

RICKS CABARET INTERNATIONAL INC  
Form DEF 14A  
June 24, 2014

**SECURITIES AND EXCHANGE COMMISSION**

**WASHINGTON, D.C. 20549**

**SCHEDULE 14A**

**INFORMATION REQUIRED IN PROXY STATEMENT**

**SCHEDULE 14A INFORMATION**

**Proxy Statement Pursuant to Section 14(a) of the  
Securities Exchange Act of 1934**

Filed by the Registrant

Filed by a Party other than the Registrant

Check the appropriate box:

Preliminary Proxy Statement

Confidential, for Use of the Commission Only (as permitted by Rule 14a-6(e)(2))

Definitive Proxy Statement

Definitive Additional Materials

Soliciting Material Pursuant Under Rule 14a-12

**Rick's Cabaret International, Inc.**

(Name of Registrant as Specified in Its Charter)

Payment of Filing Fee (Check the appropriate box):

No fee required.

Fee computed on table below per Exchange Act Rules 14a-6(i)(1) and 0-11.

(1) Title of each class of securities to which transaction applies:

(2) Aggregate number of securities to which transaction applies:

(3) Per unit price or other underlying value of transaction computed pursuant to Exchange Act Rule 0-11 (set forth the amount on which the filing fee is calculated and state how it was determined):

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(1) Amount Previously Paid:

(2) Form, Schedule or Registration Statement No.:

(3) Filing Party:

(4) Date Filed:

**RICK'S CABARET INTERNATIONAL, INC.**

**10959 CUTTEN ROAD**

**HOUSTON, TEXAS 77066**

**NOTICE OF ANNUAL MEETING OF STOCKHOLDERS**

**TO BE HELD ON WEDNESDAY, AUGUST 6, 2014**

The Annual Meeting of Stockholders (the "Annual Meeting") of Rick's Cabaret International, Inc. ("we," "us" and the "Company") will be held at 15000 Airport Freeway, Fort Worth, Texas 76155 (at Rick's DFW), on Wednesday, August 6, 2014 at 10:00 AM (Central Time) for the following purposes:

- (1) To elect six (6) directors;
- (2) To amend the certificate of formation to change the name of the Company to RCI Hospitality Holdings, Inc.;
- (3) To ratify the selection of Whitley Penn LLP as our independent registered public accounting firm for the fiscal year ending September 30, 2014;
- (4) To approve a non-binding advisory resolution on executive compensation; and
- (5) To act upon such other business as may properly come before the Annual Meeting.

Only holders of common stock of record at the close of business on June 11, 2014, will be entitled to vote at the Annual Meeting or any adjournment thereof. You are cordially invited to attend the Annual Meeting.

We have elected to furnish proxy materials and our Fiscal 2013 Annual Report on Form 10-K ("Annual Report") to many of our stockholders over the Internet pursuant to Securities and Exchange Commission rules, which should allow us to reduce costs. On or about June 27, 2014, we began mailing to our stockholders a Notice of Internet Availability of Proxy Materials (the "Notice") containing instructions on how to access our Proxy Statement and Annual Report and how to vote online. All stockholders who have previously expressed a specific request to receive paper copies of proxy materials will be sent a copy of the Proxy Statement and Annual Report by mail beginning on or about June 27, 2014. The Notice also contains instructions on how you can elect to receive a printed copy of the Proxy Statement and Annual Report, if you only received a Notice by mail. **The Proxy Statement, Annual Report to security holders for the year ended September 30, 2013, proxy card and President's letter are available at [www.proxyvote.com](http://www.proxyvote.com).**

Whether or not you plan to attend the Annual Meeting, it is important that your shares be represented and voted at the meeting. If you received the proxy materials by mail, you can vote your shares by completing, signing, dating, and

returning your completed proxy card, by telephone or over the Internet. If you received the proxy materials over the Internet, a proxy card was not sent to you, and you may vote your shares only by telephone or over the Internet. To vote by telephone or Internet, follow the instructions included in the proxy statement.

**BY ORDER OF THE BOARD OF DIRECTORS**

**ERIC S. LANGAN  
CHAIRMAN OF THE BOARD AND PRESIDENT**

**JUNE 27, 2014**

**HOUSTON, TEXAS**

**RICK'S CABARET INTERNATIONAL, INC.**

**10959 CUTTEN ROAD**

**HOUSTON, TEXAS 77066**

**PROXY STATEMENT**

**ANNUAL MEETING OF STOCKHOLDERS**

**TO BE HELD ON AUGUST 6, 2014**

This proxy statement (the "Proxy Statement") is being furnished to stockholders in connection with the solicitation of proxies by the Board of Directors of Rick's Cabaret International, Inc., a Texas corporation ("we," "us" and the "Company"), for their use at the Annual Meeting of Stockholders (the "Annual Meeting") to be held at 15000 Airport Freeway, Fort Worth, Texas 76155 (at Rick's DFW), on Wednesday, August 6, 2014 at 10:00 AM (Central Time), and at any adjournments thereof, for the purpose of considering and voting upon the matters set forth in the accompanying Notice of Annual Meeting of Stockholders.

We have elected to furnish proxy materials and our Fiscal 2013 Annual Report on Form 10-K ("Annual Report") to many of our stockholders over the Internet pursuant to Securities and Exchange Commission ("SEC") rules, which should allow us to reduce costs. On or about June 27, 2014, we began mailing to most of our stockholders a Notice of Internet Availability of Proxy Materials (the "Notice") containing instructions on how to access our Proxy Statement and Annual Report and how to vote online. All stockholders who have previously expressed a specific request to receive paper copies of proxy materials will be sent a copy of the Proxy Statement and Annual Report by mail beginning on or about June 27, 2014. The Notice also contains instructions on how you can elect to receive a printed copy of the Proxy Statement and Annual Report, if you only received a Notice by mail. **The Proxy Statement, Annual Report to security holders for the year ended September 30, 2013, proxy card and President's letter are available at [www.proxyvote.com](http://www.proxyvote.com).** The cost of solicitation of proxies is being borne by us.

The close of business on June 11, 2014 has been fixed as the record date for the determination of stockholders entitled to notice of and to vote at the Annual Meeting and any adjournment thereof. As of June 11, 2014, we had 10,037,057 shares of common stock, par value \$0.01 per share, issued and outstanding. The presence, in person or by proxy, of a majority of the outstanding shares of common stock on the record date is necessary to constitute a quorum at the Annual Meeting. Each share is entitled to one vote on all issues requiring a stockholder vote at the Annual Meeting. A plurality of the shares voted in person or represented by proxy at the Annual Meeting will elect as Directors the nominees named in Proposal Number 1. Stockholders may not cumulate their votes for the election of Directors. The affirmative vote of a majority of the shares of common stock entitled to vote at the Annual Meeting is required to approve the amendment to our certificate of formation to change our name (see Proposal Number 2). The affirmative vote of a majority of the shares of common stock present or represented by proxy and entitled to vote at

the Annual Meeting is required for the ratification of the appointment of Whitley Penn LLP as our independent registered public accounting firm (see Proposal Number 3). The affirmative vote of a majority of the total votes present in person or by proxy is required to approve the non-binding advisory resolution on executive compensation (see Proposal Number 4). Abstentions and broker non-votes will be counted for purposes of determining the presence or absence of a quorum. Abstentions and broker non-votes will not be counted as having voted either for or against a proposal.

All shares represented by properly executed proxies, unless such proxies previously have been revoked, will be voted at the Annual Meeting in accordance with the directions on the proxies. If no direction is indicated, the shares will be voted **(i) FOR THE ELECTION OF THE NOMINEES NAMED HEREIN, (ii) FOR the approval of the amendment to the certificate of formation to change the company's name (iii) FOR THE RATIFICATION OF WHITLEY PENN LLP AS THE COMPANY'S INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM FOR THE FISCAL YEAR ENDING SEPTEMBER 30, 2013 and (iv) FOR APPROVAL OF THE non-binding advisory resolution on executive compensation.** The Board of Directors is not aware of any other matters to be presented for action at the Annual Meeting. If any other matter is properly presented at the Annual Meeting, however, it is the intention of the persons named in the enclosed proxy to vote in accordance with their best judgment on such matters.

Under the rules of the New York Stock Exchange (“NYSE”), brokers who hold shares in “street name” for customers are precluded from exercising voting discretion with respect to the approval of non-routine matters (so called “broker non-votes”) where the beneficial owner has not given voting instructions. Because most large brokerage firms are NYSE member organizations, these rules affect almost all public companies and not just those listed on the NYSE. Effective July 1, 2009, the NYSE amended its rule regarding discretionary voting by brokers on uncontested elections of directors such that any investor who does not instruct the investor’s broker on how to vote in an election of directors will cause the broker to be unable to vote that investor’s shares on an election of directors. Previously, the broker could exercise its own discretion in determining how to vote the investor’s shares even when the investor did not instruct the broker on how to vote. Accordingly, with respect to the election of directors (see Proposal Number 1), a broker is not entitled to vote the shares of common stock unless the beneficial owner has given instructions. A broker is also not to vote uninstructed shares on matters relating to executive compensation, including the vote to approve a non-binding resolution on executive compensation (see Proposal Number 4). With respect to the approval of the amendment to our certificate of formation to change our name (see Proposal 2) and the ratification of the appointment of Whitley Penn LLP as our independent registered public accounting firm (see Proposal Number 3), a broker will have discretionary authority to vote the shares of our stock if the beneficial owner has not given instructions.

