterra and Gemino. The Gemino-Bonterra Credit Facility is a secured credit facility for borrowings up to $2.0 million. The amendment extends the term of the Gemino-Bonterra Credit Facility from October 29, 2013 to January 31, 2014 and amends certain financial covenants regarding Bonterra's fixed charge coverage ratio, maximum loan turn days and applicable margin. Interest accrues on the principal balance outstanding at an annual rate equal to the LIBOR rate plus the applicable margin of 4.75% to 5.00%, which fluctuates depending upon the principal amount outstanding. As of December 31, 2012, $1.3 million was outstanding under the Gemino-Bonterra Credit Facility.

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On December 20, 2012, Bonterra entered into a Third Amendment to the Credit Agreement with Gemino, which amended the original Credit Agreement, dated April 27, 2011, between Bonterra and Gemino. The Third Amendment altered the financial covenant in the original credit agreement to exclude the Oklahoma Owners under another credit agreement with Gemino from the covenant calculation of maximum loan turn days and acknowledges that Bonterra shall not be obligated, directly or indirectly, for any indebtedness or obligations of the Oklahoma Owners to Gemino.

PrivateBank Credit Facility

On September 20, 2012, in connection with the payoff of the Gemino Credit Agreement noted above, AdCare entered into a Loan and Security Agreement with PrivateBank ("PrivateBank Credit Facility"). Under the terms of the PrivateBank Credit Facility, PrivateBank provides $10.6 million principal amount for a three-year period on senior secured revolving credit facility limited to borrowing base restrictions and offset by a $0.7 million standby letter of credit at December 31, 2012, increasing to $2.5 million at July 31, 2013.

The PrivateBank Credit Facility matures on December 31, 2016. Interest is accrued on the principal balance at an annual rate of the greater of (i) 1% plus the prime interest rate per annum, or (ii) 5% per annum. Payments for the interest are due monthly and commenced on October 1, 2012. In addition, there is a non-utilization fee of 0.5% on the unused portion of the available credit. The PrivateBank Credit Facility may be prepaid at any time without premium or penalty, provided that such prepayment is accompanied by a simultaneous payment of all accrued and unpaid interest, through the date of prepayment. The PrivateBank Credit Facility is secured by a first priority security interest in the real property and improvements constituting nursing facilities owned and operated by AdCare. AdCare has unconditionally guaranteed all amounts owed to PrivateBank under the PrivateBank Credit Facility.

Proceeds from the PrivateBank Credit Facility were used to pay off all amounts outstanding under a separate $2.0 million credit facility with PrivateBank under which certain subsidiaries of AdCare were borrowers, and the Gemino Credit Facility.

On October 26, 2012, the Company and certain of its wholly owned subsidiaries, on the one hand, and PrivateBank entered into a Modification Agreement which amends the PrivateBank Credit Facility, dated as of September 20, 2012, between certain of the Company's wholly owned subsidiaries and PrivateBank. The Modification Agreement amends the loan agreement to: (i) allow PrivateBank to issue additional letters of credit for the account of the borrowers under the loan agreement; and (ii) change the total amount that may be issued under any letters of credit to $2.5 million. The modification agreement did not change the maximum amount that may be borrowed under the loan agreement by the borrowers, which remains at $10.6 million. As of December 31, 2012, $7.7 million was outstanding under the PrivateBank Credit Facility.

Contemporary Healthcare Senior

On August 17, 2012 in conjunction with the acquisition of Companions Specialized Care Center in Tulsa, OK, two wholly owned subsidiaries of the Company entered into a Loan Agreement with Contemporary Healthcare Senior ("Contemporary") and issued a promissory note in favor of Contemporary for a principal amount of $600,000 ("Contemporary $600,000 Loan"). The Contemporary $600,000 Loan matures on August 20, 2015 and interest accrues on the principal balance at an annual rate of 9.0%. Payments for the interest and a portion of the principal in excess of the borrowing base are payable monthly, commencing on September 20, 2012. As of December 31, 2012, $0.2 million was outstanding under the Contemporary $600,000 Loan.

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Senior Debt Guaranteed by HUD

Hearth and Home of Vandalia

In connection with the Company's January 2012 refinancing of the assisted living facility known as Hearth and Home of Vandalia, owned by a wholly owned subsidiary of AdCare, the Company obtained a term loan, insured by U.S. Department of Housing and Urban Development ("HUD"), with a financial institution for a total amount of $3.7 million that matures in 2041. The HUD term loan requires monthly principal and interest payments with a fixed interest rate of 3.74%. Deferred financing costs incurred on the term loan amounted to $0.2 million and are being amortized to interest expense over the life of the loan. The HUD term loan has a prepayment penalty of 8% starting in 2014 declining by 1% each year through 2022. This mortgage note was assumed by the buyer in the closing of the sale of this facility that occurred in May 2013 pursuant to the terms of the sale agreement related to the sale of six of the Company's assisted living facilities located in Ohio (see Note 3 to our Consolidated Financial Statements included in Part II, Item 8., "Financial Statements and Supplementary Data.").

Other Senior Debt Guaranteed by HUD

For three facilities, the Company has term loans insured by HUD a financial institution that totaled approximately $6.0 million at December 31, 2012. The combined HUD mortgage notes require monthly principal and interest payments of approximately $45,000 with fixed interest rates ranging from 5.95% to 7.25%. The notes mature at various dates starting in 2027 through 2038. Deferred financing costs incurred on these loans amounted to approximately $0.3 million and are being amortized to interest expense over the life of the notes. The loans have prepayment penalties of 3.5% to 6% through 2013 declining by 1% each year through 2022. The loans have certain restrictive covenants and HUD regulatory compliance requirements including maintenance of certain restricted escrow deposits and reserves for replacement.

Sale of Ohio ALFs

On December 28, 2012, AdCare sold four of its assisted living facilities located in Ohio and used a portion of the funds to pay off the principal balance of their HUD loans in the amount of $6.4 million. On February 28, 2013, AdCare completed the sale of one additional assisted living facility and used the proceeds to repay the principal balance of the HUD loan with respect to the facility in the amount of $1.9 million (see Note 23 to our Consolidated Financial Statements included in Part II, Item 8., "Financial Statements and Supplementary Data.").

Senior Debt Guaranteed by USDA

For five facilities, the Company has term loans insured 70% to 80% by the USDA with financial institutions that totaled approximately $28.4 million at December 31, 2012. The combined USDA mortgage notes require monthly principal and interest payments of approximately $0.2 million adjusted quarterly with a variable interest rate of prime plus 1.0% to 1.75% with a floor of 5.50% to 6.00%. The notes mature at various dates starting in 2035 through 2036. Deferred financing costs incurred on these loans amounted to approximately $0.8 million and are being amortized to interest expense over the life of the notes. In addition, the loans have an annual renewal fee for the USDA guarantee of 0.25% of the guaranteed portion. The loans have prepayment penalties of 8% to 9% through 2013 declining by 1% each year capped at 1% for the remainder of the term.

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Senior Debt Guaranteed by SBA

Stone County

In June 2012, Mt. V Property Holdings, LLC. ("Stone County"), a wholly owned subsidiary of AdCare, entered into a loan agreement with the Economic Development Corporation of Fulton County (the "CDC"), an economic development corporation working with the SBA, in the amount of $1.3 million. The funding from the CDC loan of $1.3 million was used to satisfy a $1.3 million Metro City Bank loan that was used to acquire the assets of a skilled nursing facility located in Arkansas known as the Stone County Nursing and Rehabilitation facility.

The CDC loan matures in July 2032 and accrues interest at a rate of 2.42% per annum. The CDC loan is payable in equal monthly installments of principal and interest based on a twenty (20) year amortization schedule. The CDC loan may be prepaid, subject to prepayment premiums, during the first 10 years. There are also annual fees associated with the CDC loan, including an SBA guarantee fee. The CDC loan is secured by a second in priority security deed on the Stone County Nursing and Rehabilitation facility and guarantees from AdCare, the SBA and a wholly owned subsidiary of AdCare. As of December 31, 2012, $1.3 million was outstanding under the CDC loan.

Other Senior Debt Guaranteed by SBA

For three facilities, the Company has term loans insured 75% by the SBA with a financial institution that totaled approximately $4.9 million at December 31, 2012. The combined SBA mortgage notes require monthly principal and interest payments of approximately $28,000 with an interest rate of 2.42% to 5.5%. The notes mature at various dates starting in 2031 through 2036. Deferred financing costs incurred on these loans amounted to approximately $0.2 million and are being amortized to interest expense over the life of the note. In addition, the loans have an annual renewal fee for the SBA guarantee of 0.13% to 0.25% of the guaranteed portion. The loans have prepayment penalties ranging from 2.48% to 3.0% declining each year until year 10.

Senior Debt Bonds, net of Discount

Eaglewood Village Bonds

In April 2012, a wholly owned subsidiary of AdCare entered into a loan agreement with the City of Springfield in the State of Ohio pursuant to which City of Springfield lent to such subsidiary the proceeds from the sale of City of Springfield's Series 2012 Bonds. The Series 2012 Bonds consist of $6.6 million in Series 2012A First Mortgage Revenue Bonds and $0.6 million in Taxable Series 2012B First Mortgage Revenue Bonds. The Series 2012 Bonds were issued pursuant to an April 2012 Indenture of Trust between the City of Springfield and the Bank of Oklahoma. The Series 2012A Bonds mature in May 2042 and accrue interest at a fixed rate of 7.65% per annum. The Series 2012B Bonds mature in May 2021 and accrue interest at a fixed rate of 8.5% per annum. Deferred financing costs incurred on the loan amounted to $0.6 million and are being amortized to interest expense over the life of the loan. The loan is secured by the Company's assisted living facility located in Springfield, Ohio known as Eaglewood Village and guaranteed by AdCare. There is an original issue discount of $0.3 million and restricted assets of $0.3 million related to this loan. As of December 31, 2012, $6.6 million was outstanding under the Series 2012A First Mortgage Revenue Bonds and $0.6 million was outstanding under the Taxable Series 2012B First Mortgage Revenue Bonds. The unamortized discount on the bonds was $0.2 million at December 31 2012.

Quail Creek

In July 2012, a wholly owned subsidiary of AdCare financed the purchase of a skilled nursing facility located in Oklahoma City, Oklahoma known as Quail Creek Nursing by the assumption of existing indebtedness under that certain Loan Agreement and Indenture of First Mortgage with The

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Bank of New York Mellon Global Corporate Trust, as assignee of The Liberty National Bank and Trust of that certain Bond Indenture, dated September 1, 1986, as amended as of September 1, 2001. The indebtedness under the Loan Agreement and Indenture consists of a principal amount of $2.8 million. In July of 2012, the purchase price allocation of fair value totaling $3.2 million was assigned to this indebtedness resulting in a $0.4 million premium that is being amortized to maturity. The loan matures in August 2016 and accrues interest at a fixed rate of 10.25% per annum. The loan is secured by the Quail Creek facility.

As of December 31, 2012, $2.8 million was outstanding under the Loan Agreement. The unamortized premium on the bonds was $0.4 million at December 31 2012.

Riverchase

The Company's consolidated variable interest entity, Riverchase Village ADK, LLC ("Riverchase"), has revenue bonds, in two series, issued by the Medical Clinical Board of the City of Hoover in the state of Alabama which the Company has guaranteed the obligation under the bonds.

The Series 2010A portion of $5.8 million matures on June 1, 2039. The Series 2010B portion of $0.5 million matures serially beginning on June 1, 2012 through June 1, 2017, with annual redemption amounts ranging from $75,000 to $100,000. The Series 2010A and 2010B bonds may be redeemed early beginning on June 1, 2012 through May 31, 2015 at a redemption price ranging from 101% to 103% of the principal amount plus accrued interest. Any early redemption after May 31, 2015 is at a redemption price of 100% of the principal amount plus accrued interest. The bonds require monthly payments of fixed interest of $38,000 at a weighted average effective interest rate of 7.9%.

As of December 31, 2012, $5.8 million was outstanding under the Series 2010A portion and $0.5 million was outstanding under the Series 2010 B portion of the bonds. The bonds contain an original issue discount that is being amortized over the term of the notes. The unamortized discount on the bonds was $0.2 million at December 31 2012.

Senior Debt Other Mortgage Indebtedness

Woodland Manor

In connection with the Company's January 2012 acquisition of the skilled nursing facility known as Woodland Manor, the Company entered into a loan agreement for $4.8 million with PrivateBank. The loan matures in December 2016 with a required final payment of $4.3 million and accrues interest at the LIBOR rate plus 4% with a minimum rate of 6% per annum. The loan requires monthly payments of principal and interest. Deferred financing costs incurred on the loan amounted to $0.1 million and are being amortized to interest expense over the life of the loan. The loan has a prepayment penalty of 5% through 2012 declining by 1% each year through 2015. The loan is secured by the Woodland Manor facility and guaranteed by AdCare. As of December 31, 2012, $4.7 million was outstanding under loan agreement.

Little Rock, Northridge and Woodland Hills

In connection with the Company's April 2012 acquisition of three skilled nursing facilities located in Arkansas known as Little Rock, Northridge and Woodland Hills, the Company entered into a loan agreement for $21.8 million with PrivateBank. The loan originally matured in March 2017 with a required final payment of $19.7 million and has since been amended. The loan accrues interest at the LIBOR rate plus 4% with a minimum rate of 6% per annum and requires monthly principal payments plus interest for total current monthly payments of $0.2 million. Deferred financing costs incurred on the loan amounted to $0.4 million and are being amortized to interest expense over the life of the loan. The loan has a prepayment penalty of 5% through 2012 declining by 1% each year through 2015. The

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loan is secured by the three facilities and guaranteed by AdCare. The Company has $1.8 million of restricted assets related to this loan.

On June 15, 2012, the Company entered into a modification agreement with PrivateBank to modify the terms of the loan agreement. The loan modification agreement, among other things, amended the loan agreement to reflect a maturity date of March 30, 2013.

A portion of the PrivateBank loan with respect to the Northridge facility and Woodland Hills facility was paid off and refinanced with a portion of the proceeds from a new credit facility with KeyBank National Association ("KeyBank") on December 28, 2012, as discussed below. On December 28, 2012, certain subsidiaries of the Company entered into a Second Modification Agreement with PrivateBank which modified the loan agreement. The modification, among other things, extends the term of the PrivateBank loan from March 30, 2013 to December 31, 2016; releases certain subsidiaries of the Company related to the Northridge facility and Woodland Hills facility from liability under two of the promissory notes and other related documents under the credit facility; and reduces the total outstanding amount owed under the credit facility from $21.8 million to $13.7 million. As of December 31, 2012, $13.7 million was outstanding under loan agreement.

Abington Place Metro City Bank

In connection with the Company's June 2012 acquisition of the skilled nursing facility located in Little Rock, Arkansas known as Abington Place, a wholly owned subsidiary of AdCare, entered into a short-term loan agreement for $3.4 million with Metro City Bank. In August 2012, the maturity date was extended from September 2012 to January 2014. The note accrues interest at the prime rate plus 2.25% with a minimum rate of 6.25% per annum. Deferred financing costs incurred on the loan amounted to $0.1 million and are amortized to interest expense over the life of the loan. The loan was secured by the Abington Place facility and guaranteed by AdCare.

The Abington Metro City Bank loan was paid off and refinanced with Key Bank on December 28, 2012 as discussed below.

Stone County

In June 2012, Mt. V Property Holdings, LLC ("Stone County"), a wholly owned subsidiary of AdCare, entered into two loan agreements with Metro City Bank in the amounts of $1.3 million and $1.8 million. The purpose of these agreements was to refinance existing debt in the original principal amount of $3.1 million used to acquire the assets of a skilled nursing facility located in Arkansas known as the Stone County Nursing and Rehabilitation facility.

The $1.3 million loan from Metro City Bank was repaid with the funding from the CDC loan of $1.3 million. The $1.8 million Metro City Bank loan matures in June 2022 and accrues interest at the prime rate plus 2.25% with a minimum rate of 6.25% per annum. Deferred financing costs incurred on this loan amounted to $0.1 million and are being amortized to interest expense over the life of the loan. The Metro City Bank loan has a prepayment penalty of 10% for any prepayment through June 2013. The penalty is reduced by 1% each year until the loan maturity date. The Metro City Bank loan is secured by the Stone County Nursing and Rehabilitation facility and is guaranteed by AdCare. As of December 31, 2012, $1.8 million was outstanding under the Metro City Bank loan.

Glenvue

In July 2012, Glenvue Health & Rehabilitation, a wholly owned subsidiary of AdCare, financed the acquisition of a skilled nursing facility located in Glennville, Georgia, by entering into a loan agreement for $6.6 million with PrivateBank. The loan matures in July 2014 with a required final payment of $6.4 million and accrues interest at an annual rate of the greater of (i) 6.0% per annum; or (ii) the

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LIBOR rate plus 4.0% per annum. The loan requires monthly payments of principal and interest. Deferred financing costs incurred on the loan amounted to $0.1 million and are being amortized to interest expense over the life of the loan. The loan is secured by the Glenvue facility and guaranteed by AdCare. As of December 31, 2012, $6.5 million was outstanding under the loan.

Companions Specialized Care

In August 2012, a wholly owned subsidiary of AdCare, financed the acquisition of a skilled nursing facility located in Tulsa, Oklahoma, known as Companions Specialized Care Center, by entering into a loan agreement for $5.0 million with Contemporary Healthcare Capital. The loan matures in August 2015 with a required final payment of $5.0 million and accrues interest at a fixed rate of 8.5% per annum. Deferred financing costs incurred on the loan amounted to $0.2 million and are being amortized to interest expense over the life of the loan. The loan has a prepayment penalty of 5% during the first year of the term and 1% during the second year of the term. The loan is secured by the Companions Specialized Care facility and guaranteed by AdCare. As of December 31, 2012, $5.0 million was outstanding under the loan.

Northridge, Woodland Hills and Abington

On December 28, 2012, the Company's wholly owned subsidiaries which own the Northridge, Woodland Hills and Abington facilities entered into a Secured Loan Agreement with the KeyBank National Association (the "KeyBank Credit Facility"). The KeyBank Credit Facility provides for a $16.5 million principal amount senior secured credit facility and matures on February 27, 2015; provided, however, that the KeyBank Borrowers may extend the maturity date by an additional six months if certain conditions are met. Interest on the KeyBank Credit Facility accrues on the principal balance thereof at an annual rate of 4.25% plus the current LIBOR rate. The KeyBank Credit Facility may be prepaid at any time without premium or penalty, provided that the KeyBank Borrowers pay any costs of KeyBank in re-employing such prepaid funds. AdCare Health Systems, Inc., AdCare Property Holdings, LLC, and AdCare Operations, LLC. have unconditionally guaranteed all amounts owing under the KeyBank Credit Facility.

Proceeds from the KeyBank Credit Facility were used to pay off all amounts outstanding under an unsecured promissory note, dated April 1, 2012, issued by the Company in favor of Strome Alpha Offshore Ltd. in the amount of $5.0 million; payoff of an existing credit facility with Metro City Bank with respect to the Abington facility in the amount of $3.4 million; and payoff of the portion of the PrivateBank Credit Facility which relates to the Northridge and Woodland Hills in the amount of $8.1 million. As of December 31, 2012, $16.5 million was outstanding under the KeyBank Credit Facility.