The enclosed Proxy, even though executed and returned, may be revoked at any time prior to the voting of the Proxy (i) by execution and submission of a revised proxy, (ii) by written notice to our Secretary, or (iii) by voting in person at the Annual Meeting.

## **PROPOSAL 1 TO ELECT SIX (6) DIRECTORS FOR THE ENSUING YEAR**

### **NOMINEES FOR DIRECTORS**

The persons named in the enclosed Proxy have been selected by the Board of Directors to serve as proxies (the “Proxies”) and will vote the shares represented by valid proxies at the Annual Meeting of Stockholders and adjournments thereof. Unless otherwise instructed or unless authority to vote is withheld, the enclosed Proxy will be voted for the election of the nominees listed below. Each duly elected Director will hold office until his successor shall have been elected and qualified. Although the Board of Directors does not contemplate that any of the nominees will be unable to serve, if such a situation arises prior to the Annual Meeting, the persons named in the enclosed Proxy will vote for the election of such other person(s) as may be nominated by the Board of Directors.

The Board of Directors unanimously recommends a vote **FOR** the election of each of the nominees listed below. All of the nominees presently serve as Directors.



**Eric S. Langan**, age 45, has been a Director since 1998 and our President since March 1999. He has been involved in the adult entertainment business since 1989. From January 1997 through the present, he has held the position of President of XTC Cabaret, Inc. From November 1992 until January 1997, Mr. Langan was the President of Bathing Beauties, Inc. Since 1989, Mr. Langan has exercised managerial control over more than a dozen adult entertainment businesses. Through these activities, Mr. Langan has acquired the knowledge and skills necessary to successfully operate adult entertainment businesses.

**Robert L. Watters**, age 63, is our founder and has been our Director since inception. Mr. Watters was our President and our Chief Executive Officer from 1991 until March 1999. Since 1999, Mr. Watters has owned and operated Rick's Cabaret, an adult entertainment club in New Orleans, Louisiana, which licenses our name. He was also a founder in 1989 and operator until 1993 of the Colorado Bar & Grill, an adult club located in Houston, Texas and in 1988 performed site selection, negotiated the property purchase and oversaw the design and permitting for the club that became the Cabaret Royale, in Dallas, Texas. Mr. Watters practiced law as a solicitor in London, England and is qualified to practice law in New York. Mr. Watters worked in the international tax group of the accounting firm of Touche, Ross & Co. (now succeeded by Deloitte & Touche) from 1979 to 1983 and was engaged in the private practice of law in Houston, Texas from 1983 to 1986, when he became involved in our full-time management. Mr. Watters graduated from the London School of Economics and Political Science, University of London, in 1973 with a Bachelor of Laws (Honours) degree and in 1975 with a Master of Laws degree from Osgoode Hall Law School, York University. Since founding Rick's Cabaret, Mr. Watters has been in the adult entertainment industry. He brings this valuable experience to the Board.

**Travis Reese**, age 44, became our Director and V.P.-Director of Technology in 1999. From 1997 through 1999, Mr. Reese had been a senior network administrator at St. Vincent's Hospital in Santa Fe, New Mexico. During 1997, Mr. Reese was a computer systems engineer with Deloitte & Touche. From 1995 until 1997, Mr. Reese was Vice President with Digital Publishing Resources, Inc., an Internet service provider. From 1994 until 1995, Mr. Reese was a pilot with Continental Airlines. From 1992 until 1994, Mr. Reese was a pilot with Hang On, Inc., an airline company. Mr. Reese has an Associate's Degree in Aeronautical Science from Texas State Technical College. In addition to being involved in the adult entertainment industry since 1992, Mr. Reese's in-depth information technology knowledge is essential to the Board's oversight of our internet businesses.

**Steven L. Jenkins**, age 57, has been a Director since June 2001. Since 1988, Mr. Jenkins has been a certified public accountant with Pringle Jenkins & Associates, P.C., located in Houston, Texas. Mr. Jenkins is the President and owner of Pringle Jenkins & Associates, P.C. Mr. Jenkins has a BBA Degree (1979) from Texas A&M University. Mr. Jenkins is a member of the AICPA and the TSCPA. Mr. Jenkins' impressive accounting background makes him a valuable asset to the Board and the Audit Committee.

**Luke Lirot**, age 57, became a Director on July 31, 2007. Mr. Lirot received his law degree from the University of San Francisco in 1986. After serving as an intern in the San Francisco Public Defender's Office in 1986, Mr. Lirot returned to Florida and established a private law practice where he continues to practice and specializes in adult entertainment issues. He is a past President of the First Amendment Lawyers' Association and has actively participated in numerous state and federal legal matters. Mr. Lirot represents as counsel scores of individuals and entities within our industry. Having practiced in this area for over 25 years, he is aware of virtually every type of legal issue that can arise, making him an important member of the Board.

**Nour-Dean Anakar**, age 57, became a Director on September 14, 2010. Mr. Anakar has over 20 years of experience in senior positions in the development and management of betting and gaming, sports and entertainment, and hospitality and leisure operations in the United States, Europe, and Latin America. From 1988 until 2000 he held executive management and business development positions with Ladbrokes USA and Ladbrokes South America. In 2001, Mr. Anakar became the managing partner of LCIN LLC and LCIN S.A., San Diego and Buenos Aires based gaming companies, which were contracted by Grupo Codere of Spain to oversee the development of all new technology gaming projects and operations in Latin America. He received his BA in Management Science from Duke University and CHA in Hospitality Management from the Conrad Hilton College at the University of Houston. Mr. Anakar's experience managing and developing businesses in industries with similar characteristics to ours make him an excellent fit to the Board.

## **OUR DIRECTORS AND EXECUTIVE OFFICERS**

Our directors are elected annually and hold office until the next annual meeting of our stockholders or until their successors are elected and qualified. Officers are elected annually and serve at the discretion of the Board of Directors.

There is no family relationship between or among any of our directors and executive officers. Our Board of Directors consists of six persons. The following table sets forth our directors and executive officers:

<b>Name</b>	<b>Age</b>	<b>Position</b>
Eric S. Langan	45	Director and CEO/President
Phillip K. Marshall	64	Chief Financial Officer
Travis Reese	44	Director and V.P.—Director of Technology
Robert L. Watters	63	Director
Steven L. Jenkins	57	Director
Luke Lirot	57	Director
Nour-Dean Anakar	57	Director

Phillip Marshall has served as our Chief Financial Officer since May 2007. He was previously controller of Dorado Exploration, Inc., an oil and gas exploration and production company, from February 2007 to May 2007. He previously served as Chief Financial Officer of CDT Systems, Inc., a publicly held water technology company, from July 2003 to September 2006. In 1972, Mr. Marshall began his public accounting career with the international accounting firm, KMG Main Hurdman. After its merger with Peat Marwick, Mr. Marshall served as an audit partner at KPMG for several years. After leaving KPMG, Mr. Marshall was partner in charge of the audit practice at Jackson & Rhodes in Dallas from 1992 to 2003, where he specialized in small publicly held companies. Mr. Marshall is also a trustee of United Mortgage Trust and United Development Funding IV, publicly held real estate investment trusts.

## **RELATED TRANSACTIONS**

Our Board of Directors has adopted a policy that our business affairs will be conducted in all respects by standards applicable to publicly held corporations and that we will not enter into any future transactions and/or loans between us and our officers, directors and 5% stockholders unless the terms are no less favorable than could be obtained from independent, third parties and will be approved by a majority of our independent and disinterested directors. We currently have four independent directors, Steven Jenkins, Nour-Dean Anakar, Luke Lirot and Robert Watters. We know of no related transactions for the years ended September 30, 2013 and 2012.

### Review, Approval, or Ratification of Transactions

Currently, we rely on our Board of Directors to review related party transactions on an ongoing basis to prevent conflicts of interest. Our Board of Directors reviews a transaction in light of the affiliations of the director, officer, or employee and the affiliations of such person's immediate family. Our Board of Directors will approve or ratify a transaction if it determines that the transaction is consistent with our best interests and the best interests of our stockholders.

## **INFORMATION CONCERNING THE BOARD OF DIRECTORS AND ITS COMMITTEES**

All directors are expected to make every effort to attend meetings of the Board of Directors, meetings of any Board Committees on which such director serves, and annual meetings of stockholders. The Board of Directors held four meetings during the fiscal year ended September 30, 2013. The Board of Directors also executed five consents to action in lieu of a meeting of the Board of Directors, which were approved unanimously. During the fiscal year ended September 30, 2013, none of our current directors attended fewer than 75 percent of the aggregate of (i) the total number of meetings of the Board of Directors held during the period for which he was a director, and (ii) the total number of meetings held by all committees of the Board on which he served during the periods that he served. Five of our six directors attended the prior year's annual meeting of stockholders. There is no family relationship between or among any of our directors and executive officers. We have four directors who meet the definition of "independent director" under the NASDAQ Marketplace rules.

Eric Langan serves as both Chairman of the Board of Directors and Chief Executive Officer. Of our four independent directors, no director has been designated "lead" independent director. Accordingly, all four independent directors have an equal role in the leadership of the Board. We believe that our overall leadership structure is appropriate based on our current size.

As a part of its oversight function, the Board of Directors monitors how management operates the company. Risk is an important part of deliberations at the Board and committee level throughout the year. Committees consider risks associated with their particular areas of responsibility. The Board of Directors as a whole considers risks affecting us. To that end, the Board conducts periodic reviews of corporate risk management policies and procedures. The Board and its committees consider, among other things, the relevant risks to us when granting authority to management and approving business strategies. Through this risk oversight process, the Board reserves the right to make changes to our leadership structure in the future if it deems such changes are appropriate and in the best interest of our stockholders.

#### AUDIT COMMITTEE

We have an Audit Committee whose current members are Steven Jenkins, Nour-Dean Anakar and Luke Lirot. Mr. Jenkins, Mr. Anakar and Mr. Lirot are independent directors. The primary purpose of the Audit Committee is to oversee our financial reporting process on behalf of the Board of Directors. The Audit Committee meets privately with our Chief Financial Officer and with our independent registered public accounting firm and evaluates the responses by the Chief Financial Officer both to the facts presented and to the judgments made by our outside independent registered public accounting firm. Steven L. Jenkins serves as the Audit Committee's Financial Expert. The Audit Committee held four meetings during the fiscal year ended September 30, 2013.

In May 2000, our Board adopted a Charter for the Audit Committee. A copy of the Audit Committee Charter can be found on our website at [www.ricksinvestor.com](http://www.ricksinvestor.com). The Charter establishes the independence of our Audit Committee and sets forth the scope of the Audit Committee's duties. The purpose of the Audit Committee is to conduct continuing oversight of our financial affairs. The Audit Committee conducts an ongoing review of our financial reports and other financial information prior to their being filed with the SEC, or otherwise provided to the public. The Audit Committee also reviews our systems, methods and procedures of internal controls in the areas of: financial reporting, audits, treasury operations, corporate finance, managerial, financial and SEC accounting, compliance with law, and ethical conduct. A majority of the members of the Audit Committee will be independent. The Audit Committee is objective, and reviews and assesses the work of our independent registered public accounting firm and our internal audit department.

#### Report of the Audit Committee

The Audit Committee has reviewed and discussed with management our audited financial statements for the fiscal year ended September 30, 2013. The Audit Committee has discussed with Whitley Penn LLP, our independent registered public accounting firm ("Whitley Penn"), the matters required to be discussed by the statement on Auditing Standards No. 61, as amended (AICPA, Professional Standards, Vol. 1, AU section 380), as adopted by the Public Company Accounting Oversight Board in Rule 3200T. The Audit Committee has received from Whitley Penn the written disclosures and the letter required by applicable requirements of the Public Company Accounting Oversight Board regarding Whitley Penn's communications with the Audit Committee concerning independence, and has discussed with Whitley Penn the independence of Whitley Penn.

Based on the review and discussions referred to in the paragraph above, the Audit Committee recommended to the Board of Directors that the audited financial statements be included in our annual report on Form 10-K for the fiscal year ended September 30, 2013. This report is furnished by the Audit Committee of our Board of Directors, whose members are:

Steven L. Jenkins

Luke Lirot

Nour-Dean Anakar

NOMINATING COMMITTEE

We have a Nominating Committee whose current members are Steven Jenkins, Nour-Dean Anakar and Luke Lirot. In July 2004, the Board unanimously adopted a Charter with regard to the process to be used for identifying and evaluating nominees for director. The Charter establishes the independence of our Nominating Committee and sets forth the scope of the Nominating Committee's duties. A majority of the members of the Nominating Committee will be independent. Pursuant to its Charter, the Committee has the power and authority to consider Board nominees and proposals submitted by our stockholders and to establish any procedures, including procedures to facilitate stockholder communication with the Board of Directors, and to make any such disclosures required by applicable law in the course of exercising such authority. A copy of the Nominating Committee's Charter can be found on our website at [www.ricksinvestor.com](http://www.ricksinvestor.com). The Nominating Committee held one meeting during the fiscal year ended September 30, 2013.

Stockholders who wish to submit a proposal for consideration by the Nominating Committee must comply with Rule 14a-8 of Regulation 14A. For proposal deadlines, see "Future Proposals of Stockholders" below. Stockholder recommendations to the Board of Directors should be sent to 10959 Cutten Road, Houston, Texas 77066, Attn: President. Any stockholder recommendations for consideration by the Nominating Committee should include the candidate's name, biographical information, information regarding any current or past relationships between the candidate and Rick's Cabaret International, Inc., a description of our shares beneficially owned by the recommending stockholder, a description of all arrangements between the candidate and the recommending stockholder and any other person under which the candidate is being recommended, a written indication of the candidate's willingness to serve on the Board of Directors, any other information required to be provided under securities laws and regulations, and a written indication to provide such other information as the Nominating Committee may reasonably request. All candidates, whether proposed by a stockholder or by any other means, will be evaluated based on the criteria established by the Board of Directors. Minimum criteria for non-employee candidates includes financial experience and "independence" as defined under applicable rules promulgated by the SEC pursuant to the Sarbanes-Oxley Act of 2002 and NASDAQ Listing Rules. Additional criteria may include: (a) satisfactory results of any background investigation; (b) experience and expertise; (c) financial resources; (d) time availability; (e) community involvement; (f) diversity of viewpoints, backgrounds, experiences and other demographics, and (g) such other criteria as the Nominating Committee may determine to be relevant.

## COMPENSATION COMMITTEE

We have a Compensation Committee whose current members are Steven Jenkins, Nour-Dean Anakar and Luke Lirot. In June 2014, the Compensation Committee unanimously adopted a Charter with regard to the Compensation Committee's responsibilities, including evaluating, reviewing and determining the compensation of our Chief Executive Officer and other executive officers. Eric S. Langan and Travis Reese are our only directors who are also officers. A copy of the Compensation Committee's Charter can be found on our website at [www.ricksinvestor.com](http://www.ricksinvestor.com). The Compensation Committee held two meetings during the fiscal year ended September 30, 2013, and executed one consent to action in lieu of a meeting.

### Compensation Committee Report

The Compensation Committee has reviewed and discussed with management the Compensation Discussion and Analysis (see below) to be included in this Proxy Statement on Schedule 14A. Based on this review and discussion, the Compensation Committee recommended to the Board of Directors that the Compensation Discussion and Analysis be included in this report. This report is furnished by the Compensation Committee of our Board of Directors, whose members are:

Steven L. Jenkins

Luke Lirot

Nour-Dean Anakar

### Compensation Committee Interlocks and Insider Participation

The Compensation Committee is comprised of Messrs. Jenkins, Lirot and Anakar. No interlocking relationship exists between any member of the Compensation Committee and any member of any other company's Board of Directors or compensation committee.

## **Stockholder Communications**



We do not currently have a process for security holders to send communications to the Board of Directors, which we believe is appropriate based on our size, the limited number of our stockholders and the limited number of communications which we receive. However, we welcome comments and questions from our stockholders. Stockholders can direct communications to our Chief Executive Officer, Eric Langan at our executive offices, 10959 Cutten Road, Houston, Texas 77066. While we appreciate all comments from stockholders, we may not be able to individually respond to all communications. We attempt to address stockholder questions and concerns in our press releases and documents filed with the SEC so that all stockholders have access to information about us at the same time. Mr. Langan collects and evaluates all stockholder communications. If the communication is directed to the Board of Directors generally or to a specific director, Mr. Langan will disseminate the communications to the appropriate party at the next scheduled Board of Directors meeting. If the communication requires a more urgent response, Mr. Langan will direct that communication to the appropriate executive officer or director. All communications addressed to our directors and executive officers will be reviewed by those parties unless the communication is clearly frivolous.

## **COMPENSATION DISCUSSION AND ANALYSIS**

This compensation discussion and analysis describes the material elements of the Company's compensation programs as they relate to our executive officers who are listed in the compensation tables appearing below. This compensation discussion and analysis focuses on the information contained in the following tables and related footnotes. The individuals who served as the Company's Chief Executive Officer and Chief Financial Officer during fiscal 2013, as well as the other individuals included in the Summary Compensation Table, are referred to as the "named executive officers."

### *Overview of Compensation Committee Role and Responsibilities*

The Compensation Committee of the Board of Directors oversees our compensation plans and policies, reviews and approves all decisions concerning the named executive officers' compensation, which may further be approved by the Board, and administers our stock option and equity plans, including reviewing and approving stock option grants and equity awards under the plans. The Compensation Committee's membership is determined by the Board and is composed entirely of independent directors.

Management plays a role in the compensation-setting process. The most significant aspects of management's role are to evaluate employee performance and recommend salary levels and equity compensation awards. Our Chief Executive Officer often makes recommendations to the Compensation Committee and the Board concerning compensation for other executive officers. Our Chief Executive Officer is a member of the Board but does not participate in Board decisions regarding any aspect of his own compensation. The Compensation Committee can retain independent advisors or consultants.