Sumter Valley and Georgetown

In connection with the closing of the Sumter and Georgetown facilities acquisition, two wholly owned subsidiaries of AdCare Sumter Valley Property Holdings, LLC and Georgetown HC&R Property Holdings, LLC entered into a Loan Agreement with Metro City Bank, dated December 31, 2012 in which Metro City Bank issued a promissory note for an aggregate principal amount of $7.0 million (the "Metro City Bank Loan"). The Metro City Bank Loan matures on February 1, 2014. Interest on the loan accrues on the principal balance thereof at an annual rate of 1.5% per annum plus the prime interest rate, to be adjusted quarterly (but in no event shall the total interest be less than 5.50% per annum), and payments for the interest are payable monthly, commencing on February 1, 2013. The entire outstanding principal balance of the loan, together with all accrued but unpaid interest thereon, is payable on February 1, 2014. AdCare and certain of its subsidiaries have unconditionally guaranteed all amounts owing under the Metro City Bank Loan. As of December 31, 2012, $7.0 million was outstanding under the Metro City Bank Loan.

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Northwest

In connection with the acquisition of the Northwest Nursing Center facility, a wholly owned subsidiary of AdCare, issued a note pursuant to a Loan Agreement with First Commercial Bank, dated December 31, 2012, for a principal amount of $1.5 million. The note matures on December 31, 2017. Interest on the note accrues on the principal balance thereof at an annual rate equal to the prime interest rate (but in no event shall the interest rate be less than 5.00% per annum), and payments for the interest are payable monthly, commencing on January 31, 2013. The entire outstanding principal balance of the note, together with all accrued but unpaid interest thereon, is payable on December 31, 2017. AdCare and certain subsidiaries of the Company have unconditionally guaranteed all amounts owing under the note. As of December 31, 2012, $1.5 million was outstanding under the loan.

Hembree Road Building

In November 2012, in connection with the acquisition of AdCare's corporate offices at Hembree Road, Roswell, Georgia, a wholly owned subsidiary of AdCare issued a promissory note in favor of Fidelity Bank for a principal amount of $1.1 million. The note matures in December 2017. Interest on the note accrues on the principal balance thereof at a fixed rate of 5.5% per annum and payments for the interest and principal are due monthly, commencing in December 2012. The entire outstanding principal balance of the note, together with all accrued but unpaid interest thereon, is payable on December 31, 2017. As of December 31, 2012, $1.0 million was outstanding under the loan.

Senior Debt Other Mortgage Indebtedness

For five facilities the Company has obtained various term loans that totaled approximately $17.3 million at December 31, 2012. The combined mortgage notes require monthly principal and interest payments of approximately $0.1 million with interest rates of 6.00% to 6.25%. The notes mature at various dates starting in 2016 through 2031. Deferred financing costs incurred on these loans amounted to approximately $0.5 million and are being amortized to interest expense over the life of the notes.

The remaining mortgage note balance is related to the financing on the Company's former corporate headquarters in Springfield, Ohio with a balance of approximately $0.2 million at December 31, 2012. The mortgage requires fixed monthly payments of approximately $3,000 plus interest at LIBOR plus 3.00% maturing in 2017. The building was sold in June 2013 and the mortgage was paid.

Other Debt

Eaglewood Village Promissory Note

In January 2012, two wholly owned subsidiaries of AdCare issued a promissory note to the seller in the amount of $0.5 million in connection with the January 2012 acquisition of the assisted living facility located in Springfield, Ohio. The note matures in January 2014 and requires a final payment of $0.5 million. The note bears interest at 6.5% per annum payable monthly beginning in February 2012. The note requires monthly principal and interest payment. The note may be prepaid without penalty at any time.

Cantone Promissory Notes

In March 2012, AdCare issued an unsecured promissory note to Cantone Asset Management LLC in the amount of $3.5 million. In April 2012, AdCare issued another promissory note to Cantone Asset Management LLC in the amount of $1.5 million. In July 2012, these two promissory notes were refinanced through the issuance to Cantone Asset Management LLC of an 8% subordinated convertible note in the principal amount of $5.0 million.

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The $5.0 million of promissory notes issued to Cantone Asset Management LLC was refinanced as part of the $7.5 million in subordinated convertible promissory notes issued in July 2012 that is discussed below.

Strome Note

In April 2012, AdCare issued an unsecured promissory note in the amount of $5.0 million to Strome Alpha Offshore Ltd. The promissory note matured in November 2012, and the Company paid off the promissory note on December 28, 2012, using the proceeds from the KeyBank Credit Facility discussed in Note 9 to our Consolidated Financial Statements included in this Annual Report. Interest accrued on the promissory note at a fixed rate of 10% per annum.

Sumter Valley Promissory Note

In connection with the acquisition of the facility known as Sumter Valley Nursing and Rehab in December 2012, a subsidiary of AdCare issued a promissory note to the seller of the facility in the amount of $0.3 million. Interest on the note accrues at a rate of 6% per annum. Principal and interest payments on the note shall be due and payable monthly, beginning on February 1, 2013, with a final payment due on the earlier of December 31, 2014, or the date upon which the Company refinances its loan relating to the Sumter facility. AdCare has unconditionally guaranteed all amounts owed under the note. At December 31, 2012, $0.2 million remained outstanding on this promissory note.

Georgetown Promissory Note

In connection with the acquisition of the facility known as Georgetown Healthcare and Rehab in December 2012, a subsidiary of AdCare issued a secured subordinated promissory note to the seller of the Georgetown facility in the amount of $1.9 million. Interest on the note accrues at a rate of 7% per annum. Interest payments on the note shall be due and payable monthly, beginning on February 1, 2013, with a final payment due on the earlier of December 31, 2013; or the date upon which the Company refinances its loan with Metro City Bank relating to the Georgetown Healthcare and Rehab Facility. AdCare has unconditionally guaranteed all amounts owing under the note.

Pinnacle Healthcare Promissory Notes

The Company previously issued promissory notes in the aggregate principal amount of $2.4 million. The notes mature March 1, 2014, and bear interest at 7% payable quarterly in arrears the first day of each December, March, June and September beginning December 1, 2011. The notes are subject to mandatory prepayment in the aggregate principal amount of $250,000 on each of March 1, 2013, June 1, 2013, September 1, 2013 and December 1, 2013 and a final payment of $150,000 on March 1, 2014. The notes may also be prepaid without penalty at any time. At December 31, 2012, $1.2 million remained outstanding.

Mountain Trace Promissory Notes

Mountain Trace ADK, LLC, a wholly owned subsidiary of AdCare, previously issued promissory notes in the aggregate principal amount of $1,000,000. The notes mature April 1, 2013, and bear interest at 11% payable quarterly in arrears the first day of each January, April, July and October beginning July 1, 2011. The notes may also be prepaid without penalty by providing fifteen days prior notice. The Company received proceeds of $0.9 million net of legal and other financing costs. At December 31, 2012, $0.2 million remained outstanding.

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Convertible Debt

Subordinated Convertible Notes Issued in 2010

On October 26, 2010, the Company entered into a Securities Purchase Agreement with certain accredited investors to sell and issue to the Purchasers an aggregate of $11.1 million in principal amount of the Company's Subordinated Convertible Notes, bearing 10% interest per annum payable quarterly in cash in arrears beginning December 31, 2010.

On October 29, 2010, the Company entered into an amendment and joinder agreement to effectuate the sale of an additional $0.8 million in principal amount of Notes. The initial sale of $11.1 million in principal amount of Notes occurred on October 26, 2010, and the subsequent sale of $0.8 million in principal amount of Notes occurred on October 29, 2010. The notes mature in October 2013.

The Notes are convertible at the option of the holder into shares of common stock of the Company at a current conversion price of $3.73 (adjusted for a 5% stock dividends paid on October 14, 2011 and October 22, 2012, as further discussed in Note 10 to our Consolidated Financial Statements included in Part II, Item 8., "Financial Statements and Supplementary Data.", and subject to adjustment for stock dividends, stock splits, combination of shares, recapitalization and other similar events) that is subject to future reductions if the Company issues equity instruments at a lower price. Since there is no minimum conversion price resulting in an indeterminate number of shares to be issued in the future, the Company determined an embedded derivative existed that was required to be bifurcated from the Notes and accounted for separately as a derivative liability recorded at fair value (see Note 15 to our Consolidated Financial Statements included in Part II, Item 8., "Financial Statements and Supplementary Data."). At the time of initial measurement, the derivative had an estimated fair value of $2.6 million resulting in a discount on the Notes. The discount is being amortized over the term of the Notes. At December 31, 2012, the unamortized discount on the Notes was $0.7 million.

There was a conversion of a $0.2 million note that was part of the October 26, 2010 offering. It was recorded in two $0.1 million allotments. The first one converted in July 2011 at a price of $4.13 per share and resulted in the issuance of 18,160 shares. The second converted in November 2011 at a price of $3.92 and resulted in the issuance of 19,132 shares. As of December 31, 2012, $11.7 million was outstanding under the Notes.

Subordinated Convertible Notes Issued in 2011

On March 31, 2011, the Company entered into a Securities Purchase Agreement with certain accredited investors to sell and issue to the Purchasers an aggregate of $2.1 million in principal amount of the Company's Subordinated Convertible Notes. On April 29, 2011, the Company issued an additional $1.8 million in principal amount of the convertible debt issuance. On May 6, 2011, the Company issued an additional $0.6 in principal amount of the Notes. As of December 31, 2012, the total outstanding principal amount of the Notes is $4.5 million. Approximately $1.4 million of the proceeds obtained were used to repay the short-term promissory note that was issued March 31, 2011 and related accrued interest.

The Notes bear a 10% interest per annum and are payable quarterly in cash in arrears beginning June 30, 2011. The Notes mature on March 31, 2014. Debt issuance costs of $0.6 million are being amortized over the life of the Notes.

The Notes are convertible at the option of the holder into shares of common stock of the Company at a conversion price of $4.80 (adjusted for a 5% stock dividends paid on October 14, 2011 and October 22, 2012, as further discussed in Note 10 to our Consolidated Financial Statements included in Part II, Item 8., "Financial Statements and Supplementary Data.", and subject to

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adjustment for stock dividends, stock splits, combination of shares, recapitalization and other similar events). The initial conversion price is subject to adjustment for any stock dividend, stock split, combination of shares, reorganization, recapitalization, reclassification or other similar events. The Notes are unsecured and subordinated in right of payment to existing and future senior indebtedness.

Subordinated Convertible Notes Issued in 2012

AdCare entered into a Securities Purchase Agreement, dated as of June 28, 2012, with certain accredited investors pursuant to which the Company issued and sold such investors on July 2, 2012 an aggregate of $7.5 million in principal amount of the Company's 8.0% subordinated convertible promissory notes. The notes bear interest at 8% per annum and such interest is payable quarterly in cash in arrears beginning on September 30, 2012. The notes mature on July 31, 2015. The notes are unsecured and subordinated in right of payment to existing and future senior indebtedness of the Company. The $7.5 million principal amount of the notes includes a refinancing of existing indebtedness of $5.0 million of promissory notes issued to Cantone Asset Management LLC.

At any time on or after the six-month anniversary of the date of issuance of the notes, the notes are convertible at the option of the holder into shares of the Company's common stock at a conversion price equal to $3.97 per share (adjusted for a 5% stock dividend paid on October 22, 2012, as further discussed in Note 10 to our Consolidated Financial Statements included in Part II, Item 8., "Financial Statements and Supplementary Data.", and subject to adjustment for stock dividends, stock splits, combination of shares, recapitalization and other similar events).

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

In addition, the holders of a majority of the aggregate principal amount of notes then outstanding may require the Company to redeem all or any portion of the notes upon a change of control transaction, at a redemption price in cash equal to 110% of the redemption amount.

Approximately $23.7 million of the scheduled maturities in 2013, 2014 and 2015, relate to the subordinated convertible notes issued in 2010, 2011 and 2012. While management cannot predict with certainty, we anticipate that some holders of the subordinated convertible notes will elect to convert their subordinated convertible notes into common stock provided the common stock continues to trade above the applicable conversion price for such notes. The conversion prices are $3.73, $4.80 and $3.97 for the subordinated convertible notes issued in 2010, 2011 and 2012, respectively. If all of the subordinated convertible notes had been converted to common stock at December 31, 2012, then the Company would have been required to issue approximately 6.4 million shares of common stock.

Debt Covenant Compliance

As of December 31, 2012, the Company (including its consolidated variable interest entity) has over twenty different credit facilities (credit facilities, mortgage notes, bonds and other credit obligations) outstanding that include various financial and administrative covenant requirements. Covenant requirements include, but are not limited to, fixed charge coverage ratios, debt service coverage ratios, minimum EBITDA or EBITDAR, current ratios and tangible net worth requirements. Certain financial covenant requirements are based on consolidated financial measurements whereas others are based on subsidiary level (i.e.; facility, multiple facilities or a combination of subsidiaries comprising less than the Company's consolidated financial measurements). Some covenants are based on annual financial metric measurements whereas others are based on monthly or quarterly financial metric measurements. The Company routinely tracks and monitors its compliance with its covenant requirements. In recent periods, including as of December 31, 2012, the Company has not been in compliance with certain financial and administrative covenants. For each instance of such non-compliance, the Company has obtained waivers or amendments to such requirements including as necessary modifications to future covenant requirements or the elimination of certain requirements in future periods.

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The following table includes financial covenant requirements as of the last measurement date as of or prior to December 31, 2012 where the Company was not in compliance with the financial covenant or it achieved compliance with the covenant requirement by a margin of 10% or less. The table also identifies the related credit facility, outstanding balance at December 31, 2012 and the next applicable future financial covenant requirement inclusive of adjustments to covenant requirements resulting from amendments executed subsequent to December 31, 2012.

Credit Facility	Balance at December 31, 2012 (000's)	Consolidated or Subsidiary Level Covenant Requirement	Financial Covenant	Measurement Period	Min/Max Financial Covenant Required	Financial Covenant Metric Achieved	Future Financial Covenant Metric Required
PrivateBank Line of Credit	$ 7,706	Subsidiary	Rent and debt service coverage ratio	Quarterly	1.10	1.38	1.10
		Consolidated	Guarantor minimum debt service coverage ratio (DSCR)	Annual	1.00	0.98*	1.00
		Consolidated	Guarantor maximum leverage ratio	Annual	11.00	10.25	11.00
Contemporary Healthcare Capital Term Note	$ 5,224	Subsidiary	Minimum implied current ratio	Quarterly	1.00	0.65*	1.00
and Line of Credit Companion Care		Subsidiary	Minimum liquidity (000's)	Quarterly	$ 250	$ 22*	$ 250
PrivateBank Mortgage Note Valley River	$ 11,495	Consolidated	DSCR	Annual	1.00	0.98*	1.00
Square 1 USDA Term Note Homestead	$ 3,529	Subsidiary	Current ratio	Quarterly	1.00	0.22*	1.00
		Subsidiary	Maximum debt to net worth	Quarterly	9.00	9.47*	9.00
		Subsidiary	Tangible net worth	Quarterly	10.0%	9.5%*	0.10
PrivateBank Line of Credit and Term	$ 13,665	Subsidiary	EBITDAR (000's)	Monthly	$ 75	$ (22)*	$ 0
Debt Certain Arkansas Facilities		Subsidiary	Fixed Charge Coverage Ratio (FCCR)	Quarterly	1.05	-1.02*	1.05
		Consolidated	DSCR	Annual	1.00	0.98*	1.00
		Consolidated	Maximum Annual Leverage	Annual	11.00	10.25	11.00
KeyBank Mortgage Note Woodland Manor	$ 16,500	Consolidated	FCCR	Quarterly	1.15	0.49*	0.85
PrivateBank Mortgage Note Glenvue	$ 6,550	Subsidiary	DSCR	Quarterly	1.35	2.40	1.35
		Consolidated	DSCR	Annual	1.00	0.98*	1.00
		Consolidated	Maximum leverage	Annual	11.00	10.25	11.00
PrivateBank Mortgage Note Woodland Manor	$ 4,707	Subsidiary	Minimum quarterly EBITDAR (000's)	Quarterly	$ 250	$ 12*	$ 250
		Subsidiary	Minimum trailing twelve month FCCR	Quarterly	1.10	1.05*	1.10
Medical Clinic Board of the City of Hoover Bonds	$ 6,290	VIE	DSCR	Annual	1.20	0.09*	1.20
		VIE	Days cash on hand	Annual	15	0*	15
		VIE	Trade payables	Annual	10.0%	44.0%*	0.10
City of Springfield Bonds	$ 7,230	Subsidiary	DSCR	Annual	1.10	0.94*	1.10
		Subsidiary	Days Cash on Hand	Annual	15	0*	15

Subsidiary	Trade payables	Annual	10.0%	27.0%*	0.10	

*
Waiver or amendment for violation of covenant obtained.

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Receivables

Our operations could be adversely affected if we experience significant delays in reimbursement from Medicare, Medicaid and other third-party revenue sources. Our future liquidity will continue to be dependent upon the relative amounts of current assets (principally cash and patient accounts receivable and current liabilities (principally accounts payable and accrued expenses). In that regard, accounts receivable can have a significant impact on our liquidity. Continued efforts by governmental and third-party payors to contain or reduce the acceleration of costs by monitoring reimbursement rates, by increasing medical review of bills for services, or by negotiating reduced contract rates, as well as any delay by the staff at our facilities in the processing of our invoices, could adversely affect our liquidity and results of operations.

Accounts receivable attributable to patient services of continuing operations totaled $24.7 million at December 31, 2012, compared to $17.2 million at December 31, 2011, representing approximately 45 days revenue in accounts receivable in both 2012 and 2011. The increase in accounts receivable is primarily the result of increased revenue in 2012.

The allowance for bad debt was $3.7 million and $1.3 million at December 31, 2012 and 2011, respectively. We continually evaluate the adequacy of our bad debt reserves based on patient mix trends, aging of older balances, payment terms and delays with regard to third-party payors, as well as other factors. We continue to evaluate and implement additional processes to strengthen our collection efforts and reduce the incidence of uncollectible accounts.

Inflation

We have historically derived a substantial portion of our revenue from the Medicare program. We also derive revenue from state Medicaid and similar reimbursement programs. Payments under these programs generally provide for reimbursement levels that are adjusted for inflation annually based upon the state's fiscal year for the Medicaid programs and in each October for the Medicare program. These adjustments may not continue in the future, and even if received, such adjustments may not reflect the actual increase in our costs for providing healthcare services.

Labor and supply expenses make up a substantial portion of our cost of services. Those expenses can be subject to increase in periods of rising inflation and when labor shortages occur in the marketplace. To date, we have generally been able to implement cost control measures or obtain increases in reimbursement sufficient to offset increases in these expenses. We may not be successful in offsetting future cost increases.

Off-Balance Sheet Arrangements

There were $0.7 million of outstanding letters of credit of December 31, 2012 that are pledged as collateral of borrowing capacity on the PrivateBank revolver.

Operating Leases

The Company leases certain office space and 11 skilled nursing facilities under non-cancelable operating leases, most of which have initial lease terms of ten to twelve years with rent escalation clauses and provisions for payments by the Company of real estate taxes, insurance and maintenance costs. Eight of the facilities were initiated in the third quarter of 2010, and two additional in the fourth quarter of 2010. One lease agreement was initiated in the fourth quarter of 2011. For the years ended December 31, 2012 and 2011, facility rent expense totaled $7.7 million and $7.2 million, respectively.

Eight of the Company's facilities are operated under a single master lease arrangement. The lease has a term of ten years into 2020. Under the master lease, a breach at a single facility could subject one or more of the other facilities covered by the same master lease to the same default risk. Failure to

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comply with regulations or governmental authorities, such as Medicare and Medicaid provider requirements, is a default under the Company's master lease agreement. In addition, other potential defaults related to an individual facility may cause a default of the entire master lease agreement. With an indivisible lease, it is difficult to restructure the composition of the portfolio or economic terms of the lease without the consent of the landlord. The Company is not aware of any defaults as of December 31, 2012.

Two of the Company's facilities are operated under a separate lease agreement. The lease is a single indivisible lease; therefore, a breach at a single facility could subject the second facility to the same default risk. The lease has a term of 12 years into 2022 and includes covenants and restrictions. A commitment is included that requires minimum capital expenditures of $375 per licensed bed per lease year at each facility which amounts to $0.1 million per year for both facilities. In recent periods, including as of December 31, 2012, the Company has not been in compliance with certain financial and administrative covenants of this lease agreement. The Company has obtained a waiver for each instance of such non-compliance.

Future minimum lease payments for each of the next five years ending December 31 are as follows:

	(Amounts in 000's)
2013	$ 8,049
2014	7,569
2015	7,407
2016	7,274
2017	7,180
Thereafter	21,639
Total	$ 59,118

The Company has also entered into lease agreements for various equipment used in the facilities. These leases are included in future minimum lease payments above.

ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Disclosure pursuant to Item 7A. of Form 10-K is not required to be reported by smaller reporting companies.

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Item 8. Financial Statements and Supplementary Data

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Stockholders
AdCare Health Systems, Inc.

We have audited the accompanying consolidated balance sheet of AdCare Health Systems, Inc. and subsidiaries (the Company) as of December 31, 2012, and the related consolidated statements of operations, stockholders' equity, and cash flows for the year then ended. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of AdCare Health Systems, Inc. and subsidiaries as of December 31, 2012 and the results of their operations and their cash flows for the year then ended, in conformity with U.S. generally accepted accounting principles.

/s/ KPMG LLP

Atlanta, Georgia

July 8, 2013

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Stockholders
AdCare Health Systems, Inc.

We have audited the accompanying consolidated balance sheet of AdCare Health Systems, Inc. and subsidiaries (the Company) as of December 31, 2011, and the related consolidated statements of operations, stockholders' equity, and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. The Company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audit included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of AdCare Health Systems, Inc. and subsidiaries as of December 31, 2011 and the results of their operations and their cash flows for the year then ended, in conformity with accounting principles generally accepted in the United States of America.

As discussed in Note 2 to the consolidated financial statements, the Company is subject to certain risks and uncertainties.

/s/ BATTELLE & BATTELLE LLP

Dayton, OH

March 19, 2012

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ADCARE HEALTH SYSTEMS, INC. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

(Amounts in 000's)

	December 31,	
	2012	**2011**
ASSETS		
Current Assets:		
Cash and cash equivalents	$ 15,937	$ 7,364
Restricted cash and investments	1,742	1,883
Accounts receivable, net	26,037	18,782
Prepaid expenses and other	489	663
Assets of disposal group held for sale	6,159	47
Total current assets	50,364	28,739
Restricted cash and investments	7,215	4,870
Property and equipment, net	151,064	102,449
Intangible assets bed licenses	2,471	1,189
Intangible assets lease rights, net	6,844	8,460
Goodwill	5,023	3,600
Escrow deposits for acquisitions		3,172
Lease deposits	1,720	1,685
Deferred loan costs, net	6,137	4,818
Other assets	3,611	122
Total assets	$ 234,449	$ 159,104
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current Liabilities:		
Current portion of notes payable and other debt	$ 6,941	$ 4,566
Current portion of convertible debt, net of discounts	10,948	
Revolving credit facilities and lines of credit	1,498	7,343
Accounts payable	19,503	12,075
Accrued expenses	13,730	9,881
Liabilities of disposal group held for sale	3,662	240
Total current liabilities	56,282	34,105
Notes payable and other debt, net of current portion:		
Senior debt, net of discounts	128,248	87,771
Convertible debt, net of discounts	12,009	14,614
Revolving credit facilities	7,706	1,308
Other debt	864	1,400
Derivative liability	3,630	1,889
Other liabilities	1,394	2,438
Deferred tax liability	104	86
Total liabilities	210,237	143,611
Commitments and contingencies (Note 14)		
Preferred stock, no par value; 1,000 shares authorized; 450 shares issued and outstanding at December 31, 2012, redemption amount $11,250; no shares issued or outstanding at December 31, 2011	9,159	
Stockholders' equity:		
	41,644	35,047

Common stock and additional paid-in capital, no par value; 29,000 shares authorized; 14,659 and 12,803 shares issued and outstanding at December 31, 2012 and 2011, respectively		
Accumulated deficit	(25,753)	(18,713)
Total stockholders' equity	15,891	16,334
Noncontrolling interest in subsidiaries	(838)	(841)
Total equity	15,053	15,493
Total liabilities and equity	$ 234,449	$ 159,104

See accompanying notes to consolidated financial statements

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ADCARE HEALTH SYSTEMS, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF OPERATIONS

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

	Year Ended December 31,	
	2012	**2011**
Revenues:		
Patient care revenues	$ 199,502	$ 136,592
Management revenues	2,156	1,620
Total revenues	201,658	138,212
Expenses:		
Cost of services (exclusive of facility rent, depreciation and amortization)	168,207	111,819
General and administrative expenses	17,005	13,281
Facility rent expense	7,689	7,193
Depreciation and amortization	6,805	3,359
Salary retirement and continuation costs	43	1,451
Total expenses	199,749	137,103
Income from Operations	1,909	1,109
Other Income (Expense):		
Interest expense, net	(13,224)	(7,381)
Acquisition costs, net of gains	(1,962)	(1,163)
Derivative (loss) gain	(1,741)	957
Gain (loss) on extinguishment of debt	500	(141)
Gain (loss) on disposal of assets	2	(111)
Other income	(124)	551
Total other expense, net	(16,549)	(7,288)
Loss from Continuing Operations Before Income Taxes	(14,640)	(6,179)
Income tax expense	(97)	(215)
Loss from Continuing Operations	(14,737)	(6,394)
Income (Loss) from Discontinued Operations, net of tax	7,197	(1,158)
Net Loss	(7,540)	(7,552)
Net Loss Attributable to Noncontrolling Interests	656	1,388
Net Loss Attributable to AdCare Health Systems, Inc.	(6,884)	(6,164)
Preferred stock dividend	(156)	
Net Income (Loss) Attributable to AdCare Health Systems, Inc. Common Stockholders	$ (7,040)	$ (6,164)
Net Income (Loss) per Common Share attributable to AdCare Health Systems, Inc. Common Stockholders Basic:		
Continuing Operations	$ (1.01)	$ (0.48)
Discontinued Operations	0.51	(0.11)

	$ (0.50)	$ (0.59)
Net Income (Loss) per Common Share attributable to AdCare Health Systems, Inc. Common Stockholders Diluted:		
Continuing Operations	$ (1.01)	$ (0.48)
Discontinued Operations	0.51	(0.11)
	$ (0.50)	$ (0.59)
Weighted Average Common Shares Outstanding:		
Basic	14,033	10,491
Diluted	14,033	10,491

See accompanying notes to consolidated financial statements

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ADCARE HEALTH SYSTEMS, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY

(Amounts in 000's)

	Common Stock Shares	Common Stock and Additional Paid-in Capital	Accumulated Deficit	Noncontrolling Interests	Total
Balance, January 1, 2011	9,205	$ 26,612	$ (12,549)	$ 547	$ 14,610
Nonemployee warrants for services		434			434
Nonemployee stock issuance for services	40	206			206
Stock based compensation expense		806			806
Exercises of options and warrants	3,518	6,796			6,796
Stock issued from debt conversion	40	193			193
Net loss			(6,164)	(1,388)	(7,552)
Balance, December 31, 2011	12,803	35,047	(18,713)	(841)	15,493
Deconsolidation of variable interest entities				660	660
Nonemployee warrants for services		859			859
Stock based compensation expense		715			715
Public stock offering, net	1,223	3,779			3,779
Exercises of options and warrants	101	137			137
Stock issued in acquisition	196	756			756
Issuance of restricted stock	336	351			351
Preferred stock dividend			(156)		(156)
Net loss			(6,884)	(656)	(7,540)
Balance, December 31, 2012	14,659	$ 41,644	$ (25,753)	$ (838)	$ 15,053

See accompanying notes to consolidated financial statements

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ADCARE HEALTH SYSTEMS, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

(Amounts in 000's)

	Year Ended December 31,	
	2012	**2011**
Cash flows from operating activities:		
Net Loss	$ (7,540)	$ (7,552)
Loss (Income) from discontinued operations	(7,197)	1,158
Loss from continuing operations	(14,737)	(6,394)
Adjustments to reconcile net loss from continuing operations to net cash provided by operating activities:		
Depreciation and amortization	6,805	3,359
Warrants issued for services	107	212
Stock-based compensation expense	891	806
Lease expense in excess of cash	430	700
Amortization of deferred financing costs	1,959	919
Amortization of debt discounts	817	901
Derivative (gain) loss	1,741	(958)
(Gain) Loss on debt extinguishment	(500)	141
Deferred tax expense	104	7
(Gain) Loss on disposal of assets	(2)	126
Gain on acquisitions		(1,104)
Provision for bad debts	4,700	1,596
Non cash acquisition costs		206
Other noncash expenses	40	80
Changes in certain assets and liabilities, net of acquisitions:		
Accounts receivable	(12,415)	(9,334)
Prepaid expenses and other	101	522
Other assets	330	(179)
Accounts payable and other liabilities	10,753	8,936
Net cash provided by operating activities continuing operations	1,124	542
Net cash provided by operating activities discontinued operations	403	1,450
Net cash provided by operating activities	1,527	1,992
Cash flow from investing activities:		
Proceeds from sale of property and equipment	3	
Change in restricted cash and investments and escrow deposits for acquisitions	(3,178)	1,070
Lease deposits		(15)
Acquisitions	(61,901)	(57,582)
Purchase of property and equipment	(5,777)	(4,245)
Net cash used in investing activities continuing operations	(70,853)	(60,772)
Net cash provided by (used in) investing activities discontinued operations	11,691	(218)
Net cash used in investing activities	(59,162)	(60,990)
Cash flows from financing activities:		
Proceeds from debt	92,476	51,864
Repayment on notes payable	(30,075)	(2,053)
Change in lines of credit	365	6,734
Debt issuance costs	(3,076)	(618)
Exercise of options and warrants	137	6,795
Proceeds from stock issuances	3,779	
Proceeds from preferred stock issuances	9,159	

Dividends paid on preferred stock	(156)	
Net cash provided by financing activities continuing operations	72,609	62,722
Net cash used in financing activities discontinued operations	(6,221)	(271)
Net cash provided by financing activities	66,388	62,451
Net Change in Cash	8,753	3,453
Cash, Beginning	7,364	3,911
Cash decrease due to deconsolidation of variable interest entities	(180)	
Cash, Ending	$ 15,937	$ 7,364
Supplemental Disclosure of Cash Flow Information:		
Cash paid during the year for:		
Interest	$ 13,023	$ 6,091
Income taxes	$	$ 197
Supplemental Disclosure of Non-Cash Activities:		
Acquisitions in exchange for debt and equity instruments	$ 11,056	$ 3,150
Warrants issued for financing costs	$ 756	$ 330
Conversion of debt to equity		$ 150
Other assets acquired in exchange of debt		$ 6,441

See accompanying notes to consolidated financial statements

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ADCARE HEALTH SYSTEMS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Description of Business

AdCare Health Systems, Inc. and Subsidiaries ("AdCare" or "the Company"), owns and operates skilled nursing and, assisted living facilities in the states of Alabama, Arkansas, Georgia, Missouri, North Carolina, Ohio, Oklahoma and South Carolina as of December 31, 2012. The Company, through wholly owned separate operating subsidiaries, as of December 31, 2012, operates 50 facilities comprised of 46 skilled nursing facilities, three assisted living facilities and one independent living/senior housing facility totaling approximately 5,000 beds. The Company's facilities provide a range of health care services to their patients and residents including, but not limited to, skilled nursing and assisted living services, social services, various therapy services, and other rehabilitative and healthcare services for both long-term residents and short-stay patients. As of December 31, 2012, of the total 50 facilities, the Company owned and operated 26 facilities, leased and operated 11 facilities, and managed 13 facilities (including one consolidated variable interest entity). As part of the Company's strategy to focus on the growth of skilled nursing facilities, the Company decided in the fourth quarter of 2011 to exit the home health business; therefore, this business is reported as discontinued operations (see Note 3). The Company sold the assets of the home health business in 2012. Additionally, in the fourth quarter of 2012, the Company entered into an agreement to sell six assisted living facilities located in Ohio and executed a sublease arrangement to exit the skilled nursing business in Jeffersonville, Georgia. The six Ohio assisted living facilities and the Jeffersonville, Georgia skilled nursing facility have an aggregate of 313 units in service. These seven facilities are also reported as discontinued operations (see Note 3). The Company sold the assets of four of the six Ohio assisted living facilities in December 2012, one in February 2013, and one in May, 2013.

Basis of Presentation

The accompanying consolidated financial statements are prepared in conformity with U.S. generally accepted accounting principles ("GAAP") in accordance with the Financial Accounting Standards Board ("FASB") Accounting Standards Codification ("ASC").

Principles of Consolidation

The consolidated financial statements include the Company's majority owned and controlled subsidiaries. "VIEs" in which the Company has a variable interest have been consolidated as controlled subsidiaries when the Company is identified as the primary beneficiary. All intercompany transactions and balances have been eliminated through consolidation. For subsidiaries that are not wholly owned by the Company, the portions not controlled by the Company are presented as non-controlling interests in the consolidated financial statements.

As further discussed in Note 20, *Variable Interest Entities*, and Note 22, *Related Party Transa*ctions, effective August 1, 2011, entities (the "Oklahoma Owners") controlled by Christopher Brogdon and his spouse, Connie Brogdon (related parties to the Company) acquired five skilled nursing facilities located in Oklahoma (the "Oklahoma Facilities"). The Company entered into a Management Agreement with the Oklahoma Owners pursuant to which a wholly-owned subsidiary of the Company supervises the management of the Oklahoma Facilities for a monthly fee equal to 5% of the monthly gross revenues of the Oklahoma Facilities. Upon acquisition, the Company concluded it was the primary beneficiary of the Oklahoma Owners and pursuant to FASB ASC Topic 810-10, *Consolidation Overall*, consolidated the Oklahoma Owners in its 2011 consolidated financial statements.

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ADCARE HEALTH SYSTEMS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

NOTE 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

During the process of finalizing the 2012 consolidated financial statements, the Company reassessed its prior conclusion that it should consolidate the Oklahoma Owners. In the reassessment process, the Company concluded that it should not have consolidated the Oklahoma Owners. In the accompanying consolidated financial statements, the Company has deconsolidated the Oklahoma Owners effective January 1, 2012 and the balance sheet, operations and cash flows of the Oklahoma Owners are not included in the Company's 2012 consolidated financial statements. The Company further concluded that including the Oklahoma Owners in its 2011 consolidated financial statements was not material to such consolidated financial statements and therefore no adjustments have been made to the previously issued quarterly and annual 2011 consolidated financial statements. Note 20, *Variable Interest Entities*, includes summarized financial information of the Oklahoma Owners for 2011 that are included in the Company's 2011 consolidated financial statements. Note 20, *Variable Interest Entities*, includes summarized financial information of the Oklahoma Owners for 2011 that are included in the Company's 2011 consolidated financial statements.

Use of Estimates

The preparation of consolidated financial statements in conformity with U.S. GAAP 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. Examples of significant estimates include allowance for doubtful accounts, contractual allowances for Medicare, Medicaid, and managed care reimbursements, deferred tax valuation allowance, fair value of derivative instruments, fair value of employee and nonemployee stock based awards, fair value estimation methods used to determine the assigned fair value of assets and liabilities acquired in acquisitions, and valuation of goodwill and other long-lived assets. Actual results could differ materially from those estimates.

Acquisition Policy

The Company periodically enters into agreements to acquire assets and/or businesses. The considerations involved in each of these agreements may include cash, financing, stock, and/or long-term lease arrangements for real properties. The Company evaluates each transaction to determine whether the acquired interests are assets or businesses. A business is defined as a self-sustaining integrated set of activities and assets conducted and managed for the purpose of providing a return to investors. A business consists of (a) inputs, (b) processes applied to those inputs, and (c) resulting outputs that are used to generate revenues. In order for an acquired set of activities and assets to be a business, it must contain all of the inputs and processes necessary for it to continue to conduct normal operations after the acquired entity is separated from the seller, including the ability to sustain revenue streams by providing its outputs to customers. An acquired set of activities and assets fails the definition of a business if it excludes one or more of the above items making it impossible to continue normal operations and sustain a revenue stream by providing its products and/or services to customers.

The Company currently operates its skilled nursing facilities in states that are subject to certificate of need ("CON") programs. The CON programs govern the establishment, construction, renovation and transferability of the rights to operate skilled nursing facilities ("SNFs"). In certain states, specifically Ohio, CON programs permit the transferability and sale of bed licenses separately from the facility. In other states, bed licenses are non-transferable separately and apart from the underlying

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ADCARE HEALTH SYSTEMS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

NOTE 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

licensed facility. Through acquisitions completed in 2011 and 2012, the Company now operates in a number of states, including Alabama, Arkansas, Georgia, Missouri, North Carolina, Oklahoma, and South Carolina, where the bed licenses are not transferable separately from the facility.

The CON/bed license arises from contractual rights and is an identifiable intangible asset that the Company assigns a fair value in transactions accounted for as business combinations. In states where the CON/bed licenses are transferable separately from the facility, the intangible asset has been determined to have an indefinite life. Because the intangible asset is separable from the facility and has separate stand-alone value, for financial reporting purposes, the fair value assigned to the CON/license is classified as a separate intangible asset in the accompanying consolidated balance sheets.

In states where the CON/bed license is non-transferable separately from the facility, the CON/bed license and building are complimentary assets and therefore, the intangible asset is assigned a definite life and amortized over the estimated remaining useful life of the related building. As complimentary assets, the intangible asset has no value separate from the building and the estimated remaining useful lives of the intangible asset and building are equal. Therefore, the intangible asset and the building are classified together as "buildings" and are included in property and equipment in the consolidated balance sheets. As of December 31, 2012 and December 31, 2011, the value of such CON bed licenses, net of amortization, was $37.1 million and $25.6 million, respectively.

Cash and Cash Equivalents

The Company considers all unrestricted short-term investments with original maturities less than three months, which are readily convertible into cash, to be cash equivalents. Certain cash, cash equivalents and investment amounts are restricted for specific purposes such as mortgage escrow requirements and reserves for capital expenditures on U.S. Department of Housing and Urban Development ("HUD") insured facilities and other restricted investments are held as collateral for other debt obligations.

Investments

The Company has certain restricted investments that are limited as to use by certain debt obligations. These investments are classified as held-to-maturity investments because the Company has the positive intent and ability to hold the securities until maturity. Held-to-maturity investments are carried at amortized cost. These restricted investments are classified as noncurrent assets given their related maturity dates and the restrictions required by the long-term debt obligations.