#### *Compensation Committee Process*

The Compensation Committee reviews executive compensation in connection with the evaluation and approval of an employment agreement, an increase in responsibilities or other factors. With respect to equity compensation awarded to other employees, the Compensation Committee or the Board grants stock options, often after receiving a recommendation from our Chief Executive Officer. The Compensation Committee also evaluates proposals for incentive and performance equity awards, and other compensation.

#### *Compensation Philosophy*

The Compensation Committee emphasizes the important link between the Company's performance, which ultimately affects stockholder value, and the compensation of its executives. Therefore, the primary goal of the Company's executive compensation policy is to try to align the interests of the executive officers with the interests of the stockholders. In order to achieve this goal, the Company attempts to, (i) offer compensation opportunities that attract and retain executives whose abilities and skills are critical to the long-term success of the Company and reward them for their efforts in ensuring the success of the Company, (ii) align the Company's compensation programs with the Company's long-term business strategies and objectives, and (iii) provide variable compensation opportunities that are directly linked to the Company's performance and stockholder value, including an equity stake in the Company. Our named executive officers' compensation utilizes two primary components — base salary and long-term equity compensation — to achieve these goals. Additionally, the Compensation Committee may award discretionary bonuses to certain executives based on the individual's contribution to the achievement of the Company's strategic objectives.

#### *Setting Executive Compensation*

We fix executive base compensation at a level we believe enables us to hire and retain individuals in a competitive environment and to reward satisfactory individual performance and a satisfactory level of contribution to our overall business goals. We also take into account the compensation that is paid by companies that we believe to be our competitors and by other companies with which we believe we generally compete for executives.

In establishing compensation packages for executive officers, numerous factors are considered, including the particular executive's experience, expertise and performance, our company's overall performance and compensation packages available in the marketplace for similar positions. In arriving at amounts for each component of compensation, our Compensation Committee strives to strike an appropriate balance between base compensation and incentive compensation. The Compensation Committee also endeavors to properly allocate between cash and non-cash compensation and between annual and long-term compensation.

*The Role of Shareholder Say-on-Pay Votes.*

At our annual meeting of shareholders held on August 16, 2011, approximately 97.0% of the shareholders who voted on the "say-on-pay" proposal approved the compensation of our named executive officers, as disclosed in the proxy statement. Although the advisory shareholder vote on executive compensation is non-binding, the Compensation Committee will consider the outcome of that vote and future votes, including the say-on-pay proposal included in this proxy statement, when making future compensation decisions for named executive officers.

### *Base Salary*

The Company provides executive officers and other employees with base salary to compensate them for services rendered during the fiscal year. Subject to the provisions contained in employment agreements with executive officers concerning base salary amounts, base salaries of the executive officers are established based upon compensation data of comparable companies in our market, the executive's job responsibilities, level of experience, individual performance and contribution to the business. We believe it is important for the Company to provide adequate fixed compensation to highly qualified executives in our competitive industry. In making base salary decisions, the Compensation Committee uses its discretion and judgment based upon personal knowledge of industry practice but does not apply any specific formula to determine the base salaries for the executive officers.

### *Equity-Based Awards—Equity Compensation Plans*

The Compensation Committee uses equity awards, usually in the form of stock options, primarily to motivate our named executive officers to realize benefits from longer-term strategies that increase stockholder value, and to promote commitment and retention. Equity awards vest upon the achievement of performance criteria that the Company believes are critical to its long-term success.

The Compensation Committee believes that stock options are an important form of long-term incentive compensation because they align the executive officer's interests with the interests of stockholders, since the options have value only if our stock price increases over time. From time to time, the Compensation Committee may consider circumstances that warrant the grant of full value awards such as restricted stock units. Examples of these circumstances include, among others, attracting a new executive to the team; recognizing a promotion to the executive team; retention; and rewarding outstanding long-term contributions.

Our equity grant practices require that stock options and other equity compensation have prices determined based on at least the fair market value on the date of grant. The fair market value of our stock option awards has historically been the NASDAQ closing price on the date of grant.

### *Retirement Savings Plan*

The Company maintains a retirement savings plan for the benefit of our executives and employees. Our Simple IRA Plan is intended to qualify as a defined contribution arrangement under the Internal Revenue Code (the "Code"). Participants may elect to defer a percentage of their eligible pretax earnings each year or contribute a fixed amount per

pay period up to the maximum contribution permitted by the Code. All participants' plan accounts are 100% vested at all times. All assets of our Simple IRA Plan are currently invested, subject to participant-directed elections, in a variety of mutual funds chosen from time to time by the Plan Administrator. Distribution of a participant's vested interest generally occurs upon termination of employment, including by reason of retirement, death or disability. We make certain matching contributions to the Simple IRA Plan.

*Perquisites and Other Personal Benefits*

The Company's executive officers participate in the Company's other benefit plans on the same terms as other employees. These plans include medical, dental, life and disability insurance. Relocation benefits also are reimbursed and are individually negotiated when they occur. The Company reimburses each executive officer for all reasonable business and other expenses incurred by them in connection with the performance of their duties and obligations under their employment agreements. The Company does not provide named executive officers with any significant perquisites or other personal benefits except for an auto for each executive's business use.

**Summary Compensation Table**

The following table reflects all forms of compensation for services to us for the fiscal years ended September 30, 2013, 2012 and 2011 of certain executive officers.

Name and Principal Position	Year	Salary (\$)	Bonus (\$)	Stock Awards (\$)	Option Awards (\$)	Non- Equity Incentive Plan Compensation (\$)	Nonqualified Deferred Compensation Earnings (\$)	All other compensation (\$)	Total (\$)		
(a)	(b)	(c)	(d)	(e)	(f)	(g)	(h)	(i)	(j)		
Eric S. Langan, President/ CEO	2013 2012 2011	764,423 623,077 600,000	-0- -0- -0-	-0- -0- -0-	249,387 83,129 -	(1) (1) -	-0- -0- -0-	-0- -0- -	99,859 72,683 53,729	(1) (1) (1)	1,113,669 778,889 653,729
Phillip Marshall, CFO	2013 2012 2011	223,813 215,000 204,615	-0- 10,000 30,000	-0- -0- -	44,267 14,896 -	(2) (2) -	-0- -0- -	-0- -0- -	28,145 30,615 27,426	(2) (2) (2)	296,225 270,511 262,041
Travis Reese, Executive Vice President	2013 2012 2011	231,538 204,615 200,000	-0- -0- -0-	-0- -0- -	56,304 18,808 -	(3) (3) -	-0- -0- -	-0- -0- -	18,193 27,862 37,969	(3) (3) (3)	306,035 251,285 237,969

On December 31, 2008, we had approximately 735 stockholders of record.

We have never paid cash dividends on our common shares. Holders of common shares are entitled to receive dividends. Our

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ability to pay dividends will depend upon our future earnings and net worth. We are restricted by Ohio law from paying dividends on any of our outstanding shares while insolvent or if such payment would result in a reduction of our stated capital below the required amount.

It is the intention of our Board periodically to consider the payment of dividends, based on future earnings, operating and financial condition, capital requirements and other factors deemed relevant by the Board. There is no assurance that we will be able or will desire to pay dividends in the near future or, if dividends are paid, in what amount. Our Board may decide not to pay dividends in the near future, even if funds are legally available, in order to provide us with more funds for operations.

For the year ended December 31, 2008, there were no sales of unregistered securities. Additionally, we did not repurchase any equity securities of the Company.

**Equity Compensation Plan Information**

The following table sets forth additional information as of December 31, 2008, 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.

	(a)	(b)	(c)
	Number of Securities to be Issued Upon Exercise of Outstanding Options, Warrants and Rights	Weighted-Average Exercise Price of Outstanding Options, Warrants and Rights	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 <sup>(1)</sup> <sup>(2)</sup> <sup>(3)</sup>	1,371,305	\$2.18	6,800
Equity compensation plan not approved by security holders	0	\$0.00	0

<sup>(1)</sup> Options were granted in August 2004 and vest over a five year period contingent on continued employment. The total number of shares available under this option plan are 120,000. At December 31, 2008, 94,800 options had vested with no remaining options to vest. Due to separation of employment, 19,400 options have been forfeited during the five year vesting period.

<sup>(2)</sup> During May, 2007, we granted 199,000 options under our September 2005 stock option plan. The total number of shares available under this option plan is 200,000. The options vest over a five year period contingent on continued employment. At December 31, 2008, 76,080 options had vested with an additional 108,120 remaining to vest. Due to separation of employment, 2,520 vested options and 12,280 unvested options have been forfeited.

(3) On November 16, 2007, our Board of Directors authorized the issuance of warrants to officers and directors of the company. A total of 1,102,710 warrants were granted and vest over a five year period. The warrants remain exercisable for ten years. The exercise price of the warrants in each of the five years following the issuance of the warrants is determined as follows: warrants vesting in 2008 are exercisable at \$1.21; warrants vesting in 2009 are exercisable at \$2.25; warrants vesting in 2010 through 2012 are exercisable at a price equal to the greater of (i) the average closing price of the Company's common stock on NYSE Alternext US exchange during the month of January each year or (ii) \$3.00. On August 15, 2008, the warrant plan received shareholder approval and subsequently, 218,460 warrants vested with an additional 740,457 remaining to vest. Due to separation of employment, 133,388 unvested warrants were forfeited.