Patient Care Receivables and Revenues

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

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

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ADCARE HEALTH SYSTEMS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

NOTE 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

For residents under reimbursement arrangements with third-party payors, including Medicaid, Medicare and private insurers, revenue is recorded based on contractually agreed-upon amounts on a per patient, daily basis.

Potentially uncollectible patient accounts are provided for on the allowance method based upon management's evaluation of outstanding accounts receivable at period-end and historical experience. Uncollected accounts that are written off are charged against allowance. As of December 31, 2012 and 2011, management recorded an allowance for uncollectible accounts of $3.7 million and $1.3 million, respectively.

Management Fee Receivables and Revenue

Management fee receivables and revenue are recorded in the month that services are provided. As of December 31, 2012 and 2011, management recorded an allowance for uncollectible management fee receivables of $0.0 million and $0.1 million, respectively.

Leases and Leasehold Improvements

At the inception of each lease, the Company performs an evaluation to determine whether the lease should be classified as an operating lease or capital lease. As of December 31, 2012, all of the Company's leased facilities are accounted for as operating leases. The Company records rent expense for operating leases that contain scheduled rent increases on a straight-line basis over the term of the lease. The accumulated difference between the straight-line expense recognition and the actual cash rent paid is reflected in Other Liabilities in the Consolidated Balance Sheet and was $1.4 and $1.0 million as of December 31, 2012 and 2011, respectively. The lease term is also used to provide the basis for establishing depreciable lives for buildings subject to lease and leasehold improvements.

Earnings per Share

Basic earnings per share is computed by dividing net income or loss by the weighted-average number of shares of common stock outstanding during the period. Diluted earnings per share is similar to basic earnings per share except net income or loss is adjusted by the impact of the assumed issuance of convertible shares and the weighted-average number of common shares outstanding and includes potentially dilutive securities, such as options, warrants, non-vested shares, and additional shares issuable under convertible notes outstanding during the period when such potentially dilutive securities are not anti-dilutive. Potentially dilutive securities from option, warrants and unvested restricted shares are calculated in accordance with the treasury stock method, which assumes that proceeds from the exercise of all options and warrants with exercise prices exceeding the average market value are used to repurchase common stock at market value. The incremental shares remaining after the proceeds are exhausted represent the potentially dilutive effect of the securities. Potentially dilutive securities from convertible promissory notes are calculated based on the assumed issuance at the beginning of the period, as well as any adjustment to income that would result from their assumed issuance. For 2012 and 2011, potentially dilutive securities of 13.9 million and 7.7 million were excluded from the diluted loss per share calculation because including them would have been anti-dilutive in both periods.

For the years ended December 31, 2012 and 2011, no potentially dilutive securities were included in the diluted earnings per share calculation because to do so would be anti-dilutive. The following

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ADCARE HEALTH SYSTEMS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

NOTE 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

table provides a reconciliation of net income (loss) for continuing and discontinued operations and the number of common shares used in the computation of both basic and diluted earnings per share:

	Years Ended December 31,					
	2012			2011		
(Amounts in 000's, except per share data)	Income (loss)	Shares(1)	Per Share	Income (loss)	Shares(1)	Per Share
Continuing Operations:						
Loss from continuing operations	$ (14,737)			$ (6,394)		
Net loss attributable to noncontrolling interests	656			$ 1,388		
Basic loss from continuing operations	$ (14,081)	14,033	$ (1.00)	$ (5,006)	10,491	$ (0.48)
Preferred stock dividend	(156)		$ (0.01)			
Effect from options, warrants and non-vested shares						
Effect from assumed issuance of convertible shares(2)						
Diluted loss from continuing operations	$ (14,237)	14,033	$ (1.01)	$ (5,006)	10,491	$ (0.48)
Discontinued Operations:						
Basic income (loss) from discontinued operations	$ 7,197	14,033	$ 0.51	$ (1,158)	10,491	$ (0.11)
Diluted income (loss) from discontinued operations	$ 7,197	14,033	$ 0.51	$ (1,158)	10,491	$ (0.11)
Net Loss Attributable to AdCare:						
Basic loss	$ (7,040)	14,033	$ (0.50)	$ (6,164)	10,491	$ (0.59)
Diluted loss	$ (7,040)	14,033	$ (0.50)	$ (6,164)	10,491	$ (0.59)

(1) The weighted average shares outstanding include retroactive adjustments from stock dividends (see Note 10).

(2) The impacts of the assumed issuance of the subordinated convertible promissory note issued in 2010, 2011 and 2012 were excluded in those periods where the impact would be anti-dilutive.

Deferred Financing Costs

The Company records deferred financing costs associated with debt obligations. Costs are amortized over the term of the related debt using the straight-line method and are reflected as interest expense. The straight-line method yields results substantially similar to those that would be produced under the effective interest rate method.

Intangible Assets and Goodwill

Intangible assets consist of finite lived and indefinite lived intangibles. The Company's finite lived intangibles include lease rights and certain CON/bed licenses that are not separable from the associated buildings. Finite lived intangibles are amortized over their estimated useful lives. For the Company's

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ADCARE HEALTH SYSTEMS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

NOTE 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

lease related intangibles, the estimated useful life is based on the terms of the underlying facility leases, currently averaging approximately ten years. For the Company's CON/bed licenses that are not separable from the buildings, the estimated useful life is based on the building life when acquired with an average estimated useful life of approximately 31 years. The Company evaluates the recoverability of the finite lived intangibles whenever an impairment indicator is present.

The Company's indefinite lived intangibles consist primarily of values assigned to CON/bed licenses that are separable from the buildings. The Company does not amortize goodwill or indefinite lived intangibles. On an annual basis, the Company evaluates the recoverability of the indefinite lived intangibles and goodwill by performing an impairment test. The Company performs its annual test for impairment during the fourth quarter of each year. There have been no required impairment adjustments to intangible assets and goodwill during 2012 or 2011 other than the impairment of goodwill related to Discontinued Operations (see Note 3).

Income Taxes

An asset or liability is recognized for the deferred tax consequences of temporary differences between the tax bases of assets and liabilities and their reported amounts in the consolidated financial statements. These temporary differences would result in taxable or deductible amounts in future years when the reported amounts of the assets are recovered or liabilities are settled. Deferred tax assets are also recognized for the future tax benefits from net operating loss and other carry forwards. A valuation allowance is provided if it is more likely than not that some portion or all of the net deferred tax assets will not be realized. In evaluating the need to record or continue to reflect a valuation allowance, all items of positive evidence and negative evidence are considered.

The Company's taxable income includes all amounts attributable to AdCare, and excludes all non-controlling interests as these entities are not part of the consolidated tax group. The excluded entities are all pass-through entities that are not subject to corporate level income taxes. As such, the taxable income is passed on to other parties/entities that are not part of the consolidated financial statements.

The Company is subject to income taxes in the U.S. and numerous state and local jurisdictions. Judgment is required in evaluating uncertain tax positions. The Company recognizes a tax benefit only if it is more likely than not that a particular tax position will be sustained upon examination or audit. In general, the Company's tax returns filed for the 1996 through 2012 tax years are still subject to potential examination by taxing authorities. Interest and penalties related to uncertain tax positions, if any, are recorded as income tax expense in the consolidated financial statements.

Concentrations of Credit Risk

Financial instruments which potentially expose the Company to concentrations of credit risk consist primarily of cash and cash equivalents, restricted cash, restricted investments, and accounts receivable. Cash and cash equivalents, restricted cash and restricted investments are held with various financial institutions. From time to time, these balances exceed the federally insured limits. These balances are maintained with high quality financial institutions which management believes limits the risk.

Accounts receivable are recorded at net realizable value. The Company performs ongoing evaluations of its residents and significant third-party payers with which they contract, generally not

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ADCARE HEALTH SYSTEMS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

NOTE 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

requiring collateral. Management believes that credit risk with respect to accounts receivable from residents is limited based on the stature and diversity of the third-party payers with which they contract. The Company maintains an allowance for doubtful accounts which management believes is sufficient to cover potential losses. Delinquent accounts receivable are charged against the allowance for doubtful accounts once likelihood of collection has been determined. Accounts receivable are considered to be past due and placed on delinquent status based upon contractual terms, how frequently payments are received, and on an individual account basis.

Property and Equipment

Property and equipment are stated at cost. Expenditures for major improvements are capitalized. Depreciation commences when the assets are placed in service. Maintenance and repairs which do not improve or extend the life of the respective assets are charged to expense as incurred. Upon disposal of assets, the cost and related accumulated depreciation are removed from the accounts and any gain or loss is recorded. Depreciation is recorded on a straight-line basis over the estimated useful lives of the respective assets. Property and equipment also includes bed license intangibles for States other than Ohio (where the building and bed license are deemed complimentary assets) and are amortized over the life of the building. The Company reviews property and equipment for potential impairment whenever events or changes in circumstances indicate that the carrying amounts of assets may not be recoverable.

In 2012, the Company recognized a $0.4 million impairment charge to write down the carrying value of an office building located in Rogers, Arkansas. The office building was acquired in a 2011 acquisition. The purchase price allocation for that acquisition was deemed finalized as of December 31, 2011. Subsequent to December 31, 2011, it was determined that the acquired office building would not be utilized and the building was not in use and was made available for sale as of March 31, 2012. The impairment charge represents a change in the fair value of the building from that utilized in the 2011 purchase price allocation to the estimated net realizable value, less cost to sell, as of December 31, 2012. The impairment charge is classified as depreciation expense in the consolidated statements of operations and is included in the Company's Skilled Nursing Facility segment.

An impairment charge of $0.1 million was also recognized in 2012 to reduce the net book value of the Company's former Springfield, Ohio corporate office to net realizable value. In 2012, the Company completed the transition of its corporate office from Springfield, Ohio, to Roswell, Georgia. The impairment charge is classified as depreciation expense in the consolidated statements of operations.

The Rogers, Arkansas and Springfield, Ohio office buildings are classified as assets of disposal group held for sale in the accompanying December 31, 2012 consolidated balance sheet. Subsequent to December 31, 2012, the Springfield, Ohio office building was sold for the approximate net book value and the Rogers, Arkansas office building remains for sale.

Advertising

Advertising costs are expensed as incurred. Advertising costs for the years ended December 31, 2012 and 2011 were approximately $0.4 million and $0.2 million, respectively.

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ADCARE HEALTH SYSTEMS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

NOTE 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Stock Based Compensation

Stock based compensation for employee options and warrants is measured at the grant date based upon the fair value of the awards and is recognized as compensation expense over the requisite service period, net of estimated forfeitures. The Company estimates the fair value of stock options and warrants using the Black-Scholes-Merton option-pricing model. The fair value of restricted stock awards is equal to the Company's stock price on the date of grant.

The Company issues warrants to non-employees from time to time for various services. The Company estimates the fair value of warrants using the Black-Scholes-Merton option-pricing model.

Fair Value Measurements and Financial Instruments

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

Level 1	Quoted market prices in active markets for identical assets or liabilities
Level 2	Other observable market-based inputs or unobservable inputs that are corroborated by market data
Level 3	Significant unobservable inputs

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

Derivative Instruments

The Company generally does not use derivative instruments to hedge exposures to certain risks. However, the Company entered into a securities purchase agreement with respect to the issuance of subordinated convertible notes in October 2010 which includes a conversion feature that is not afforded equity classification and embodies risks that are not clearly and closely related to the host debt agreement. As such, this conversion feature is an embedded derivative instrument that is required to be bifurcated from the debt instrument and reported separately as a derivative liability at fair value.

The Company estimates the fair value of the conversion feature derivative instrument by using the Black-Scholes-Merton option-pricing model because it embodies the requisite assumptions necessary to estimate the fair value of this instrument. Changes in fair value of this derivative instrument are reported in the consolidated statement of operations.

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ADCARE HEALTH SYSTEMS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

NOTE 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Insurance

The Company is self-insured for employee medical claims and has a large deductible workers' compensation plan (in all states except for Ohio, where workers' compensation is covered under a premium-only policy provided by the Ohio Bureau of Worker's Compensation, a state funded program required by Ohio's monopolistic workers' compensation system). Additionally, the Company maintains insurance programs, including general and professional liability, property, casualty, directors' and officers' liability, crime, automobile, employment practices liability and earthquake and flood. The Company believes that its insurance programs are adequate and where there has been a direct transfer of risk to the insurance carrier, the Company does not recognize a liability in the consolidated financial statements.

The Company's services subject it to certain liability risks which may result in malpractice claims being asserted against the Company if its services are alleged to have resulted in patient injury or other adverse effects. The Company carries policies to protect against such claims.

Employee medical insurance programs are offered as a component of the Company's employee benefits. As of December 31, 2012, all employee medical plans are self-insured and a liability for claims incurred but not reported or unsettled claims are recognized as a liability in the consolidated financial statements. Prior to October 1, 2012, employee medical plans were provided on an insured versus self-insured basis.

Discontinued Operations

As part of the Company's strategy to focus on the growth of skilled nursing facilities, the Company decided in the fourth quarter of 2011 to exit the home health business. In the fourth quarter of 2012, the Company continued this strategy and entered into an agreement to sell six assisted living facilities located in Ohio. The Company also entered into a sublease arrangement in the fourth quarter of 2012 to exit the operations of a skilled nursing facility in Jeffersonville, Georgia. The results of operations and cash flows for the home health business, the six Ohio assisted living facilities and the Jeffersonville, Georgia skilled nursing facility are reported as discontinued operations under FASB ASC Topic 205-20, *Discontinued Operations* (see Note 3). Assets and liabilities of the disposal groups to be sold or assumed by a buyer are classified held for sale in the consolidated balance sheets at December 31, 2012 and 2011. The Company sold the assets of four of the six Ohio assisted living facilities in December 2012, one in February 2013, and one in May, 2013.

Recently Issued Accounting Pronouncements

Effective January 1, 2012, the Company adopted FASB Accounting Standard Update ("ASU") 2010-06, *Improving Disclosures About Fair Value Measurements,* that amends previous guidance for fair value measurement and disclosure requirements. The revised guidance changes certain fair value measurement principles, clarifies the application of existing fair value measurements, and expands the disclosure requirements, particularly for Level 3 fair value measurements. Adoption of the amendments did not have a material impact on the Company's consolidated financial statements.

Effective January 1, 2012, the Company adopted FASB ASU 2011-07, *Presentation of Bad Debt Expense*, that requires health care entities to separately present bad debt expense related to patient care revenue as a reduction of patient care revenue (net of contractual allowances and discounts) on

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ADCARE HEALTH SYSTEMS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

NOTE 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

the statement of operations for which the ultimate collection of all or a portion of the amounts billed or billable cannot be determined at the time services are rendered. Adoption of this update does not have an impact on the Company's consolidated financial statements since the Company assesses the ability to pay of its patients and residents prior to their admission to the Company's facilities.

Also effective January 1, 2012, the Company adopted FASB ASU 2011-08, *Intangibles Goodwill and Other*, that gives companies the option to make a qualitative evaluation about the likelihood of goodwill impairment. Companies are required to perform the two-step impairment test only if they conclude that the fair value of a reporting unit is more likely than not less than its carrying value. The Company adopted the accounting update for its goodwill impairment test performed for the year ended December 31, 2012.

In July, 2012, the FASB issued new accounting guidance intended to simplify how an entity tests indefinite-lived intangible assets for impairment. The guidance will allow an entity to first assess qualitative factors to determine whether it is necessary to perform the quantitative impairment test. An entity will no longer be required to calculate the fair value of an indefinite-lived intangible asset unless the entity determines, based upon a qualitative assessment, that it is more likely than not that the asset's fair value is less than its carrying amount. This accounting guidance is effective for the Company for the annual and any interim indefinite-lived intangible asset impairment tests performed for the year ending December 31, 2013.

Reclassifications

Certain reclassifications have been made to the 2011financial information to conform to the 2012 presentation. Reclassifications to 2011 financial information previously reported include reclassifications to reflect debt issued in connection with acquisitions on a gross basis, reflecting the proceeds from debt issuance as a financing activity, and the consideration transferred funded by the debt issuance as a component of the cost of acquisitions in investment activities in the consolidated statements of cash flows. The Company reclassified $2.7 million of goodwill acquired in conjunction with 2011 acquisitions that were previously reported as CON/bed licenses and included in property and equipment.

NOTE 2. LIQUIDITY AND PROFITABILITY

For the year ended and as of December 31, 2012, we had a net loss of $7.5 million and negative working capital of $5.9 million. At December 31, 2012, we had $15.9 million in cash and cash equivalents and $171.9 million in indebtedness, including current maturities and discontinued operations, of which $23.0 million is current debt (including the Company's outstanding convertible promissory notes with a principal amount in the aggregate of $11.7 million which mature in October 2013 and approximately $3.7 million of mortgage notes included in liabilities of disposal group). Our ability to achieve profitable operations is dependent on continued growth in revenue and controlling costs.

We anticipate that scheduled debt service (excluding outstanding convertible promissory notes but including principal, interest, collateral and capital improvement fund or other escrow deposits) will total approximately $17.2 million and cash outlays for acquisition costs, maintenance capital expenditures, dividends on our Series A Preferred Stock and income taxes will total approximately $4.7 million for the year ending December 31, 2013. Debt service requirements for the year ending December 31, 2013 include approximately $1.9 million of bullet maturities that the Company believes could be refinanced

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ADCARE HEALTH SYSTEMS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

NOTE 2. LIQUIDITY AND PROFITABILITY (Continued)

on a longer term basis. In recent periods, we have refinanced shorter term acquisition debt, including seller notes, with traditional longer term mortgage notes, some of which have been executed under government guaranteed lending programs. Although, we anticipate the conversion to common stock of the Company's outstanding convertible promissory notes with a principal amount in the aggregate of $11.7 million which mature in October 2013, we believe that our anticipated cash flow and committed funding sources would allow us to pay these notes in cash. These promissory notes are convertible into shares of common stock of the Company at $3.73 per share. The closing price of the common stock exceeded $4.00 per share from January 1, 2013 through July 5, 2013, except for the last three trading days in March 2013. As discussed further below, if we were required to pay these notes in cash, then the Company may be required to restructure its outstanding indebtedness, implement further cost reduction initiatives, sell assets, or delay, modify, or abandon its expansion plans due to our limited liquidity in such an event.

We estimate that cash flow from operations, including approximately $2.0 million cash outlay for costs with respect to the Audit Committee review and inquiry discussed in Part II, Item 9A. "Controls and Procedures," and other working capital changes will be approximately $17.8 million for the year ending December 31, 2013. The Company expanded its existing credit facility with Gemino Healthcare Finance, LLC ("Gemino"): (i) in May 2013, to refinance and include one of the facilities the Company acquired in December 2012; and (ii) in June 2013, to refinance and include two additional facilities the Company also acquired in December 2012. We routinely have ongoing discussions with existing and potential new lenders to refinance current debt on a longer term basis. We have been successful in recent years in raising new equity capital and believe, based on recent discussions that these markets will continue to be available to us for raising capital in 2013.

Based on existing cash balances, anticipated cash flows for the year ending December 31, 2013, and new sources of capital, we believe there will be sufficient funds for our operations, scheduled debt service, and capital expenditures at least through the next 12 months. On a longer term basis, we have approximately $80.4 million of debt payments and maturities due between 2014 and 2016, excluding convertible promissory notes which are convertible into shares of common stock. We believe our long-term liquidity needs will be satisfied by these same sources, as well as borrowings as required to refinance indebtedness.

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

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ADCARE HEALTH SYSTEMS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

NOTE 2. LIQUIDITY AND PROFITABILITY (Continued)

may be required to restructure its outstanding indebtedness, implement further cost reduction initiatives, sell assets, or delay, modify, or abandon its expansion plans.

NOTE 3. DISCONTINUED OPERATIONS

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

Total revenues from discontinued operations were $14.3 million and $14.9 million, respectively, in 2012 and 2011. Net income (loss) from discontinued operations was $7.2 million and $(1.2) million, respectively, in 2012 and 2011. Interest expense included in discontinued operations was $0.6 million and $0.8 million in 2012 and 2011, respectively. Income tax expense (benefit) included in discontinued operations was $0.02 and $(0.2) million in 2012 and 2011, respectively. The 2012 net income from discontinued operations includes a gain on sale of $6.7 million, including a $6.9 million gain on the sale of four of the six Ohio assisted living facilities sold for $16.1 million in December 2012 and a $0.2 million loss on the exit of the Jeffersonville, Georgia leased business operation. The 2011 net loss from discontinued operations includes a $1.8 million goodwill impairment charge pertaining to the home health business.

The assets and related debt of the home health business are reflected as assets and liabilities of a disposal group held for sale at December 31, 2011. The assets of the home health business were sold during 2012 for less than $0.1 million resulting in an immaterial gain on the sale. The two remaining Ohio assisted living facilities held for sale at December 31, 2012 are Lincoln Lodge Retirement Residence (known as Lincoln Lodge) and Hearth & Home of Vandalia (known as Vandalia). The assets of Lincoln Lodge and Vandalia to be sold and the Vandalia HUD mortgage note of $3.7 million to be assumed by the buyer are reflected as assets and liabilities of a disposal group held for sale at December 31, 2012. The Lincoln Lodge HUD mortgage note of $1.9 million at December 31, 2012 is reflected in the current portion of notes payable and other debt and was paid off from the proceeds of the Lincoln Lodge sale that occurred on February 28, 2013. The sale of Vandalia closed on May 6, 2013. Pursuant to the purchase and sale agreement, the combined purchase price for the sale of Vandalia and Lincoln Lodge is $6.0 million ($2.3 million net of assumed debt). Subsequent to December 31, 2012, the Company recognized a combined gain on sale in 2013 of less than $0.1 million and cash proceeds, net of costs and debt payoff, of $0.3 million.

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ADCARE HEALTH SYSTEMS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

NOTE 3. DISCONTINUED OPERATIONS (Continued)

Assets and liabilities of the disposal groups held for sale at December 31, 2012 and 2011 are as follows:

Amounts in (000's)	December 31, 2012	December 31, 2011
Property and equipment, net	$ 5,840	$ 45
Other assets	319	2
Assets of disposal group held for sale	$ 6,159	$ 47
Notes payable	3,662	240
Liabilities of disposal group held for sale	$ 3,662	$ 240

NOTE 4. SEGMENTS

Consistent with the Company's strategy to focus on the growth of its skilled nursing segment and the sale of the majority of its assisted living facilities (see Note 3) beginning in the fourth quarter of 2012, the Company evaluates operating performance of its 35 skilled nursing facilities, the three remaining assisted living facilities and the one independent living facility on a combined basis. Through the fourth quarter of 2012, the Company reported its operations under three segments: SNF, Assisted Living Facilities ("ALF"), and Corporate & Other.

With the execution of an agreement to sell six of its assisted living facilities located in Ohio occurring during the fourth quarter of 2012, the Company has provided segment reporting herein for 2012 and 2011 based on its prior three operating segments. The SNF and ALF segments provide services to individuals needing long-term care in a nursing home or assisted living setting and management of those facilities. The Corporate & Other segment engages in the management of facilities and accounting and IT services. The Company previously evaluated operating performance and allocated resources primarily based upon segment operating income (loss). Segment operating results exclude interest expense and other non-operating income and expenses. The table below contains continuing operations segment information for the years ended December 31, 2012 and 2011 based on the Company's former operating segments. The revenue, expenses, and income/(loss) of all

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ADCARE HEALTH SYSTEMS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

NOTE 4. SEGMENTS (Continued)

facilities reflected in discontinued operations (see Note 3) are excluded. Assets of disposal group are included in Corporate and other below.

Amounts in (000's)	SNF	ALF	Corporate & Other	Eliminations	Total
Year ended December 31, 2012					
Total revenues	$ 195,182	$ 4,319	$ 12,195	$ (10,038)	$ 201,658
Cost of services	174,140	3,725	380	(10,038)	168,207
General and administrative			17,005		17,005
Facility rent expense	7,499		190		7,689
Depreciation and amortization	5,278	403	1,124		6,805
Salary retirement and continuation costs			43		43
Operating income/(loss)	$ 8,265	$ 191	$ (6,547)	$	$ 1,909
Total assets	$ 146,159	$ 12,905	$ 85,676	$ (10,291)	$ 234,449
Capital spending	$ 4,278	$ 205	$ 1,294	$	$ 5,777
Year ended December 31, 2011					
Total revenue	$ 135,137	$ 1,455	$ 9,493	$ (7,873)	$ 138,212
Cost of services	118,220	1,466	6	(7,873)	111,819
General and administrative			13,281		13,281
Facility rent expense	7, 086		107		7,193
Depreciation and amortization	2,945	171	243		3,359
Salary retirement and continuation costs			1,451		1,451
Operating income/(loss)	$ 6,886	$ (182)	$ (5,595)	$	$ 1,109
Total assets	$ 109,681	$ 6,978	$ 51,993	$ (9,548)	$ 159,104
Capital spending	$ 2,046	$ 78	$ 2,121	$	$ 4,245

NOTE 5. PROPERTY AND EQUIPMENT

Property and Equipment consist of the following:

(Amounts in 000's)	Estimated Useful Lives (Years)	December 31, 2012	December 31, 2011
Buildings and improvements	5 - 40	$ 137,842	$ 93,371
Equipment	2 - 10	10,448	7,108
Land		8,469	7,636
Computer related	2 - 10	2,670	2,414
Construction in process		510	77
		159,939	110,606
Less: accumulated depreciation and amortization expense		8,875	8,157
Property and equipment, net		$ 151,064	$ 102,449

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ADCARE HEALTH SYSTEMS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

NOTE 5. PROPERTY AND EQUIPMENT (Continued)

For the twelve months ended December 31, 2012 and 2011, total depreciation and amortization expense was $6.8 million and $2.6 million, respectively. Total depreciation expense and amortization expense excludes $1.1 million and $0.6 million in 2012 and 2011, respectively, that is recognized in net income (loss) from discontinued operations.

NOTE 6. INTANGIBLE ASSETS AND GOODWILL

Intangible assets consist of the following:

(Amounts in 000's)	Lease Rights	Bed Licenses (included in property and equipment)	Bed Licenses Separable	Total
Balances, December 31, 2011				
Gross	$ 9,545	$ 26,149	$ 1,189	$ 36,883
Accumulated amortization	(1,085)	(533)		(1,618)
Net carrying amount	$ 8,460	$ 25,616	$ 1,189	$ 35,265
Reclass adjustment from bed licenses to goodwill		(2,694)		(2,694)
Deconsolidation of Oklahoma Owners		(3,458)		(3,458)
Acquisitions		18,481	1,282	19,763
Amortization expense	(1,616)	(905)		(2,521)
Balances, December 31, 2012				
Gross	$ 9,545	$ 38,478	$ 2,471	$ 50,494
Accumulated amortization	(2,701)	(1,438)		(4,139)
Net carrying amount	$ 6,844	$ 37,040	$ 2,471	$ 46,355

(Amounts in 000's)	Lease Rights	Bed Licenses (included in property and equipment)	Bed Licenses Separable	Total
Balances, December 31, 2010				
Gross	$ 9,020	$ 6,120	$ 1,189	$ 16,329
Accumulated amortization	(169)			(169)
Net carrying amount	$ 8,851	$ 6,120	$ 1,189	$ 16,160
Acquisitions	525	20,029		20,554
Amortization expense	(916)	(533)		(1,449)
Balances, December 31, 2011				
Gross	$ 9,545	$ 26,149	$ 1,189	$ 36,883
Accumulated amortization	(1,085)	(533)		(1,618)
Net carrying amount	$ 8,460	$ 25,616	$ 1,189	$ 35,265

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ADCARE HEALTH SYSTEMS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

NOTE 6. INTANGIBLE ASSETS AND GOODWILL (Continued)

Amortization expense for bed licenses included in property and equipment is included in property and equipment depreciation and amortization expense (See Note 5). Amortization expense for lease rights was $1.6 million and $0.9 million for the years ended December 31, 2012 and 2011, respectively. Estimated amortization expense for all definite lived intangibles for each of the future years ending December 31 is as follows:

Amounts in (000's)	Bed Licenses	Lease Rights
2013	$ 1,283	$ 997
2014	1,283	938
2015	1,283	813
2016	1,283	813
2017	1,283	813
Thereafter	30,625	2,470
Total	$ 37,040	$ 6,844

The following table summarizes the changes in the carrying amount of goodwill for the years ended December 31, 2012 and 2011.

	(Amounts in 000's)
Balances, December 31, 2011	
Goodwill	$ 5,374
Accumulated impairment losses	(1,774)
Total	$ 3,600
Deconsolidation of variable interest entities	(1,122)
Goodwill acquired in acquisitions	3,451
Disposed in sale of business (net of accumulated impairment losses of $1,774)	(906)
Impairment losses	
Net change during year	$ 1,423
Balances, December 31, 2012	
Gross	$ 5,023
Accumulated impairment losses	
Total	$ 5,023

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ADCARE HEALTH SYSTEMS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

NOTE 6. INTANGIBLE ASSETS AND GOODWILL (Continued)

	(Amounts in 000's)
Balances, December 31, 2010	
Goodwill	$ 2,680
Accumulated impairment losses	
Total	$ 2,680
Goodwill acquired in acquisitions	2,694
Impairment losses	(1,774)
Balances, December 31, 2011	
Gross	$ 2,680
Accumulated impairment losses	(1,774)
Goodwill as previously reported	906
Goodwill acquired in acquisitions (see note below)	2,694
Total	$ 3,600

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

NOTE 7. RESTRICTED CASH AND INVESTMENTS

The following presents the Company's various restricted cash, escrow deposits and investments:

Amounts in (000's)	December 31, 2012	2011
HUD escrow deposits	$ 279	$ 326
Funds held in trust for residents		45
Refundable escrow deposits		500
Principal and interest escrow	106	
Collateral certificates of deposit	1,357	1,012
Total current portion	1,742	1,883
HUD replacement reserve	372	1,130
Reserves for capital improvements	1,602	1,767
Restricted investments for other debt obligations	5,241	1,973
Total noncurrent portion	7,215	4,870
Total restricted cash and investments	$ 8,957	$ 6,753

HUD escrow deposits The Regulatory Agreements we have entered into in connection with the financing secured through HUD for facilities requiring monthly escrow deposits for taxes and insurance.

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ADCARE HEALTH SYSTEMS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

NOTE 7. RESTRICTED CASH AND INVESTMENTS (Continued)

Funds held in trust for residents Nursing homes are required to maintain a savings account for the use of the residents to deposit their personal funds. The Company maintains such accounts for their nursing home residents with an offsetting liability as these funds are payable to the residents on demand. In some locations, the residents' funds are managed by a third party and are not reflected on the balance sheet. In 2012, all facilities transitioned to the third party manager for the resident funds.

Refundable escrow deposits In March 2012, the Company terminated an agreement to acquire or lease 15 skilled nursing facilities in South Carolina, North Carolina, Virginia, and Tennessee and, as a result of such termination, the deposit was refunded.

Collateral certificates of deposit In 2012, a short term mortgage obtained by the Company required a certificate of deposit to be held as collateral. The certificate of deposit matured in March 2013.

HUD replacement reserve The Regulatory Agreements entered into in connection with the financing secured through HUD also requires monthly escrow deposits for replacement and improvement of the HUD project assets.

Reserves for capital improvements Several of the acquired facilities also have requirements to have funds set aside for capital improvements.

Restricted investments for other debt obligations One of the Company's consolidated variable interest entities entered into a bond agreement that requires a project fund and a debt service reserve fund. In addition, two mortgages obtained in 2010 required two five year certificates of deposit to be held as collateral. The certificates of deposit are required to be held to maturity through October 2015 and will automatically renew if the lender continues to require them as collateral.

NOTE 8. ACCRUED EXPENSES

Accrued expenses consist of the following:

	December 31,	
Amounts in (000's)	**2012**	**2011**
Accrued payroll related	$ 5,626	$ 5,040
Accrued employee benefits	3,790	2,023
Real estate and other taxes	1,245	982
Other accrued expenses	3,069	1,836
Total	$ 13,730	$ 9,881

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ADCARE HEALTH SYSTEMS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

NOTE 9. NOTES PAYABLE AND OTHER DEBT

Notes payable and other debt consists of the following:

Amounts in (000's)	December 31, 2012	2011
Revolving credit facilities and lines of credit	$ 9,204	$ 8,651
Senior debt guaranteed by HUD	9,699	15,738
Senior debt guaranteed by USDA	28,370	38,717
Senior debt guaranteed by SBA	6,189	5,087
Senior debt bonds, net of discount	16,265	6,176
Senior debt other mortgage indebtedness	75,188	24,063
Other debt	4,004	4,196
Convertible debt issued in 2010, net of discount	10,948	10,105
Convertible debt issued in 2011	4,509	4,509
Convertible debt issued in 2012	7,500	
Total	171,876	117,242
Less current portion	19,387	11,909
Less portion included in liabilities of disposal group held for sale	3,662	240
Notes payable and other debt, net of current portion	$ 148,827	$ 105,093

Scheduled Maturities

The schedule below summarizes the scheduled maturities as of December 31, 2012 for each of the next five years and thereafter. The 2013 maturities include $3.7 million related to the Vandalia HUD mortgage note classified as liabilities of disposal group held for sale at December 31, 2012 that was assumed by the buyer of the Hearth & Home of Vandalia assisted living facility that the Company sold in a transaction that closed in May 2013 (see Note 3 and Note 23).

	Amounts in (000's)
2013	$ 23,661
2014	20,561
2015	30,888
2016	41,000
2017	3,750
Thereafter	52,789
Subtotal	172,649
Less: unamortized discounts ($702 classified as current)	(1,131)
Plus: unamortized premiums ($90 classified as current)	358
Total notes and other debt	$ 171,876

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ADCARE HEALTH SYSTEMS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

NOTE 9. NOTES PAYABLE AND OTHER DEBT (Continued)

Debt Covenant Compliance

As of December 31, 2012, the Company (including its consolidated variable interest entity) has over twenty different credit facilities (credit facilities, mortgage notes, bonds and other credit obligations) outstanding that include various financial and administrative covenant requirements. Covenant requirements include, but are not limited to, fixed charge coverage ratios, debt service coverage ratios, minimum EBITDA or EBITDAR, current ratios and tangible net worth requirements. Certain financial covenant requirements are based on consolidated financial measurements whereas others are based on subsidiary level (i.e.; facility, multiple facilities or a combination of subsidiaries comprising less than the Company's consolidated financial measurements). Some covenants are based on annual financial metric measurements whereas others are based on monthly or quarterly financial metric measurements. The Company routinely tracks and monitors its compliance with its covenant requirements. In recent periods, including as of December 31, 2012, the Company has not been in compliance with certain financial and administrative covenants. For each instance of such non-compliance, the Company has obtained waivers or amendments to such requirements including as necessary modifications to future covenant requirements or the elimination of certain requirements in future periods.

Revolving Credit Facilities and Lines of Credit

Gemino Credit Facility

On September 20, 2012, AdCare terminated and paid off all amounts outstanding under that certain Credit Agreement, dated October 29, 2010, between Gemino Healthcare Finance, LLC ("Gemino") and AdCare (the "Gemino Credit Facility"). The Gemino Credit Facility was a secured credit facility for borrowings up to $7.5 million, which was to mature on October 29, 2013. As of September 20, 2012, the amount outstanding in principal balance was approximately $4.2 million which was paid from funds made available to AdCare from a new credit facility entered into with The PrivateBank and Trust Company ("PrivateBank"). Interest accrued on the principal balance outstanding of the Gemino Credit Facility at an annual rate equal to LIBOR rate plus the applicable margin of 4.75% to 5.00%, depending on the principal amount outstanding. The Gemino Credit Facility contained various financial covenants and other restrictions, including a fixed charge cover ratio and maximum loan turn days, as well as borrowing base restrictions. No material early termination penalties were incurred by AdCare as a result of the termination.

At December 31, 2011, the outstanding balance of approximately $7.3 million for the Gemino Credit Facility was classified as current as a result of the required lockbox arrangement and subjective acceleration clauses.

Gemino-Bonterra Amendment

On September 20, 2012, ADK Bonterra/Parkview, LLC, a wholly owned subsidiary of AdCare ("Bonterra") entered into a Second Amendment to the Credit Agreement with Gemino ("Gemino-Bonterra Credit Facility"), which amended the original Credit Agreement dated April 27, 2011 between Bonterra and Gemino. The Gemino-Bonterra Credit Facility is a secured credit facility for borrowings up to $2.0 million. The amendment extends the term of the Gemino-Bonterra Credit Facility from October 29, 2013 to January 31, 2014 and amends certain financial covenants regarding Bonterra's fixed charge coverage ratio, maximum loan turn days and applicable margin. Interest accrues on the principal

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ADCARE HEALTH SYSTEMS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

NOTE 9. NOTES PAYABLE AND OTHER DEBT (Continued)

balance outstanding at an annual rate equal to the LIBOR rate plus the applicable margin of 4.75% to 5.00%, which fluctuates depending upon the principal amount outstanding. As of December 31, 2012, $1.3 million was outstanding under the Gemino-Bonterra Credit Facility.

On December 20, 2012, Bonterra entered into a Third Amendment to the Credit Agreement with Gemino, which amended the original Credit Agreement, dated April 27, 2011, between Bonterra and Gemino. The Third Amendment altered the financial covenant in the original credit agreement to exclude the Oklahoma Owners under another credit agreement with Gemino from the covenant calculation of maximum loan turn days and acknowledges that Bonterra shall not be obligated, directly or indirectly, for any indebtedness or obligations of the Oklahoma Owners to Gemino.

PrivateBank Credit Facility

On September 20, 2012, in connection with the payoff of the Gemino Credit Agreement noted above, AdCare entered into a Loan and Security Agreement with PrivateBank ("PrivateBank Credit Facility"). Under the terms of the PrivateBank Credit Facility, PrivateBank provides $10.6 million principal amount for a three-year period on senior secured revolving credit facility limited to borrowing base restrictions and offset by a $0.7 million standby letter of credit at December 31, 2012, increasing to $2.5 million at July 31, 2013.

The PrivateBank Credit Facility matures on December 31, 2016. Interest is accrued on the principal balance at an annual rate of the greater of (i) 1% plus the prime interest rate per annum, or (ii) 5% per annum. Payments for the interest are due monthly and commenced on October 1, 2012. In addition, there is a non-utilization fee of 0.5% on the unused portion of the available credit. The PrivateBank Credit Facility may be prepaid at any time without premium or penalty, provided that such prepayment is accompanied by a simultaneous payment of all accrued and unpaid interest, through the date of prepayment. The PrivateBank Credit Facility is secured by a first priority security interest in the real property and improvements constituting nursing facilities owned and operated by AdCare. AdCare has unconditionally guaranteed all amounts owed to PrivateBank under the PrivateBank Credit Facility.