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**Item 6. Selected Financial Data**

Not Applicable.

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

**Overview**

We are a Springfield, Ohio based developer, owner and manager of retirement communities, assisted living facilities, nursing homes, and provide home health care services in the state of Ohio. We currently manage sixteen facilities, comprised of six skilled nursing centers, seven assisted living residences and three independent living/senior housing facilities, totaling approximately 850 beds.

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

We focus on two primary indicators in evaluating the financial performance of our business. Those indicators are facility occupancy and staffing. Facility occupancy is important as higher occupancy generally leads to higher revenue. According to the Ohio Health Care Association, average nursing home occupancy within Ohio was 88.6% for 2007. Over the past 10 years, occupancy has averaged 87.8% statewide according to the State of Ohio. Our nursing homes averaged 84.9% for 2008 and assisted living averaged 90.3%. For 2007 our nursing facilities averaged 84.4% and assisted living averaged 90.7%. Statewide averages are not published for assisted living facilities.

In recent years, we observed the trend that more seniors were staying in their homes for a longer period of time prior to moving into a long-term care setting. We have also observed that more seniors are using nursing and assisted living facilities for short rehabilitation stays and then moving back to their homes. We have taken advantage of this opportunity and expanded our operations to provide personal care and health care services in the home. Accordingly, in January, 2005, we acquired Assured Health Care, a home health care service provider located in Dayton, Ohio. Assured has been providing home health care services in the greater Dayton area for nearly 15 years.

On May 15, 2008, we completed our acquisition of the New Lincoln Lodge. This acquisition was effective April 1, 2008. Consequently, many of the expense areas in our income statement have increased. The New Lincoln Lodge is a 51 unit senior living facility located in Columbus, Ohio.

During 2008, we completed refinancing three of our assisted living facilities and one skilled nursing facility. The new financings are long-term fixed interest rate non-recourse HUD insured loans.

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**Segments**

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

*Management and Facility Based Care Segment*

We have implemented changes at our skilled nursing facilities to improve occupancy and revenue. We have recently completed renovations at two facilities we own and one facility we lease with additional renovations planned during 2009. We continue to focus our attention towards providing care to more patients covered by Medicare where our profit margins are typically higher than those of Medicaid. For the year ended December 31, 2008, compared to the year ended December 31, 2007, overall occupancy in our skilled nursing centers increased .5% and occupancy in our assisted living centers decreased .4%.

Revenue in our management and facility based care segment increased approximately \$1,657,000 or 7.5% as result of the acquisition of the New Lincoln Lodge along with increases in rates charged to our privately paying residents. Net loss declined as result of the higher rates charged as well increases in Medicare covered residents. Total assets increased primarily as a result of the acquisition of the New Lincoln Lodge.

*Home Based Care Segment*

Our home health division has reduced and, in most cases, eliminated services to patients where our reimbursement provided very little profit margin. This has resulted in a lower number of patient visits and lower revenue but increased profit margins. The majority of the reduced revenue has been offset by lower payroll and related expenses. The benefits of this change have been offset by overall lower visits than anticipated. We are in the process of utilizing our home health services in our assisted living and independent living properties creating cross selling opportunities which will further enhance our revenue. These needs have previously been satisfied by other home health agencies.

Revenue in our home based care segment decreased approximately \$414,000 or 13%. This is primarily the result of eliminating services to low margin payer sources. Net profit increased approximately \$2,000 or 1% due to increasing services to primarily Medicare and commercial insurance covered patients offset by accrued expenses for income tax payable.

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The table below shows the net income (loss) from both our management and facility-based care operation and our home based care operation for the years ended December 31, 2008 and 2007.

	(Amounts in 000s)					
	Manage- ment and Facility Based <u>Care</u>	Home Based <u>Care</u>	Total <u>Segments</u>	Discon- tinued <u>operations</u>	Cor- <u>porate</u>	<u>Total</u>
Year ended December 31, 2008:						
Net Revenue	23,782	2,804	26,586	-	(1,793)	24,793
Net Profit (Loss)	(1,252)	176	(1,076)	-	-	(1,076)
Total Assets	24,280	2,545	26,825	-	-	26,825
Capital Spending	468	9	477	-	-	477
Year ended December 31, 2007:						
Net Revenue	22,125	3,218	25,343	-	(1,675)	23,668
Net Profit (Loss)	(980)	174	(806)	587	-	(219)
Total Assets	22,134	2,357	24,491	-	-	24,491
Capital Spending	1,374	6	1,380	-	-	1,380

**Consolidated Results of Operations****Year Ended December 31, 2008 and December 31, 2007*****Revenue***

Approximately 93% of our revenue is derived from patient care services provided by our skilled nursing facilities, assisted living facilities and home health agency. The following table compares revenue for the years ended December 31, 2008 and 2007:

	December 31, <u>2008</u>	December 31, <u>2007</u>	<u>Increase</u>	<u>% Change</u>
Patient care revenue	\$23,008,754	\$21,928,808	\$1,079,946	4.9%
Management, consulting and development fee revenue	1,784,540	1,738,948	45,592	2.6%
	\$24,793,294	\$23,667,756	\$1,125,538	4.8%

For the periods compared, patient care revenue increased \$1,079,946 or 4.9%. Average occupancy in our skilled nursing facilities and assisted living facilities was nearly unchanged from 2007 to 2008. Charges for private paying residents at our assisted living and skilled nursing facilities increased approximately 5% beginning January 1, 2008. Additionally, the number of residents covered by Medicare in our skilled nursing facilities have increased approximately 23% from 2007 to 2008 contributing significantly to our increased revenue. Home health revenue declined primarily as a result of reducing services provided to payers that are not profitable or only marginally profitable as well as overall lower visits being provided to other payers. Payroll and related payroll costs were reduced accordingly to partially offset the reduced revenue. Additionally, patient care revenue increased due to the acquisition of the New Lincoln Lodge effective April 1, 2008 which resulted in an additional \$466,000 in revenue for 2008. Management, consulting and development fee revenue increased \$45,592 or 2.6% as a result of higher management fees charged to our managed only properties as a result of negotiated increases.

Table of Contents*Operating Expenses*

	December 31, <u>2008</u>	December 31, <u>2007</u>	<u>Increase</u>	<u>% Change</u>
Payroll and related payroll costs	\$15,649,862	\$14,762,090	\$887,772	6.0%
Other operating expenses	8,248,157	7,746,505	501,652	6.5%
Depreciation and amortization	882,900	847,440	35,460	4.2%
	\$24,780,919	\$23,356,035	\$1,424,884	6.1%

Operating expenses for the year ended December 31, 2008 increased by approximately \$1,425,000 or 6.1%. Payroll and related payroll costs for the year ended December 31, 2008 increased by approximately \$888,000 or 6.0%. The acquisition of New Lincoln Lodge contributed approximately \$175,000 to the increased payroll and related costs. Increased administrative staff expense and higher payroll expense at our assisted living centers was partially offset by lower payroll expense at our home health agency and skilled nursing centers. Payroll expense at our home health agency was lower as a result of discontinuing services provided to payers that are not profitable or only marginally profitable. These savings were partially offset by employee wages which have increased approximately 3% as a result of annual wage increases. Administrative staff has increased in the areas of management information systems and human resources in order to satisfy the increasing demands on these departments. Additionally, we accrued approximately \$162,000 in payroll expense related to the retirement benefits of our previous Chief Operating Officer who retired on September 30, 2008. Additionally, we incurred approximately \$640,000 in non-cash expenses primarily related to the warrants approved by shareholders at our August 15, 2008, shareholder meeting and other share based compensation.

Other operating expenses increased approximately \$500,000 or 6.5%. A number of factors contributed to this increase including approximately \$105,000 in non-cash expenses related to warrants granted to our investment banker, approximately \$161,000 due to inflationary increases in supplies at our assisted living centers, an increase in expenses at our skilled nursing facilities of approximately \$36,000 as a result of the increased number of Medicare residents offset by lower supplies usage in our home health division of approximately \$(27,000) as a result of fewer visits being provided and nearly \$225,000 in expenses related to New Lincoln Lodge which was acquired in April, 2008.

Depreciation and amortization increased approximately \$35,000 or 4.2% primarily due to depreciation expense related to the acquisition of the New Lincoln Lodge and related depreciation as well as the addition of other depreciable assets during the year.

*Income from Operations*

Income from continuing operations for the year ended December 31, 2008 was approximately \$12,000 compared to approximately \$312,000 for the year ended December 31, 2007, an decrease of approximately \$300,000 or 96%. Total revenue grew by 4.8% from 2007 to 2008 ahead of growth in operating expenses of 4.2%. Approximately \$640,000 of operating expenses in 2008 was related to non-cash expenses for warrants with an additional \$162,000 related to a one time charge for retirement expenses for our Chief Operating Officer.