Proceeds from the PrivateBank Credit Facility were used to pay off all amounts outstanding under a separate $2.0 million credit facility with PrivateBank under which certain subsidiaries of AdCare were borrowers, and the Gemino Credit Facility.

On October 26, 2012, the Company and certain of its wholly owned subsidiaries, on the one hand, and PrivateBank entered into a Modification Agreement which amends the PrivateBank Credit Facility, dated as of September 20, 2012, between certain of the Company's wholly owned subsidiaries and PrivateBank. The Modification Agreement amends the loan agreement to: (i) allow PrivateBank to issue additional letters of credit for the account of the borrowers under the loan agreement; and (ii) change the total amount that may be issued under any letters of credit to $2.5 million. The modification agreement did not change the maximum amount that may be borrowed under the loan agreement by the borrowers, which remains at $10.6 million. As of December 31, 2012, $7.7 million was outstanding under the PrivateBank Credit Facility.

Contemporary Healthcare Senior

On August 17, 2012 in conjunction with the acquisition of Companions Specialized Care Center in Tulsa, OK, two wholly owned subsidiaries of the Company entered into a Loan Agreement with

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ADCARE HEALTH SYSTEMS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

NOTE 9. NOTES PAYABLE AND OTHER DEBT (Continued)

Contemporary Healthcare Senior ("Contemporary") and issued a promissory note in favor of Contemporary for a principal amount of $600,000 ("Contemporary $600,000 Loan"). The Contemporary $600,000 Loan matures on August 20, 2015 and interest accrues on the principal balance at an annual rate of 9.0%. Payments for the interest and a portion of the principal in excess of the borrowing base are payable monthly, commencing on September 20, 2012. As of December 31, 2012, $0.2 million was outstanding under the Contemporary $600,000 Loan.

Senior Debt Guaranteed by HUD

Hearth and Home of Vandalia

In connection with the Company's January 2012 refinancing of the assisted living facility known as Hearth and Home of Vandalia, owned by a wholly owned subsidiary of AdCare, the Company obtained a term loan, insured by U.S. Department of Housing and Urban Development ("HUD"), with a financial institution for a total amount of $3.7 million that matures in 2041. The HUD term loan requires monthly principal and interest payments with a fixed interest rate of 3.74%. Deferred financing costs incurred on the term loan amounted to $0.2 million and are being amortized to interest expense over the life of the loan. The HUD term loan has a prepayment penalty of 8% starting in 2014 declining by 1% each year through 2022. This mortgage note was assumed by the buyer in the closing of the sale of this facility that occurred in May 2013 pursuant to the terms of the sale agreement related to the sale of six of the Company's assisted living facilities located in Ohio (see Note 3 to our Consolidated Financial Statements included in this Annual Report).

Other Senior Debt Guaranteed by HUD

For three facilities, the Company has term loans insured by HUD a financial institution that totaled approximately $6.0 million at December 31, 2012. The combined HUD mortgage notes require monthly principal and interest payments of approximately $45,000 with fixed interest rates ranging from 5.95% to 7.25%. The notes mature at various dates starting in 2027 through 2038. Deferred financing costs incurred on these loans amounted to approximately $0.3 million and are being amortized to interest expense over the life of the notes. The loans have prepayment penalties of 3.5% to 6% through 2013 declining by 1% each year through 2022. The loans have certain restrictive covenants and HUD regulatory compliance requirements including maintenance of certain restricted escrow deposits and reserves for replacement.

Sale of Ohio ALFs

On December 28, 2012, AdCare sold four of its assisted living facilities located in Ohio and used a portion of the funds to pay off the principal balance of their HUD loans in the amount of $6.4 million. On February 28, 2013, AdCare completed the sale of one additional assisted living facility and used the proceeds to repay the principal balance of the HUD loan with respect to the facility in the amount of $1.9 million (see Note 23 to our Consolidated Financial Statements included in this Annual Report).

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ADCARE HEALTH SYSTEMS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

NOTE 9. NOTES PAYABLE AND OTHER DEBT (Continued)

Senior Debt Guaranteed by USDA

For five facilities, the Company has term loans insured 70% to 80% by the USDA with financial institutions that totaled approximately $28.4 million at December 31, 2012. The combined USDA mortgage notes require monthly principal and interest payments of approximately $0.2 million adjusted quarterly with a variable interest rate of prime plus 1.0% to 1.75% with a floor of 5.50% to 6.00%. The notes mature at various dates starting in 2035 through 2036. Deferred financing costs incurred on these loans amounted to approximately $0.8 million and are being amortized to interest expense over the life of the notes. In addition, the loans have an annual renewal fee for the USDA guarantee of 0.25% of the guaranteed portion. The loans have prepayment penalties of 8% to 9% through 2013 declining by 1% each year capped at 1% for the remainder of the term.

Senior Debt Guaranteed by SBA

Stone County

In June 2012, Mt. V Property Holdings, LLC. ("Stone County"), a wholly owned subsidiary of AdCare, entered into a loan agreement with the Economic Development Corporation of Fulton County (the "CDC"), an economic development corporation working with the SBA, in the amount of $1.3 million. The funding from the CDC loan of $1.3 million was used to satisfy a $1.3 million Metro City Bank loan that was used to acquire the assets of a skilled nursing facility located in Arkansas known as the Stone County Nursing and Rehabilitation facility.

The CDC loan matures in July 2032 and accrues interest at a rate of 2.42% per annum. The CDC loan is payable in equal monthly installments of principal and interest based on a twenty (20) year amortization schedule. The CDC loan may be prepaid, subject to prepayment premiums, during the first 10 years. There are also annual fees associated with the CDC loan, including an SBA guarantee fee. The CDC loan is secured by a second in priority security deed on the Stone County Nursing and Rehabilitation facility and guarantees from AdCare, the SBA and a wholly owned subsidiary of AdCare. As of December 31, 2012, $1.3 million was outstanding under the CDC loan.

Other Senior Debt Guaranteed by SBA

For three facilities, the Company has term loans insured 75% by the SBA with a financial institution that totaled approximately $4.9 million at December 31, 2012. The combined SBA mortgage notes require monthly principal and interest payments of approximately $28,000 with an interest rate of 2.42% to 5.5%. The notes mature at various dates starting in 2031 through 2036. Deferred financing costs incurred on these loans amounted to approximately $0.2 million and are being amortized to interest expense over the life of the note. In addition, the loans have an annual renewal fee for the SBA guarantee of 0.13% to 0.25% of the guaranteed portion. The loans have prepayment penalties ranging from 2.48% to 3.0% declining each year until year 10.

Senior Debt Bonds, net of Discount

Eaglewood Village Bonds

In April 2012, a wholly owned subsidiary of AdCare entered into a loan agreement with the City of Springfield in the State of Ohio pursuant to which City of Springfield lent to such subsidiary the proceeds from the sale of City of Springfield's Series 2012 Bonds. The Series 2012 Bonds consist of

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ADCARE HEALTH SYSTEMS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

NOTE 9. NOTES PAYABLE AND OTHER DEBT (Continued)

$6.6 million in Series 2012A First Mortgage Revenue Bonds and $0.6 million in Taxable Series 2012B First Mortgage Revenue Bonds. The Series 2012 Bonds were issued pursuant to an April 2012 Indenture of Trust between the City of Springfield and the Bank of Oklahoma. The Series 2012A Bonds mature in May 2042 and accrue interest at a fixed rate of 7.65% per annum. The Series 2012B Bonds mature in May 2021 and accrue interest at a fixed rate of 8.5% per annum. Deferred financing costs incurred on the loan amounted to $0.6 million and are being amortized to interest expense over the life of the loan. The loan is secured by the Company's assisted living facility located in Springfield, Ohio known as Eaglewood Village and guaranteed by AdCare. There is an original issue discount of $0.3 million and restricted assets of $0.3 million related to this loan. As of December 31, 2012, $6.6 million was outstanding under the Series 2012A First Mortgage Revenue Bonds and $0.6 million was outstanding under the Taxable Series 2012B First Mortgage Revenue Bonds. The unamortized discount on the bonds was $0.2 million at December 31 2012.

Quail Creek

In July 2012, a wholly owned subsidiary of AdCare financed the purchase of a skilled nursing facility located in Oklahoma City, Oklahoma known as Quail Creek Nursing by the assumption of existing indebtedness under that certain Loan Agreement and Indenture of First Mortgage with The Bank of New York Mellon Global Corporate Trust, as assignee of The Liberty National Bank and Trust of that certain Bond Indenture, dated September 1, 1986, as amended as of September 1, 2001. The indebtedness under the Loan Agreement and Indenture consists of a principal amount of $2.8 million. In July of 2012, the purchase price allocation of fair value totaling $3.2 million was assigned to this indebtedness resulting in a $0.4 million premium that is being amortized to maturity. The loan matures in August 2016 and accrues interest at a fixed rate of 10.25% per annum. The loan is secured by the Quail Creek facility.

As of December 31, 2012, $2.8 million was outstanding under the Loan Agreement. The unamortized premium on the bonds was $0.4 million at December 31 2012.

Riverchase

The Company's consolidated variable interest entity, Riverchase Village ADK, LLC ("Riverchase"), has revenue bonds, in two series, issued by the Medical Clinical Board of the City of Hoover in the state of Alabama which the Company has guaranteed the obligation under the bonds.

The Series 2010A portion of $5.8 million matures on June 1, 2039. The Series 2010B portion of $0.5 million matures serially beginning on June 1, 2012 through June 1, 2017, with annual redemption amounts ranging from $75,000 to $100,000. The Series 2010A and 2010B bonds may be redeemed early beginning on June 1, 2012 through May 31, 2015 at a redemption price ranging from 101% to 103% of the principal amount plus accrued interest. Any early redemption after May 31, 2015 is at a redemption price of 100% of the principal amount plus accrued interest. The bonds require monthly payments of fixed interest of $38,000 at a weighted average effective interest rate of 7.9%.

As of December 31, 2012, $5.8 million was outstanding under the Series 2010A portion and $0.5 million was outstanding under the Series 2010 B portion of the bonds. The bonds contain an original issue discount that is being amortized over the term of the notes. The unamortized discount on the bonds was $0.2 million at December 31 2012.

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ADCARE HEALTH SYSTEMS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

NOTE 9. NOTES PAYABLE AND OTHER DEBT (Continued)

Senior Debt Other Mortgage Indebtedness

Woodland Manor

In connection with the Company's January 2012 acquisition of the skilled nursing facility known as Woodland Manor, the Company entered into a loan agreement for $4.8 million with PrivateBank. The loan matures in December 2016 with a required final payment of $4.3 million and accrues interest at the LIBOR rate plus 4% with a minimum rate of 6% per annum. The loan requires monthly payments of principal and interest. Deferred financing costs incurred on the loan amounted to $0.1 million and are being amortized to interest expense over the life of the loan. The loan has a prepayment penalty of 5% through 2012 declining by 1% each year through 2015. The loan is secured by the Woodland Manor facility and guaranteed by AdCare. As of December 31, 2012, $4.7 million was outstanding under loan agreement.

Little Rock, Northridge and Woodland Hills

In connection with the Company's April 2012 acquisition of three skilled nursing facilities located in Arkansas known as Little Rock, Northridge and Woodland Hills, the Company entered into a loan agreement for $21.8 million with PrivateBank. The loan originally matured in March 2017 with a required final payment of $19.7 million and has since been amended. The loan accrues interest at the LIBOR rate plus 4% with a minimum rate of 6% per annum and requires monthly principal payments plus interest for total current monthly payments of $0.2 million. Deferred financing costs incurred on the loan amounted to $0.4 million and are being amortized to interest expense over the life of the loan. The loan has a prepayment penalty of 5% through 2012 declining by 1% each year through 2015. The loan is secured by the three facilities and guaranteed by AdCare. The Company has $1.8 million of restricted assets related to this loan.

On June 15, 2012, the Company entered into a modification agreement with PrivateBank to modify the terms of the loan agreement. The loan modification agreement, among other things, amended the loan agreement to reflect a maturity date of March 30, 2013.

A portion of the PrivateBank loan with respect to the Northridge facility and Woodland Hills facility was paid off and refinanced with a portion of the proceeds from a new credit facility with KeyBank National Association ("KeyBank") on December 28, 2012, as discussed below. On December 28, 2012, certain subsidiaries of the Company entered into a Second Modification Agreement with PrivateBank which modified the loan agreement. The modification, among other things, extends the term of the PrivateBank loan from March 30, 2013 to December 31, 2016; releases certain subsidiaries of the Company related to the Northridge facility and Woodland Hills facility from liability under two of the promissory notes and other related documents under the credit facility; and reduces the total outstanding amount owed under the credit facility from $21.8 million to $13.7 million. As of December 31, 2012, $13.7 million was outstanding under loan agreement.

Abington Place Metro City Bank

In connection with the Company's June 2012 acquisition of the skilled nursing facility located in Little Rock, Arkansas known as Abington Place, a wholly owned subsidiary of AdCare, entered into a short-term loan agreement for $3.4 million with Metro City Bank. In August 2012, the maturity date was extended from September 2012 to January 2014. The note accrues interest at the prime rate plus

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ADCARE HEALTH SYSTEMS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

NOTE 9. NOTES PAYABLE AND OTHER DEBT (Continued)

2.25% with a minimum rate of 6.25% per annum. Deferred financing costs incurred on the loan amounted to $0.1 million and are amortized to interest expense over the life of the loan. The loan was secured by the Abington Place facility and guaranteed by AdCare.

The Abington Metro City Bank loan was paid off and refinanced with Key Bank on December 28, 2012 as discussed below.

Stone County

In June 2012, Mt. V Property Holdings, LLC ("Stone County"), a wholly owned subsidiary of AdCare, entered into two loan agreements with Metro City Bank in the amounts of $1.3 million and $1.8 million. The purpose of these agreements was to refinance existing debt in the original principal amount of $3.1 million used to acquire the assets of a skilled nursing facility located in Arkansas known as the Stone County Nursing and Rehabilitation facility.

The $1.3 million loan from Metro City Bank was repaid with the funding from the CDC loan of $1.3 million. The $1.8 million Metro City Bank loan matures in June 2022 and accrues interest at the prime rate plus 2.25% with a minimum rate of 6.25% per annum. Deferred financing costs incurred on this loan amounted to $0.1 million and are being amortized to interest expense over the life of the loan. The Metro City Bank loan has a prepayment penalty of 10% for any prepayment through June 2013. The penalty is reduced by 1% each year until the loan maturity date. The Metro City Bank loan is secured by the Stone County Nursing and Rehabilitation facility and is guaranteed by AdCare. As of December 31, 2012, $1.8 million was outstanding under the Metro City Bank loan.

Glenvue

In July 2012, Glenvue Health & Rehabilitation, a wholly owned subsidiary of AdCare, financed the acquisition of a skilled nursing facility located in Glennville, Georgia, by entering into a loan agreement for $6.6 million with PrivateBank. The loan matures in July 2014 with a required final payment of $6.4 million and accrues interest at an annual rate of the greater of (i) 6.0% per annum; or (ii) the LIBOR rate plus 4.0% per annum. The loan requires monthly payments of principal and interest. Deferred financing costs incurred on the loan amounted to $0.1 million and are being amortized to interest expense over the life of the loan. The loan is secured by the Glenvue facility and guaranteed by AdCare. As of December 31, 2012, $6.5 million was outstanding under the loan.

Companions Specialized Care

In August 2012, a wholly owned subsidiary of AdCare, financed the acquisition of a skilled nursing facility located in Tulsa, Oklahoma, known as Companions Specialized Care Center, by entering into a loan agreement for $5.0 million with Contemporary Healthcare Capital. The loan matures in August 2015 with a required final payment of $5.0 million and accrues interest at a fixed rate of 8.5% per annum. Deferred financing costs incurred on the loan amounted to $0.2 million and are being amortized to interest expense over the life of the loan. The loan has a prepayment penalty of 5% during the first year of the term and 1% during the second year of the term. The loan is secured by the Companions Specialized Care facility and guaranteed by AdCare. As of December 31, 2012, $5.0 million was outstanding under the loan.

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ADCARE HEALTH SYSTEMS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

NOTE 9. NOTES PAYABLE AND OTHER DEBT (Continued)

Northridge, Woodland Hills and Abington

On December 28, 2012, the Company's wholly owned subsidiaries which own the Northridge, Woodland Hills and Abington facilities entered into a Secured Loan Agreement with the KeyBank National Association (the "KeyBank Credit Facility"). The KeyBank Credit Facility provides for a $16.5 million principal amount senior secured credit facility and matures on February 27, 2015; provided, however, that the KeyBank Borrowers may extend the maturity date by an additional six months if certain conditions are met. Interest on the KeyBank Credit Facility accrues on the principal balance thereof at an annual rate of 4.25% plus the current LIBOR rate. The KeyBank Credit Facility may be prepaid at any time without premium or penalty, provided that the KeyBank Borrowers pay any costs of KeyBank in re-employing such prepaid funds. AdCare Health Systems, Inc., AdCare Property Holdings, LLC, and AdCare Operations, LLC. have unconditionally guaranteed all amounts owing under the KeyBank Credit Facility.

Proceeds from the KeyBank Credit Facility were used to pay off all amounts outstanding under an unsecured promissory note, dated April 1, 2012, issued by the Company in favor of Strome Alpha Offshore Ltd. in the amount of $5.0 million; payoff of an existing credit facility with Metro City Bank with respect to the Abington facility in the amount of $3.4 million; and payoff of the portion of the PrivateBank Credit Facility which relates to the Northridge and Woodland Hills in the amount of $8.1 million. As of December 31, 2012, $16.5 million was outstanding under the KeyBank Credit Facility.

Sumter Valley and Georgetown

In connection with the closing of the Sumter and Georgetown facilities acquisition, two wholly owned subsidiaries of AdCare Sumter Valley Property Holdings, LLC and Georgetown HC&R Property Holdings, LLC entered into a Loan Agreement with Metro City Bank, dated December 31, 2012 in which Metro City Bank issued a promissory note for an aggregate principal amount of $7.0 million (the "Metro City Bank Loan"). The Metro City Bank Loan matures on February 1, 2014. Interest on the loan accrues on the principal balance thereof at an annual rate of 1.5% per annum plus the prime interest rate, to be adjusted quarterly (but in no event shall the total interest be less than 5.50% per annum), and payments for the interest are payable monthly, commencing on February 1, 2013. The entire outstanding principal balance of the loan, together with all accrued but unpaid interest thereon, is payable on February 1, 2014. AdCare and certain of its subsidiaries have unconditionally guaranteed all amounts owing under the Metro City Bank Loan. As of December 31, 2012, $7.0 million was outstanding under the Metro City Bank Loan.

Northwest

In connection with the acquisition of the Northwest Nursing Center facility, a wholly owned subsidiary of AdCare, issued a note pursuant to a Loan Agreement with First Commercial Bank, dated December 31, 2012, for a principal amount of $1.5 million. The note matures on December 31, 2017. Interest on the note accrues on the principal balance thereof at an annual rate equal to the prime interest rate (but in no event shall the interest rate be less than 5.00% per annum), and payments for the interest are payable monthly, commencing on January 31, 2013. The entire outstanding principal balance of the note, together with all accrued but unpaid interest thereon, is payable on December 31,

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ADCARE HEALTH SYSTEMS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

NOTE 9. NOTES PAYABLE AND OTHER DEBT (Continued)

2017. AdCare and certain subsidiaries of the Company have unconditionally guaranteed all amounts owing under the note. As of December 31, 2012, $1.5 million was outstanding under the loan.

Hembree Road Building

In November 2012, in connection with the acquisition of AdCare's corporate offices at Hembree Road, Roswell, Georgia, a wholly owned subsidiary of AdCare issued a promissory note in favor of Fidelity Bank for a principal amount of $1.1 million. The note matures in December 2017. Interest on the note accrues on the principal balance thereof at a fixed rate of 5.5% per annum and payments for the interest and principal are due monthly, commencing in December 2012. The entire outstanding principal balance of the note, together with all accrued but unpaid interest thereon, is payable on December 31, 2017. As of December 31, 2012, $1.0 million was outstanding under the loan.

Senior Debt Other Mortgage Indebtedness

For five facilities the Company has obtained various term loans that totaled approximately $17.3 million at December 31, 2012. The combined mortgage notes require monthly principal and interest payments of approximately $0.1 million with interest rates of 6.00% to 6.25%. The notes mature at various dates starting in 2016 through 2031. Deferred financing costs incurred on these loans amounted to approximately $0.5 million and are being amortized to interest expense over the life of the notes.

The remaining mortgage note balance is related to the financing on the Company's former corporate headquarters in Springfield, Ohio with a balance of approximately $0.2 million at December 31, 2012. The mortgage requires fixed monthly payments of approximately $3,000 plus interest at LIBOR plus 3.00% maturing in 2017. The building was sold in June 2013 and the mortgage was paid.

Other Debt

Eaglewood Village Promissory Note

In January 2012, two wholly owned subsidiaries of AdCare issued a promissory note to the seller in the amount of $0.5 million in connection with the January 2012 acquisition of the assisted living facility located in Springfield, Ohio. The note matures in January 2014 and requires a final payment of $0.5 million. The note bears interest at 6.5% per annum payable monthly beginning in February 2012. The note requires monthly principal and interest payment. The note may be prepaid without penalty at any time.

Cantone Promissory Notes

In March 2012, AdCare issued an unsecured promissory note to Cantone Asset Management LLC in the amount of $3.5 million. In April 2012, AdCare issued another promissory note to Cantone Asset Management LLC in the amount of $1.5 million. In July 2012, these two promissory notes were refinanced through the issuance to Cantone Asset Management LLC of an 8% subordinated convertible note in the principal amount of $5.0 million.

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ADCARE HEALTH SYSTEMS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

NOTE 9. NOTES PAYABLE AND OTHER DEBT (Continued)

The $5.0 million of promissory notes issued to Cantone Asset Management LLC was refinanced as part of the $7.5 million in subordinated convertible promissory notes issued in July 2012 that is discussed below.

Strome Note

In April 2012, AdCare issued an unsecured promissory note in the amount of $5.0 million to Strome Alpha Offshore Ltd. The promissory note matured in November 2012, and the Company paid off the promissory note on December 28, 2012, using the proceeds from the KeyBank Credit Facility discussed in Note 9 to our Consolidated Financial Statements included in this Annual Report. Interest accrued on the promissory note at a fixed rate of 10% per annum.

Sumter Valley Promissory Note

In connection with the acquisition of the facility known as Sumter Valley Nursing and Rehab in December 2012, a subsidiary of AdCare issued a promissory note to the seller of the facility in the amount of $0.3 million. Interest on the note accrues at a rate of 6% per annum. Principal and interest payments on the note shall be due and payable monthly, beginning on February 1, 2013, with a final payment due on the earlier of December 31, 2014, or the date upon which the Company refinances its loan relating to the Sumter facility. AdCare has unconditionally guaranteed all amounts owed under the note. At December 31, 2012, $0.2 million remained outstanding on this promissory note.

Georgetown Promissory Note

In connection with the acquisition of the facility known as Georgetown Healthcare and Rehab in December 2012, a subsidiary of AdCare issued a secured subordinated promissory note to the seller of the Georgetown facility in the amount of $1.9 million. Interest on the note accrues at a rate of 7% per annum. Interest payments on the note shall be due and payable monthly, beginning on February 1, 2013, with a final payment due on the earlier of December 31, 2013; or the date upon which the Company refinances its loan with Metro City Bank relating to the Georgetown Healthcare and Rehab Facility. AdCare has unconditionally guaranteed all amounts owing under the note.

Pinnacle Healthcare Promissory Notes

The Company previously issued promissory notes in the aggregate principal amount of $2.4 million. The notes mature March 1, 2014, and bear interest at 7% payable quarterly in arrears the first day of each December, March, June and September beginning December 1, 2011. The notes are subject to mandatory prepayment in the aggregate principal amount of $250,000 on each of March 1, 2013, June 1, 2013, September 1, 2013 and December 1, 2013 and a final payment of $150,000 on March 1, 2014. The notes may also be prepaid without penalty at any time. At December 31, 2012, $1.2 million remained outstanding.

Mountain Trace Promissory Notes

Mountain Trace ADK, LLC, a wholly owned subsidiary of AdCare, previously issued promissory notes in the aggregate principal amount of $1,000,000. The notes mature April 1, 2013, and bear interest at 11% payable quarterly in arrears the first day of each January, April, July and October beginning July 1, 2011. The notes may also be prepaid without penalty by providing fifteen days prior

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ADCARE HEALTH SYSTEMS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

NOTE 9. NOTES PAYABLE AND OTHER DEBT (Continued)

notice. The Company received proceeds of $0.9 million net of legal and other financing costs. At December 31, 2012, $0.2 million remained outstanding.

Convertible Debt

Subordinated Convertible Notes Issued in 2010

On October 26, 2010, the Company entered into a Securities Purchase Agreement with certain accredited investors to sell and issue to the Purchasers an aggregate of $11.1 million in principal amount of the Company's Subordinated Convertible Notes, bearing 10% interest per annum payable quarterly in cash in arrears beginning December 31, 2010.

On October 29, 2010, the Company entered into an amendment and joinder agreement to effectuate the sale of an additional $0.8 million in principal amount of Notes. The initial sale of $11.1 million in principal amount of Notes occurred on October 26, 2010, and the subsequent sale of $0.8 million in principal amount of Notes occurred on October 29, 2010. The notes mature in October 2013.

The Notes are convertible at the option of the holder into shares of common stock of the Company at a current conversion price of $3.73 (adjusted for a 5% stock dividends paid on October 14, 2011 and October 22, 2012, as further discussed in Note 10 to our Consolidated Financial Statements included in this Annual Report, and subject to adjustment for stock dividends, stock splits, combination of shares, recapitalization and other similar events) that is subject to future reductions if the Company issues equity instruments at a lower price. Since there is no minimum conversion price resulting in an indeterminate number of shares to be issued in the future, the Company determined an embedded derivative existed that was required to be bifurcated from the Notes and accounted for separately as a derivative liability recorded at fair value (see Note 15). At the time of initial measurement, the derivative had an estimated fair value of $2.6 million resulting in a discount on the Notes. The discount is being amortized over the term of the Notes. At December 31, 2012, the unamortized discount on the Notes was $0.7 million.

There was a conversion of a $0.2 million note that was part of the October 26, 2010 offering. It was recorded in two $0.1 million allotments. The first one converted in July 2011 at a price of $4.13 per share and resulted in the issuance of 18,160 shares. The second converted in November 2011 at a price of $3.92 and resulted in the issuance of 19,132 shares. As of December 31, 2012, $11.7 million was outstanding under the Notes.

Subordinated Convertible Notes Issued in 2011

On March 31, 2011, the Company entered into a Securities Purchase Agreement with certain accredited investors to sell and issue to the Purchasers an aggregate of $2.1 million in principal amount of the Company's Subordinated Convertible Notes. On April 29, 2011, the Company issued an additional $1.8 million in principal amount of the convertible debt issuance. On May 6, 2011, the Company issued an additional $0.6 in principal amount of the Notes. As of December 31, 2012, the total outstanding principal amount of the Notes is $4.5 million. Approximately $1.4 million of the proceeds obtained were used to repay the short-term promissory note that was issued March 31, 2011 and related accrued interest.

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ADCARE HEALTH SYSTEMS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

NOTE 9. NOTES PAYABLE AND OTHER DEBT (Continued)

The Notes bear a 10% interest per annum and are payable quarterly in cash in arrears beginning June 30, 2011. The Notes mature on March 31, 2014. Debt issuance costs of $0.6 million are being amortized over the life of the Notes.

The Notes are convertible at the option of the holder into shares of common stock of the Company at a conversion price of $4.80 (adjusted for a 5% stock dividends paid on October 14, 2011 and October 22, 2012, as further discussed in Note 10 to our Consolidated Financial Statements included in this Annual Report, and subject to adjustment for stock dividends, stock splits, combination of shares, recapitalization and other similar events). The initial conversion price is subject to adjustment for any stock dividend, stock split, combination of shares, reorganization, recapitalization, reclassification or other similar events. The Notes are unsecured and subordinated in right of payment to existing and future senior indebtedness.

Subordinated Convertible Notes Issued in 2012

AdCare entered into a Securities Purchase Agreement, dated as of June 28, 2012, with certain accredited investors pursuant to which the Company issued and sold such investors on July 2, 2012 an aggregate of $7.5 million in principal amount of the Company's 8.0% subordinated convertible promissory notes. The notes bear interest at 8% per annum and such interest is payable quarterly in cash in arrears beginning on September 30, 2012. The notes mature on July 31, 2015. The notes are unsecured and subordinated in right of payment to existing and future senior indebtedness of the Company. The $7.5 million principal amount of the notes includes a refinancing of existing indebtedness of $5.0 million of promissory notes issued to Cantone Asset Management LLC.

At any time on or after the six-month anniversary of the date of issuance of the notes, the notes are convertible at the option of the holder into shares of the Company's common stock at a conversion price equal to $3.97 per share (adjusted for a 5% stock dividend paid on October 22, 2012, as further discussed in Note 10 to our Consolidated Financial Statements included in this Annual Report, and subject to adjustment for stock dividends, stock splits, combination of shares, recapitalization and other similar events).

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

In addition, the holders of a majority of the aggregate principal amount of notes then outstanding may require the Company to redeem all or any portion of the notes upon a change of control transaction, at a redemption price in cash equal to 110% of the redemption amount.

Approximately $23.7 million of the scheduled maturities in 2013, 2014 and 2015, relate to the subordinated convertible notes issued in 2010, 2011 and 2012. While management cannot predict with certainty, we anticipate that some holders of the subordinated convertible notes will elect to convert their subordinated convertible notes into shares of common stock provided the common stock continues to trade above the applicable conversion price for such notes. The conversion prices are $3.73, $4.80 and $3.97 for the subordinated convertible notes issued in 2010, 2011 and 2012,

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ADCARE HEALTH SYSTEMS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

NOTE 9. NOTES PAYABLE AND OTHER DEBT (Continued)

respectively. If all of the subordinated convertible notes had been converted to common stock at December 31, 2012, then the Company would have been required to issue approximately 6.4 million shares of common stock.

NOTE 10. PREFERRED STOCK AND STOCKHOLDERS' EQUITY

Shares Authorized and Reserved

At December 31, 2012, the Company had reserved approximately 13.9 million shares of its authorized but unissued common stock for possible future issuance in connection with the following potential future events:

	Shares (000's)
Exercise of outstanding and future grants of stock options under approved plans	3,026
Exercise of outstanding stock warrants employees	1,806
Exercise of outstanding stock warrants non-employees	1,961
Convertible debt shares issuable (including additional 20% required under agreements)	7,140
Total authorized shares reserved	13,933

Stock Dividends

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

On August 31, 2011, the Company's Board of Directors declared a 5% stock dividend issued on October 14, 2011 to stockholders of record at the close of business on September 30, 2011. As a result of the stock dividend, the number of outstanding shares of common stock increased by 0.6 million shares in 2011.

As the Company was in a deficit position for both 2012 and 2011, there was no recorded impact to the reported amounts of stockholders' equity in the accompanying consolidated balance sheet. All references to the number of common shares and per-share amounts included in these consolidated financial statements are restated based on the increased number of shares giving retroactive effect to the stock dividend to prior year amounts.

2012 Public Common Stock Offering

In March 2012, the Company closed a firm commitment underwritten public offering of 1.1 million shares of common stock at an offering price to the public of $3.75 per share. The Company also granted the underwriter in the offering an option for 45 days to purchase up to an additional 165,000 shares of common stock to cover over-allotments, if any. In connection with the underwriter's partial exercise of this option, the Company issued an additional 65,000 shares of common stock at an offering

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ADCARE HEALTH SYSTEMS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

NOTE 10. PREFERRED STOCK AND STOCKHOLDERS' EQUITY (Continued)

price to the public of $3.75 per share on May 22, 2012. The Company received net proceeds of $3.8 million after deducting underwriting discounts and other offering-related expenses of $0.6 million.

2011 Warrant Call

In August 2011, the Company called for redemption the outstanding warrants to purchase shares of common stock sold in the Company's initial public offering and private placement offering. Each warrant exercised in response to the call was exercised for 1.05 shares of common stock at a price of $2.38 per share as adjusted for the 2010 stock dividend. Any warrants not exercised expired on the last day of the exercise period and were redeemed at $.10 per underlying share of common stock. In connection with the warrant call, the Company issued 2,897,149 shares of common stock. The Company received aggregate net proceeds of $6.3 million upon such exercises including issuance costs of $0.6 million. The remaining unexercised warrants expired requiring the Company to pay the aggregate call amount of $3,000.

Preferred Stock

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

Holders of the Series A Preferred Stock generally have no voting rights but have limited voting rights under certain circumstances. The Company may not redeem the Series A Preferred Stock before December 1, 2017, except the Company is required to redeem the Series A Preferred Stock following a "Change of Control," as defined. On and after December 1, 2017, the Company may, at its option, redeem the Series A Preferred Stock, in whole or in part, by paying $25.00 per share, plus any accrued and unpaid dividends to the redemption date.

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

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ADCARE HEALTH SYSTEMS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

NOTE 11. STOCK BASED COMPENSATION

The following table summarizes employee and nonemployee stock based compensation for the years ended December 31, 2012 and 2011:

Amounts in (000's)	December 31, 2012	December 31, 2011
Employee compensation:		
Stock options	$ 486	$ 212
Employee warrants	229	594
Total option and warrants compensation	715	806
Board restricted stock	176	
Total Employee Compensation Expense	$ 891	$ 806
Non-employee compensation:		
Warrants	$ 859	$ 434
Less: Deferred financing and prepaid services	(783)	(330)
Amortization of prepaid services	696	108
Total Nonemployee Compensation Expense	$ 772	$ 212

The Company uses the Black-Scholes-Merton option-pricing model for estimating the fair values of employee share options, employee and nonemployee warrants and similar instruments with the following key assumptions:

Expected Dividend Yield: The Company has not historically paid cash dividends on its common stock, and does not expect to pay cash dividends on its common stock in the near future. Accordingly, our expected dividend yield is zero.

Expected Volatility: The Company estimates the expected volatility factor using the Company's historical stock price volatility. For the calculations in the first quarter of 2011, the estimated expected volatility also included the weighted-average historical volatility of similar companies within the same 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 and warrants being valued.

Expected Term: The Company currently uses a simplified method for calculating the expected term based on the vesting and contractual expiration dates. For non-employee warrants awarded to certain service providers or financing partners, the Company uses the contractual life of the warrants as the expected term, as the Company does not have sufficient experience with the service providers or financing partners to determine when they could be expected to exercise their warrants.

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ADCARE HEALTH SYSTEMS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

NOTE 11. STOCK BASED COMPENSATION (Continued)

The assumptions used in calculating the fair value of employee stock options and warrants using the Black-Scholes-Merton option-pricing model are set forth in the following table:

	2012	2011
Dividend Yield	0.0%	0.0%
Expected Volatility	40.0% - 46.1%	65.6%
Risk-Free Interest Rate	.25% - 1.05%	1.23%
Expected Term	4.0 - 6.5 years	4.7 years

The assumptions used in calculating the fair value of non-employee stock options and warrants using the Black-Scholes-Merton option-pricing model are set forth in the following table:

	2012	2011
Dividend Yield	0.0%	0.0%
Expected Volatility	38.5% - 47.8%	62.0%
Risk-Free Interest Rate	0.25% - 0.72%	0.86%
Expected Term	3 - 10 years	1.7 years

Employee Stock Options

The Company has three active employee stock option plans.

The 2004 plan expires March 31, 2014 and provides for a maximum of 347,288 shares of common stock to be issued.

The 2005 plan expires September 30, 2015 and provides for a maximum of 578,812 shares of common stock to be issued.

The 2011 plan expires March 28, 2021 and provides for a maximum of 2,100,000 shares of common stock to be issued.

All three plans permit the granting of incentive or nonqualified stock options. The 2011 plan also permits the granting of restricted stock. The plans are administered by the Board of Directors which has the authority to determine the employees to whom awards will be made, the amounts of the awards, and the other terms and conditions of the awards.

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ADCARE HEALTH SYSTEMS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

NOTE 11. STOCK BASED COMPENSATION (Continued)

The following summarizes the Company's stock option activity for the years ended December 31, 2012 and 2011:

	Number of Shares	Weighted Average Exercise Price	Weighted Average Remaining Contract Life	Aggregate Intrinsic Value
Outstanding at January 1, 2012	575,277	$ 3.90		
Stock Dividend	73,393	$ 4.25		
Granted	996,200	$ 4.46		
Exercised	(66,867)	$ 1.39		
Forfeited	(186,483)	$ 4.31		
Expired	(40,659)	$ 2.78		
Outstanding at December 31, 2012	1,350,861	$ 4.57	6.6 years	900,426
Exercisable at December 31, 2012	268,457	$ 4.22	5.2 years	260,123

	Number of Shares	Weighted Average Exercise Price	Weighted Average Remaining Contract Life	Aggregate Intrinsic Value
Outstanding at January 1, 2011	212,404	$ 1.79		
Stock Dividend	16,298	$ 3.79		
Granted	487,000	$ 4.77		
Exercised	(37,338)	$ 1.74		
Forfeited	(98,807)	$ 4.53		
Expired	(4,280)	$ 2.26		
Outstanding at December 31, 2011	575,277	$ 3.90	8.3 years	370,606
Exercisable at December 31, 2011	213,178	$ 2.66	5.7 years	370,606

The weighted average grant date fair value of options granted during 2012 and 2011 was $1.36 and $2.21, respectively. At December 31, 2012, the Company has approximately $1.2 million of unrecognized compensation expense related to unvested options. Assuming no pre-vesting forfeitures, this expense will be recognized as a charge to earnings over a weighted-average remaining service period of 2.3 years. The total intrinsic value of options exercised during 2012 and 2011, was $0.2 million and $0.1 million, respectively.

Employee Common Stock Warrants

In addition to the Company's stock option plans, the Company grants, in accordance with the rules and regulations of the NYSE MKT LLC, stock warrants to officers, directors, employees and certain consultants to the Company from time to time as determined by the Board of Directors. The Board of Directors administers the granting of warrants, determines the persons to whom awards will be made, the amount of the awards, and the other terms and conditions of the awards.