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	December 31, <u>2008</u>	December 31, <u>2007</u>	(Decrease)/ <u>Increase</u>	<u>%</u> <u>Change</u>
Interest income	\$23,287	\$59,300	\$(36,014)	(60.7)%
Interest expense, others	(1,265,622)	(978,731)	(286,891)	29.3%
Interest expense, related parties	(36,446)	(66,432)	29,986	(45.1)%
Minority interest in earnings of consolidated entities	(57,919)	(94,811)	38,892	(38.9)%
Other income (expense)	4,200	(37,014)	41,214	(111.3)%
	\$(1,332,500)	\$(1,117,688)	\$(212,813)	19.0%

Interest income decreased approximately \$36,000 or 60.7% for the year ended December 31, 2008, as a result of less interest earned on certificates of deposit. Interest expense for the year ended December 31, 2008 increased approximately \$287,000 or 29.3%. Approximately \$210,000 of this increase is due to the recognition of the balance of the unamortized financing costs associated with our Community's Hearth & Home properties and Hearth & Care of Greenfield. Additionally, the acquisition of the New Lincoln Lodge in April, 2008, caused interest expense to increase approximately \$100,000. These increases were partially offset by lower interest expense of approximately \$35,000 on our variable rate loans.

Other expense for the year ended December 31, 2007 was approximately \$37,000. This is the result of recognizing as expense, costs that had been capitalized that were associated with the contemplated merger with Family Home Health Services. When the merger agreement was discontinued, the accumulated costs were immediately recognized as expense. For the year ended December 31, 2008, other income was \$4,200 and was due to the lease of commercial space at the New Lincoln Lodge.

*Summary*

The loss from continuing operations for the year ended December 31, 2008 was approximately \$1,076,000 compared to a loss from continuing operations of approximately \$628,000 for the year ended December 31, 2007. The loss during 2008 was partially offset by recognizing a gain of approximately \$414,000 related to our acquisition of the New Lincoln Lodge.

Income tax expense for the year ended December 31, 2008, of approximately \$170,000 is related to the amortization of purchased goodwill under Internal Revenue Code section 197.

Income from discontinued operations was approximately \$409,000 for the year ended December 31, 2007, as the result of recognizing a gain on the sale of assets in our discontinued operations during 2007.

Net loss for the years ended December 31, 2008 and 2007, was approximately \$1,076,000 and \$219,000 respectively.



Table of Contents**Changes in Balance Sheet**

The following table contains certain balance sheet items and their respective change from 2007 to 2008. For a complete balance sheet, please refer to page 29 of this 10-K.

	December 31, <u>2008</u>	December 31, <u>2007</u>	Increase/ (Decrease)	% <u>Change</u>
Cash and cash equivalents	\$1,266,315	\$926,625	\$339,690	36.7%
Certificate of deposit, restricted	\$-	\$209,637	\$(209,637)	(100.0)%
Advances and receivables from affiliates, current	\$17,635	\$27,558	\$(9,923)	(36.0)%
Long-term care resident receivables, net	\$2,008,847	\$2,115,364	\$(106,517)	(5.0)%
Restricted cash	\$1,155,596	\$973,975	\$181,621	18.6%
Property and equipment	\$16,772,660	\$14,425,868	\$2,346,792	16.3%
Note receivable, net	\$-	\$221,413	\$(221,413)	(100.0)%
Accounts payable	\$1,009,002	\$1,416,313	\$(407,311)	(28.8)%
Accrued expenses	\$2,838,407	\$2,060,222	\$778,185	37.8%
Forward purchase contract	\$-	\$900,000	\$(900,000)	(100.0)%
Notes payable and other debt, net of current portion	\$16,974,788	\$12,813,338	\$4,161,450	32.5%
Notes payable to stockholders, net of current portion	\$34,626	\$810,084	\$(775,458)	(95.7)%
Other liabilities	\$299,314	\$559,509	\$(260,195)	(46.5)%
Income tax payable	\$170,007	\$-	\$170,007	100.0%

Cash increased approximately \$340,000 primarily due to cash generated by operations. Please refer to the Cash Flow section of the Liquidity and Capital Resources section of this management discussion and analysis for a thorough discussion of cash.

Certificate of deposit, restricted, was eliminated in 2008 as a result of refinancing the loan for Hearth & Care of Greenfield. Once the loan was refinanced, the certificate of deposit was liquidated and the proceeds used to retire other debt.

Advances and receivables from affiliates, current, decreased approximately \$9,900 due to an account receivable being written off against bad debt reserved for collection of the account. The account had been previously fully reserved for potential bad debt.

Long term care resident receivables decreased approximately \$107,000 or 5% as a result of increased collections.

Restricted cash increased approximately \$182,000 due to additional deposits made as a result of refinancing four of our properties with HUD during 2008 as well as interest earned and additional deposits to HUD reserves for replacements.

Property and equipment increased by approximately \$2,347,000 primarily as a result of the acquisition of the New Lincoln Lodge.

Note receivable, net, decreased approximately \$221,000 as a result of the acquisition of the New Lincoln Lodge. This note receivable was forgiven as partial consideration in the acquisition of the assets.

Accounts payable decreased by approximately \$407,000 primarily as a result of improved cash flow at some of the properties and therefore improved ability to satisfy accounts payable requirements.

Accrued expenses increased approximately \$778,000 or 37.8% primarily due to increased accruals at year end for invoices not yet received and due to the accrual of retirement benefits for our retiring Chief Operating Officer.

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The Forward Purchase Contract was satisfied in November 2008 when we acquired the remaining partners interests in Hearth & Home of Van Wert giving us 100% ownership of the property.

Notes payable and other debt, net of current portion, increased approximately \$4,160,000. The increase is due primarily to the acquisition of the New Lincoln Lodge. Additionally, increases are due to additional debt incurred in relation to the refinancing of four of our properties with HUD during 2008 as well as refinancing our notes payable, stockholder.

Notes payable, stockholder, net of current portion, decreased approximately \$775,000 as a result of refinancing the majority of the debt with a traditional bank loan.

Other liabilities decreased approximately \$260,000 primarily as a result of changes in market value associated with invested deferred compensation.

Income tax payable increased approximately \$170,000 during 2008 in relation to the amortization of purchased goodwill under Internal Revenue Code section 197.

**Liquidity and Capital Resources**

As a newer public company, we have incurred legal, accounting and other expenses that we did not incur as a private company related to the Securities Exchange Commission's reporting requirements under the Securities Exchange Act of 1934, as amended, and compliance with the various provisions of the Sarbanes-Oxley Act of 2002. As of December 31, 2008, we have incurred increased expenses with respect to Sarbanes-Oxley Section 404 compliance. In addition, there are increased expenses for investor relations, legal, auditing and board activities that we did not have before becoming a public company.

We have obtained directors and officer's liability insurance and key man life insurance which we did not have in the past and as a result we have incurred additional costs. We expect to fund these additional costs using cash flows from expanded operations and financing activities and additional indebtedness such as a new line of credit.

***Overview***

We had negative net working capital as of December 31, 2008 of approximately \$540,000 as compared to negative net working capital of approximately \$1,167,000 for the year ended December 31, 2007, a decrease of \$627,000. The majority of the decrease in negative net working capital was the result of satisfying our commitment under the forward purchase contract, which matured in October, 2008, partially offset by increases in accrued expenses.

On November 14, 2008, we established a \$100,000 line of credit with Huntington National Bank to assist with cash flow. As of December 31, 2008, approximately \$97,000 was being used in operations of the Company.

We have established a \$150,000 line of credit using funds from our non-qualified deferred compensation plan. Members of this plan, which is only available to senior management, authorized the transfer of funds to establish the line of credit with interest accruing at 8%. We withdrew \$150,000 from a deferred employee compensation plan (see note 17 to the consolidated financial statements). We deposited the funds into an interest bearing savings account. We intend to use the savings to fund temporary cash short falls. We repaid the withdrawn funds to the plan at the end of 2008 with interest that accrued at 8%. In January, 2009, we reestablished the line of credit from the non-qualified

deferred compensation plan with same terms as 2008. The funds are presently used in the operations of the company.

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

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We discontinued the operations of Hearth & Home of Marion, a wholly owned subsidiary, in November, 2003, and entered a land installment contract in January, 2004, to sell the assets of Hearth & Home of Marion for \$1,600,000. In early 2007, we agreed to reduce the price to \$1,300,000. On September 6, 2007, we completed the disposition of assets held by Hearth & Home of Marion. The buyer was Concerned Citizens Against Violence Against Women, Inc., DBA Turning Point, a non-profit organization providing shelter and services to abused women. The transaction resulted in recognizing a gain on the sale of approximately \$619,000.

In November 2008, we completed the acquisition of Hearth & Home of Van Wert as required by our forward purchase contract to acquire the outstanding partnership interest in Hearth & Home of Van Wert by October 2008. The cost of acquiring the partners interest was approximately \$950,000 and was primarily satisfied with cash received at the closing of financing for Hearth & Care of Greenfield and with a note payable to the sellers of approximately \$28,500 bearing interest of 5% due in November, 2010 a note payable to a seller of \$112,500 that bears no interest but for which interest has been imputed at 5% resulting in a discount of approximately \$8,400. Total notes payable to sellers is approximately \$141,000.

***Notes Payable and Other Debt***

For the year ended December 31, 2008 and the year ended December 31, 2007, we had notes payable and other debt outstanding of \$17,688,111 and \$13,586,616, respectively with weighted average interest rates of 6.6% and 6.8%, respectively. Approximately 13% of our debt is now at a variable interest rate compared to approximately 50% in 2007 as a result of refinancing loans that were previously at a variable interest rate to fixed interest rate loans. We project a change of 1% in interest rates could result in a change in interest expense of approximately \$23,000.

Our debt instruments contain various financial covenants and other restrictions including requirements for the following: minimum income and cash flow, debt service coverage, tangible net worth and working capital requirements. Many of these debt instruments also contain cross default provisions and limitations on the amount of additional debt we can raise. We were not in compliance with loan covenants on the following loan at December 31, 2007:

In connection with the financing and loan agreement used to re-finance an assisted living property located in Van Wert, Ohio, the property is required on an annual basis to maintain a minimum tangible net worth and such net worth shall not be less than 10% of total assets. As of December 31, 2007, the minimum requirement was \$308,846 and the actual tangible net worth was \$252,491. Also, 10% of the total assets was \$335,338 as compared to the actual tangible net worth of \$252,491; and therefore, both covenants were not in compliance. However, both net worth covenants were waived by WesBanco on March 21, 2008. As of December 31, 2008, we were in compliance with these covenants.

On June 26, 2008 we completed the refinancing of three assisted living properties known as Community s Hearth & Home. This refinancing replaced our adjustable rate demand taxable notes, series 2002 Bonds in the original principal amount of \$4,200,000 obtained in 2002. Interest on the note was indexed at the LIBOR rate. We refinanced this debt with two HUD insured loans at a fixed interest rate of 6.65% with a 35 year amortization. The new financing consists of two loans, one for the two Springfield, Ohio properties and one for the Urbana, Ohio property. The new loans are in the amount of \$1,863,800 and \$2,142,700, respectively, and total \$4,006,500. As a result of this refinancing, in June 2008, we recognized the balance of the unamortized financing costs of approximately \$106,000 from the 2002 Bond financing. Additionally, Huntington National Bank released the balance of cash previously pledged to secure a letter of credit related to the 2002 financing.

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

On July 29, 2008, we completed refinancing our Hearth & Care of Greenfield skilled nursing facility located in Greenfield, Ohio. This refinancing replaced our existing note payable in the amount of \$1,412,000 and returned over \$800,000 to the



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Company for cash utilized to complete the room additions and renovations of the property. Our new financing is a HUD insured loan at a fixed interest rate of 6.5% with a 30 year amortization. As a result of this refinancing, in July, 2008, we

recognized approximately \$51,000 in expenses related to financing costs of the refinanced debt. As a result of this refinancing, the restricted certificate of deposit in the amount of approximately \$217,000 was released and liquidated. Proceeds were used to repay a loan in the amount of \$190,000 with the balance of the proceeds being used to supplement operating cash flow.

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

***Note Payable to Stockholder***

For the year ended December 31, 2008 and the year ended December 31, 2007 note payable to stockholder was \$44,058 and \$819,110, respectively, with interest rates of approximately 3.25% and 6.8%, respectively. The loan originally matured in May 2007 but was extended to May 2009. However, in July, 2008, we completed refinancing \$760,000 of this loan with a bank loan leaving a balance due on our note payable to stockholder of \$44,058 as of December 31, 2008.

***Cash Flow***

Activities that affect our cash flows from operations are numerous. For instance, the acuity of our assisted living residents affects the monthly fees we charge them and the fees increase in relation to the level of services required to take care of them. In the skilled nursing facilities, patients who are covered under Medicare are paid higher reimbursement rates than patients who are covered under Medicaid. Also, the length of stay in our nursing homes affects cash flow. In our nursing homes and assisted living homes, our strategy is to try to provide all the services required to keep our patients in our facilities as long as we can (to age in place).

Our cash requirements are satisfied primarily with cash generated from operating activities and debt. Our cash flow is dependent on our ability to collect accounts receivable in a timely manner. Accounts receivable collections in the health care industry can be very complex processes. At December 31, 2008, approximately 77% of our skilled nursing facility residents were covered by the Medicaid and Medicare programs. These are reliable payment sources which make our likelihood of collection very high. However, the time it takes to receive payment on a claim from these sources can be long. On average, accounts receivable were outstanding nearly 33 days before collection as of December 31, 2008 which is lower than December 31, 2007 days of 37. The status of collection efforts is monitored very closely by our senior management. (See additional discussion under Patient Care Receivables in the Critical Accounting Policies and Use of Estimates on page 24.)

**December 31, 2008 as compared to December 31, 2007**

During 2008, we satisfied our cash requirements primarily with cash generated from operating activities. Our cash was used principally for the operations of our properties. Cash provided by operating activities was approximately \$439,000 as a result of decreased accounts receivable, increased accounts payable and accrued expenses offset by increases in prepaid expenses and other assets.

Net cash used in investing activities for the years ended December 31, 2008 and December 31, 2007 was approximately \$1,419,000 and \$521,000, respectively. For the year ended December 31, 2008, cash used in investing activities was primarily the result of satisfying the forward purchase contract for approximately \$941,000 and the purchase of property, plant and equipment for approximately \$477,000. For the year ended December 31, 2007, cash used in investing activities was primarily the result of the addition of property and equipment partially offset by the proceeds of the sale of assets of our discontinued operations.

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For the year ended December 31, 2008, net cash provided by financing activities was approximately \$1,319,000 and was the result of cash received upon refinancing certain loans offset by repayments on the original loans. Repayments on note payable to stockholder were the result of refinancing the loan with traditional bank debt. Repayments on notes payable were the result of refinancing existing debt as well as routine debt repayments.

Net cash used in financing activities for the year ended December 31, 2007 was \$580,963. This is primarily the result of routine repayments on notes payable and additional financing costs incurred as a result of refinancing one of our properties.

### **Inflation**

The resident fees that we receive from the properties that we own or lease and the management fees we receive from the facilities we manage for third parties are our primary source of income at this time. This source of income is affected by the monthly rental rates and the occupancy rates. The monthly rental rates are dependent on various factors including competition, market conditions and the locations of the properties. We evaluate and prepare budgets for our properties on an annual basis. At that time, we assess the impact of inflation on the operations of the properties, including but not limited to, budgeting increases for real estate taxes, utilities, employee expenses, food and supplies. However, some factors are difficult to quantify, such as potential increases in employee expenses as a result of the current shortage of qualified nurses, and there can be no assurance that the resident rental rates will increase or that costs will not increase due to inflation or other causes. We strive to be the provider of choice in each of our markets and to charge market or better than market rates.

### **Critical Accounting Policies and Use of Estimates**

We prepare our financial statements in accordance with accounting principles generally accepted in the United States. 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 estimates. These estimates are evaluated by management and revised as circumstances change. We believe that the following are critical accounting policies:

#### **Our financial statements reflect consolidation with entities in which we have determined to have a controlling financial interest**

In December of 2003, the Financial Accounting Standards Board ( FASB ) issued FIN 46R which addresses the consolidation of business enterprises which focus on primary beneficiaries in variable interest entities as defined in the interpretation. We have evaluated our relationship with Community s Hearth & Home, LTD., and determined that these entities are variable interest entities pursuant to FIN46R of which we are the primary beneficiary. We consolidated the entities as of December 31, 2003.

#### **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. On an ongoing basis, we have experienced very few collection problems and do not anticipate

significant increases unless the economy where our properties are located encounters a severe down trend. Approximately 78% 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.

**Long-lived Assets and Goodwill**

We account for our long-lived assets of property, plant and equipment other than goodwill by applying the provisions of SFAS No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets. We review the value of our long-lived assets on an

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annual basis or sooner if required for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. The determination and measurement of an impairment loss under these accounting standards requires the significant use of judgment and estimates based on many factors which can be subject to changing circumstances. Some of the changing circumstances could be market conditions, interest rates, competition and the economy.

Beginning January 1, 2002, we accounted for goodwill under the provisions of SFAS No. 142, Goodwill and Other Intangible Assets, which requires us to no longer amortize goodwill. We now test goodwill on an annual basis for the purpose of assessing the potential of its impairment and making the appropriate adjustments if required. We no longer amortize costs associated with the acquisition of certificates of need required in Ohio for nursing homes.

### **Incentive Stock Option Plan**

Through December 31, 2005, we accounted for our employees' stock option plans under the recognition and measurement principles of APB Opinion No. 25, Accounting for Stock Issued to Employees and related interpretations. No stock based employee compensation is reflected in net income, as all options granted under our plans are at an exercise price equal to the market value of the underlying common stock as of the date of grant. There had been no market for our common stock; accordingly, the exercise price established at time of grant was based on the judgment of the option committee.

Effective January 1, 2006, we began accounting for options by applying the fair value recognition provisions of FASB 123R, Share Based Payments, the effects of which are included in our financial statements for the year ended December 31, 2007 and 2008.