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ADCARE HEALTH SYSTEMS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

NOTE 11. STOCK BASED COMPENSATION (Continued)

The following summarizes the Company's employee common stock warrant activity for the years ended December 31, 2012 and 2011:

	Number of Shares	Weighted Average Exercise Price	Weighted Average Remaining Contract Life	Aggregate Intrinsic Value
Outstanding at January 1, 2012	1,720,020	$ 3.10		
Stock Dividend	86,004	$ 2.99		
Granted				
Exercised				
Forfeited				
Outstanding at December 31, 2012	1,806,024	$ 2.99	5.6 years	3,181,251
Exercisable at December 31, 2012	1,539,126	$ 2.79	5.1 years	3,014,103

	Number of Shares	Weighted Average Exercise Price	Weighted Average Remaining Contract Life	Aggregate Intrinsic Value
Outstanding at January 1, 2011	1,289,412	$ 2.64		
Stock Dividend	71,162	$ 2.93		
Granted	450,000	$ 4.18		
Exercised	(70,433)	$ 2.08		
Forfeited	(20,121)	$ 2.38		
Outstanding at December 31, 2011	1,720,020	$ 3.10	6.6 years	1,676,791
Exercisable at December 31, 2011	1,345,020	$ 2.78	5.8 years	1,666,991

There were no employee warrants granted in 2012; the weighted average grant date fair value of employee warrants granted during 2011 was $2.29. The Company has approximately $0.2 million of unrecognized compensation expense related to unvested employee warrants as of December 31, 2012. Assuming no pre-vesting forfeitures, this expense will be recognized as a charge to earnings over a weighted-average remaining service period of 2.4 years. There were no employee warrants exercised during 2012; the total intrinsic value of employee warrants exercised during 2011 was $0.4 million.

Restricted Stock

In June 2012, the Company approved issuing, pursuant to the 2011 Plan, 270,000 shares of common stock with a three-year restriction on transfer to its nine directors. The restricted stock has all the rights of a shareholder from the date of grant, including, without limitation the right to receive dividends and the right to vote. The Company determined the fair value of the restricted stock at date of grant to be equal to the grant date closing stock price of $3.20. The related compensation expense is being recognized over the three-year restricted period. The compensation expense for year ended December 31, 2012 was $0.2 million with unrecognized compensation expense of $0.7 million remaining at December 31, 2012.

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ADCARE HEALTH SYSTEMS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

NOTE 11. STOCK BASED COMPENSATION (Continued)

On July 2, 2012, in connection with the issuance of the $7.5 million principal amount of 8% subordinated convertible notes, the Company granted 50,000 shares of restricted common stock with a one-year restriction on transferability to the placement agent as partial consideration for its service on the offering. The Company determined the fair value of the restricted stock to be equal to the grant date closing stock price of $3.50. The related compensation expense is included in deferred loan costs and is being amortized as interest expense over the term of the 8% subordinated convertible notes. The expense for the year ended December 31, 2012 was $0.1 million with unrecognized expense of $0.1 million remaining at December 31, 2012.

The following summarizes the Company's restricted stock activity for the year ended December 31, 2012:

	Number of Shares	Weighted Avg. Grant Date Fair Value
Unvested at January 1, 2012		
Granted	320,000	$ 3.25
Stock Dividend	16,000	$ 3.25
Vested	(52,500)	$ 3.50
Forfeited		
Unvested at December 31, 2012	283,500	$ 3.20

Nonemployee Common Stock Warrants

The following summarizes the Company's non-employee common stock warrant activity for the period ended December 31, 2012 and 2011:

	Number of Shares	Weighted Average Exercise Price	Weighted Average Remaining Contract Life	Aggregate Intrinsic Value
Outstanding at January 1, 2012	1,153,574	$ 3.85		
Stock Dividend	94,054	$ 3.85		
Granted	777,500	$ 3.82		
Exercised	(28,941)	$ 1.26		
Expired	(34,730)	$ 3.82		
Outstanding at December 31, 2012	1,961,457	$ 3.78	1.7 years	1,934,826
Exercisable at December 31, 2012	1,950,957	$ 3.77	1.7 years	1,930,836

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ADCARE HEALTH SYSTEMS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

NOTE 11. STOCK BASED COMPENSATION (Continued)

	Number of Shares	Weighted Average Exercise Price	Weighted Average Remaining Contract Life	Aggregate Intrinsic Value
Outstanding at January 1, 2011	953,074	$ 3.13		
Stock Dividend	86,236	$ 3.84		
Granted	300,000	$ 4.91		
Exercised	(179,452)	$ 1.78		
Expired	(6,284)	$ 3.11		
Outstanding at December 31, 2011	1,153,574	$ 3.85	2.0 years	437,432
Exercisable at December 31, 2011	1,153,574	$ 3.85	2.0 years	437,432

During 2012 and 2011, the Company granted warrants to nonemployees with a weighted-average per share fair value estimated at $0.99 and $1.45, respectively. The warrants have contractual terms between two and ten years. The majority vested immediately on the date of grant.

NOTE 12. OFFERING WARRANTS

A summary of the status of the Company's warrants issued in connection with the initial public offering is presented below:

	December 31, 2011
Beginning balance	2,927,925
Stock Dividend	
Exercised	(2,897,149)
Redeemed	(30,776)
Ending balance	

In August 2011, the Company called for redemption all of the outstanding offering warrants issued in the initial public offering.

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ADCARE HEALTH SYSTEMS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

NOTE 13. INCOME TAXES

The provision for income taxes attributable to continuing operations for the years ended December 31, 2012 and December 31, 2011 is presented below.

(Amounts in 000's)	December 31, 2012	2011
Current Tax Expense (Benefit):		
Federal	$ (97)	$
State	90	215
	$ (7)	$ 215
Deferred Tax Expense:		
Federal	$	$
State	104	0
	$ 104	$ 0
Total income tax expense	$ 97	$ 215

The income tax expense applicable to continuing and discontinued operations is presented below.

(Amounts in 000's)	December 31, 2012	2011
Income tax expense on continuing operations	$ 97	$ 215
Income tax expense (benefit) on discontinued operations	(20)	(191)
Total income tax expense	$ 77	$ 24

At December 31, 2012 and 2011, the tax effect of significant temporary differences representing deferred tax assets and liabilities are as follows:

(Amounts in 000's)	December 31, 2012	2011
Net current deferred tax asset:		
Allowance for doubtful accounts	$ 1,265	$ 494
Accrued expenses	464	429
	1,729	923
Net long-term deferred tax asset (liability):		
Net operating loss carry forwards	4,825	3,896
Noncontrolling interests		38
Property, equipment & intangibles	(1,091)	(1,434)
Stock based compensation	848	832
Convertible debt adjustments	1,876	1,074
Other	(277)	648
	6,181	5,054

Total deferred tax assets	7,910	5,977
Valuation allowance	(8,014)	(6,063)
Net deferred tax liability	$ (104)	$ (86)

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ADCARE HEALTH SYSTEMS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

NOTE 13. INCOME TAXES (Continued)

The items accounting for the differences between income taxes computed at the federal statutory rate and the provision for income taxes are as follows:

	December 31,	
	2012	**2011**
Federal income tax at statutory rate	34.0%	34.0%
State and local taxes	(0.6)%	(3.1)%
Consolidated VIE LLCs	(1.5)%	(7.6)%
Nondeductible expenses	(0.8)%	(0.9)%
Other	1.7%	0.4%
Change in valuation allowance	(33.5)%	(26.3)%
Effective tax rate	(0.7)%	(3.5)%

As of December 31, 2012 AdCare had consolidated federal net operating loss ("NOL") carry forwards of $14.2 million. These NOLs begin to expire in 2018 through 2032 and currently are offset by a full valuation allowance.

Given the Company's historical net operating losses, a full valuation allowance has been established on the Company's net deferred tax assets. The Company has generated additional deferred tax liabilities related to its tax amortization of certain acquired indefinite lived intangible assets because these assets are not amortized for book purposes. The tax amortization in current and future years gives rise to a deferred tax liability which will only reverse at the time of ultimate sale or book impairment. Due to the uncertain timing of this reversal, the temporary differences associated with indefinite lived intangibles cannot be considered a source of future taxable income for purposes of determining a valuation allowance. As such, the deferred tax liability cannot be used to support an equal amount of the deferred tax asset related to the NOL carry forward ("naked credit"). This resulted in recognizing deferred Federal tax expense of $0.1 million for each of the years ended December 31, 2012 and 2011, and a deferred tax liability of $0.1 million as of both December 31, 2012 and 2011.

NOTE 14. COMMITMENTS AND CONTINGENCIES

Regulatory Matters

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

A significant portion of the Company's revenue is derived from Medicaid and Medicare, for which reimbursement rates are subject to regulatory changes and government funding restrictions. Any significant future change to reimbursement rates could have a material effect on the Company's operations.

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ADCARE HEALTH SYSTEMS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

NOTE 14. COMMITMENTS AND CONTINGENCIES (Continued)

Operating Leases

The Company leases certain office space and 11 skilled nursing facilities under non-cancelable operating leases, most of which have initial lease terms of ten to twelve years with rent escalation clauses and provisions for payments by the Company of real estate taxes, insurance and maintenance costs. Eight of the facilities were initiated in the third quarter of 2010, and two additional in the fourth quarter of 2010. One lease agreement was initiated in the fourth quarter of 2011. For the years ended December 31, 2012 and 2011, facility rent expense totaled $7.7 million and $7.2 million, respectively.

Eight of the Company's facilities are operated under a single master lease arrangement. The lease has a term of ten years into 2020. Under the master lease, a breach at a single facility could subject one or more of the other facilities covered by the same master lease to the same default risk. Failure to comply with regulations or governmental authorities, such as Medicare and Medicaid provider requirements, is a default under the Company's master lease agreement. In addition, other potential defaults related to an individual facility may cause a default of the entire master lease agreement. With an indivisible lease, it is difficult to restructure the composition of the portfolio or economic terms of the lease without the consent of the landlord. The Company is not aware of any defaults as of December 31, 2012.

Two of the Company's facilities are operated under a separate lease agreement. The lease is a single indivisible lease; therefore, a breach at a single facility could subject the second facility to the same default risk. The lease has a term of 12 years into 2022 and includes covenants and restrictions. A commitment is included that requires minimum capital expenditures of $375 per licensed bed per lease year at each facility which amounts to $0.1 million per year for both facilities. In recent periods, including as of December 31, 2012, the Company has not been in compliance with certain financial and administrative covenants of this lease agreement. The Company has obtained a waiver for each instance of such non-compliance.

Future minimum lease payments for each of the next five years ending December 31 are as follows:

	(Amounts in 000's)
2013	$ 8,049
2014	7,569
2015	7,407
2016	7,274
2017	7,180
Thereafter	21,639
Total	$ 59,118

The Company has also entered into lease agreements for various equipment used in the facilities. These leases are included in future minimum lease payments above.

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ADCARE HEALTH SYSTEMS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

NOTE 14. COMMITMENTS AND CONTINGENCIES (Continued)

Legal Matters

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

In addition to the potential lawsuits and claims described above, the Company is also subject to potential lawsuits under the Federal False Claims Act and comparable state laws alleging submission of fraudulent claims for services to any healthcare program (such as Medicare) or payer. A violation may provide the basis for exclusion from federally funded healthcare programs. As of December 31, 2012, the Company does not have any material loss contingencies recorded or requiring disclosure based upon the evaluation of the probability of loss from known claims, except as disclosed below.

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

Commitments

Special Termination Benefits

The Company incurred certain salary retirement and continuation costs of $1.5 million related to separation agreements with certain of the Company's former officers. The benefits include wage continuation and fringe benefits which are to be paid out to these former employees over various future periods ranging from a 6-month period to a 24-month period. The remaining unpaid balance accrued as of December 31, 2012 is $0.3 million.

Commitment to Future Lease Payments

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

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ADCARE HEALTH SYSTEMS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

NOTE 15. THIRD-PARTY REIMBURSEMENT

Medicare

Payments for Medicare resident services are made under a prospective payment system. There is no retroactive adjustment to allowable cost. The Company is paid one of several prospectively set rates that vary depending on the resident's service needs. Payment rates are established on a federal basis by the Centers for Medicare & Medicaid Services ("CMS"). The final settlement process is primarily a reconciliation of services provided and rates paid. As a result, no material settlement estimates are expected.

Medicaid

Payments for Medicaid resident services are calculated and made under a prospective reimbursement system. Payment rates are based on actual cost, limited by certain ceilings, adjusted by a resident service needs factor and updated for inflation. The direct care portion of the rate can be adjusted prospectively for changes in residents' service needs. While interim rates are subject to reconsideration and appeal, once this process is completed, they are not subject to subsequent retroactive adjustment. However, the states in which the Company operates have the opportunity to audit the cost report used to establish the prospective rate. If the state departments discover non-allowable or misclassified costs that resulted in overpayments to the Company, the funds may be recovered by the state departments through the final rate recalculation process. For the years ended December 31, 2012 and 2011, management believes that adequate provisions have been made for potential adjustments.

Laws and Regulations

Laws and regulations governing the Medicare and Medicaid programs are complex and subject to interpretation. The Company believes that it is materially in compliance with all applicable laws and regulations and is not aware of any pending or threatened investigation involving allegations of potential wrongdoing. While no such regulatory inquiries have been made, compliance with such laws and regulations can be subject to future government review and interpretation, as well as significant regulatory action including fines, penalties and exclusion from the Medicare and Medicaid programs.

NOTE 16. FAIR VALUE MEASUREMENTS

Recurring Fair Value Measurements

The following are the major categories of assets and liabilities measured at fair value on a recurring basis during the years ended December 31, 2012 and 2011, using quoted prices in active markets for identical assets (Level 1); significant other observable inputs (Level 2); and significant unobservable inputs (Level 3).

Amounts in (000's)		Level 1:	Level 2:	Level 3:	Total
Derivative Liability	2012	$	$	$ 3,630	$ 3,630
Derivative Liability	2011	$	$	$ 1,889	$ 1,889

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ADCARE HEALTH SYSTEMS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

NOTE 16. FAIR VALUE MEASUREMENTS (Continued)

Following is a reconciliation of the beginning and ending balances for assets and liabilities measured at fair value on a recurring basis using significant unobservable inputs (Level 3) during the period ended December 31, 2012:

Amounts in (000's)	Derivative Liability
Beginning Balance	$ 1,889
Debt extinguishment	
Derivative loss	1,741
Ending Balance	$ 3,630

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

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

Nonrecurring Fair Value Measurements

During 2011, the Company recorded a goodwill impairment charge of $1.8 million which is reflected in the loss from discontinued operations. The impairment charge was a result of the required goodwill impairment test that requires the goodwill to be written down to the estimate of the implied fair value. The goodwill was measured using primarily an income approach with significant unobservable inputs (Level 3).

NOTE 17. CURRENT VULNERABILITY DUE TO CERTAIN CONCENTRATIONS

The Company's operations are concentrated in the long-term care market, which is a heavily regulated environment. The operations of the Company are subject to the administrative directives, rules and regulations of federal and state regulatory agencies, including, but not limited to, CMS, and the Department of Health and Aging in all states in which the Company operates. Such administrative directives, rules and regulations, including budgetary reimbursement funding, are subject to change by

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ADCARE HEALTH SYSTEMS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

NOTE 17. CURRENT VULNERABILITY DUE TO CERTAIN CONCENTRATIONS (Continued)

an act of Congress, the passage of laws by the General Assembly or an administrative change mandated by one of the executive branch agencies. Such changes may occur with little notice or inadequate funding to pay for the related costs, including the additional administrative burden, to comply with a change.

Given the significant concentration of revenue from third-party payors, including Medicare and Medicaid programs, along with recent healthcare reform and budgetary constraints of governmental agencies, there is potential for reimbursement rate reductions in the near term that could materially and adversely impact the Company's revenue and profitability.

The Company has 100% of its 3,804 skilled nursing facility beds that it owns or leases certified under the Medicaid and Medicare programs. A summary of occupancy utilization and net revenues for these nursing facility beds is as follows:

For the Years Ended	Percent of Total Occupancy	Percent of Long-Term Care Receivables	Percent of Patient Care Revenue
Medicaid			
December 31, 2012	73%	39%	54%
December 31, 2011	76%	35%	56%
Medicare			
December 31, 2012	14%	30%	29%
December 31, 2011	14%	30%	31%
Other Payers			
December 31, 2012	13%	31%	17%
December 31, 2011	10%	35%	13%

NOTE 18. DEFERRED COMPENSATION PLAN

The Company maintains a non-qualified deferred compensation plan available to a select group of management or highly compensated employees. Contributions to the plan are made by the participants. The Company does not provide any matching contributions. The benefits of the plan are payable upon the employee's separation of employment with the Company.

As of December 31, 2012 and 2011, the Company had a gross asset of $.01 million and $0.3 million, respectively, to reflect the amount of investments held in the plan and a corresponding liability acknowledging the Company's obligation to employees participating in the plan (included in other assets and other liabilities in the accompanying consolidated balance sheet). At December 31, 2011, the Company had one outstanding loan for $0.2 million. This loan was subsequently repaid in 2012. The underlying assets are recorded at fair value and primarily represent short term fixed income assets invested at the participants' direction. Contributions to and payments from the plan in 2012 and 2011 were not material.

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ADCARE HEALTH SYSTEMS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

NOTE 19. ACQUISITIONS

Summary of 2012 Acquisitions

During the year ended December 31, 2012, the Company acquired a total of eleven skilled nursing facilities and one assisted living facility described further below. The total purchase price for each acquisition is after final closing adjustments. The Company has incurred a total of $2.0 million of acquisition costs related to these acquisitions and has recorded the cost in the "Other Income (Expense)" section of the Consolidated Statements of Operations.

Eaglewood Care Center and Eaglewood Village

On January 1, 2012, the Company acquired the Eaglewood Care Center, a skilled nursing facility and the Eaglewood Village facility, an assisted living facility each located in Springfield, Ohio. The total purchase price was $12.4 million.

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

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ADCARE HEALTH SYSTEMS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

NOTE 19. ACQUISITIONS (Continued)

Little Rock, Northridge and Woodland Hills

On April 1, 2012, the Company acquired the Little Rock, Northridge and Woodland Hills facilities, three skilled nursing facilities located in Little Rock, Arkansas. The total purchase price was $27.2 million.

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

Abington Place

On April 30, 2012, the Company acquired Abington Place, a skilled nursing facility located in Little Rock, Arkansas. The total purchase price was $3.6 million.

		(Amounts in 000s')
Consideration transferred:		
Net proceeds from loans	$	3,296
Cash from earnest money deposits		250
Security deposit for lease/May rent		35
Total consideration transferred	$	3,581
Assets acquired:		
Land	$	210
Building		225
Equipment and furnishings		2,090
Intangible assets bed licenses		840
Goodwill		235
Total assets acquired		3,600
Liabilities assumed:		
Real estate taxes and other		(19)

Total identifiable net assets	$	3,581

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ADCARE HEALTH SYSTEMS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

NOTE 19. ACQUISITIONS (Continued)

Glenvue Nursing Home

On July 2, 2012, the Company acquired Glenvue Nursing, a skilled nursing facility located in Glennville, Georgia. The total purchase price was $8.2 million.

	(Amounts in 000's)	
Consideration transferred:		
Net proceeds from loans	$	6,573
Cash from earnest money deposits		