### **Recent Accounting Pronouncements**

In May 2008, the Financial Accounting Standards Board ( FASB ) issued Statement of Financial Accounting Standards ( SFAS ) SFAS No. 162, The Hierarchy of Generally Accepted Accounting Principles. SFAS No. 162 identifies the sources of accounting principles and the framework for selecting the principles to be used in the preparation of financial statements of non-governmental entities that are presented in conformity with generally accepted accounting principles. SFAS No. 162 is effective 60 days following the Securities and Exchange Commission's approval of the Public Company Accounting Oversight Board Auditing amendments to AU Section 411, The Meaning of Present Fairly in Conformity with Generally Accepted Accounting Principles. The Company has not yet evaluated the impact that SFAS No. 162 will have on its consolidated financial statements.

In March 2008, the FASB issued SFAS No. 161, Disclosures about Derivative Instruments and Hedging Activities, an amendment of FASB Statement No. 133 ( SFAS 161 ), which requires enhanced disclosures about (i) how and why an entity uses derivative instruments, (ii) how derivative instruments and related hedged items are accounted for under SFAS No. 133, Accounting for Derivative Instruments and Hedging Activities, as amended and its related interpretations, and (iii) how derivative instruments and related hedged items affect an entity's financial position, financial performance, and cash flows. SFAS No. 161 also requires that objectives for using derivative instruments be disclosed in terms of underlying risk and accounting designation and requires cross-referencing within the footnotes. This statement also suggests disclosing the fair values of derivative instruments and their gains and losses in a tabular format. This statement is effective for financial statements issued for fiscal years and interim periods beginning after

November 15, 2008 and therefore is effective for our first quarter in fiscal 2009. The Company does not expect the adoption of SFAS No. 161 to have a material impact on the Company's consolidated financial position, results of operations or cash flows.

In September 2006, the FASB issued Statement of Financial Accounting Standards No. 157 ( SFAS 157 ), *Fair Value Measurements* . This statement establishes a single authoritative definition of fair value, sets out a framework for measuring fair value, and requires additional disclosures about fair-value measurements. SFAS 157 defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date . For the Company, SFAS 157 is effective for the fiscal year beginning January 1, 2008. The adoption of this standard did not have a material effect on the Company's consolidated financial position, results of operations or cash flows.

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In February 2008, the FASB issued Staff Position 157-2 ( FSP 157-2 ). FSP 157-2 permits delayed adoption of SFAS 157 for certain non-financial assets and liabilities, which are not recognized at fair value on a recurring basis, until fiscal years and interim periods beginning after November 15, 2008. As permitted by FSP 157-2, the Company has elected to delay the adoption of SFAS 157 for qualifying non-financial assets and liabilities, such as fixed assets and intangibles. The Company does not expect the adoption of FSP 157-2 to have a material impact on the on the Company s consolidated financial position, results of operations or cash flows.

In December 2007, the FASB issued SFAS No. 160, Noncontrolling Interests in Consolidated Financial Statements an amendment of ARB No. 51 ("SFAS 160"). SFAS 160 establishes accounting and reporting standards that require noncontrolling interests to be reported as a component of equity, changes in a parent's ownership interest while the parent retains its controlling interest be accounted for as equity transactions, and any retained noncontrolling equity investment upon the deconsolidation of a subsidiary be initially measured at fair value. SFAS 160 is to be applied prospectively to business combinations consummated on or after the beginning of the first annual reporting period on or after December 15, 2008. The Company has evaluated SFAS 160 and does not believe it will have a material impact on its consolidated financial position, results of operations and cash flows. SFAS 160 will be adopted by the Company in January, 2009.

In December 2007, The FASB issued SFAS No. 141 (revised 2007), Business Combinations ("SFAS 141R"). SFAS 141R establishes the principles and requirements for how an acquirer: 1) recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree; 2) recognizes and measures the goodwill acquired in the business combination or gain from a bargain purchase; and 3) determines what information to disclose to enable users of the financial statements to evaluate the nature and financial effects of the business combination. SFAS 141R is to be applied prospectively to business combinations consummated on or after the beginning of the first annual reporting period on or after December 15, 2008 (fiscal year 2009 for the Company). The Company is currently evaluating the impact SFAS 141R will have on any potential future business combinations.

On February 15, 2007, the Financial Accounting Standards Board ( FASB ) issued Statement of Financial Accounting Standards No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities Including an Amendment of FASB Statement No. 115* ( FASB 159 ). This standard permits an entity to measure financial instruments and certain other items at estimated fair value. Most of the provisions of SFAS No. 159 are elective; however, the amendment to FASB No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, applies to all entities that own trading and available-for-sale securities. The fair value option created by SFAS 159 permits an entity to measure eligible items at fair value as of specified election dates. The fair value option (a) may generally be applied instrument by instrument, (b) is irrevocable unless a new election date occurs, and (c) must be applied to the entire instrument and not to only a portion of the instrument. SFAS 159 is effective as of the beginning of the first fiscal year that begins after November 15, 2007. Early adoption is permitted as of the beginning of the previous fiscal year provided that the entity (i) makes that choice in the first 120 days of that year, (ii) has not yet issued financial statements for any

interim period of such year, and (iii) elects to apply the provisions of FASB 157. We are currently evaluating the impact of SFAS 159, if any, on our consolidated financial statements.

**Item 7A. Quantitative and Qualitative Disclosures About Market Risk**

Not Required



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**Item 8. Financial Statements and Supplementary Data**

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**REPORT OF INDEPENDENT REGISTERED  
PUBLIC ACCOUNTING FIRM**

To the Stockholders

AdCare Health Systems, Inc.

and Subsidiaries

Springfield, Ohio

We have audited the accompanying consolidated balance sheet of AdCare Health Systems, Inc and Subsidiaries as of December 31, 2008, 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. 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, 2008, 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.

Dayton, Ohio

March 31, 2009

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To the Stockholders

AdCare Health Systems, Inc.

and Subsidiaries

Springfield, Ohio

We have audited the accompanying consolidated balance sheet of AdCare Health Systems, Inc. and Subsidiaries as of December 31, 2007, 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. 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 also 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 consolidated financial position of AdCare Health Systems, Inc. and Subsidiaries as of December 31, 2007, and the consolidated results of their operations and their cash flows for the year then ended, in conformity with accounting principles generally accepted in the United States.

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

Miami, Florida

March 28, 2008

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**ADCARE HEALTH SYSTEMS, INC. AND SUBSIDIARIES**  
**CONSOLIDATED BALANCE SHEETS**

	December 31,	
<u>ASSETS</u>	2008	2007
Current Assets:		
Cash and cash equivalents	\$ 1,266,315	\$ 926,625
Certificate of deposit, restricted	-	209,637
Accounts receivable:		
Long-term care resident receivables, net	2,008,847	2,115,364
Management, consulting and development receivables, net	258,811	259,778
Advances and receivables from affiliates	17,635	27,558
Prepaid expenses and other	478,534	453,219
Total current assets	4,030,142	3,992,181
Restricted cash	1,155,596	973,975
Property and equipment, net	16,772,660	14,425,868
Note receivable, net	-	221,413
License, net	1,189,307	1,189,307
Goodwill	2,679,482	2,638,193
Other assets	1,012,340	1,050,506
Total Assets	\$26,839,527	\$24,491,443
<u>LIABILITIES AND STOCKHOLDERS</u>		
<u>EQUITY</u>		
Current Liabilities:		
Current portion of notes payable and other debt	\$ 713,323	\$ 773,279
Current portion of note payable to stockholder	9,432	9,026
Accounts payable	1,009,002	1,416,313
Accrued expenses	2,838,407	2,060,222
Forward purchase contract	-	900,000
Total current liabilities	4,570,164	5,158,840
Notes payable and other debt, net of current portion	16,974,788	12,813,338
Note payable to stockholder, net of current portion	34,626	810,084
Other liabilities	299,314	559,509
Income tax payable	170,007	-
Minority Interest in Equity of Consolidated Entities	269,193	255,070

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Total Liabilities	22,318,092	19,296,841
Stockholders' equity:		
Preferred stock, no par value; 500,000 shares authorized; no shares issued or outstanding	-	-
Common stock and additional paid-in capital, no par value; 14,500,000 shares authorized; 3,786,129 shares issued and outstanding	14,766,967	14,063,956
Accumulated deficit	(10,245,532)	(9,169,354)
Total stockholders' equity	4,521,435	4,894,602
Total liabilities and stockholders' equity	\$26,839,527	\$24,491,443

See notes to consolidated financial statements

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**ADCARE HEALTH SYSTEMS, INC. AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF OPERATIONS**

	Year Ended December 31,	
	2008	2007
<b>Revenues:</b>		
Patient care revenues	\$23,008,754	\$21,928,808
Management, consulting and development fee revenue	1,784,540	1,738,948
Total revenue	24,793,294	23,667,756
<b>Expenses:</b>		
Payroll and related payroll costs	15,649,862	14,762,090
Other operating expenses	8,248,157	7,746,505
Depreciation and amortization	882,900	847,440
Total expenses	24,780,919	23,356,035
Income from Operations	12,375	311,721
<b>Other Income (Expense):</b>		
Interest income	23,287	59,300
Interest expense, others	(1,265,622)	(978,731)
Interest expense, related parties	(36,446)	(66,432)
Minority interest in earnings of consolidated entities	(57,919)	(94,811)
Other income (expense)	4,200	(37,014)
Total other (expenses)	(1,332,500)	(1,117,688)
Gain on Acquisition	413,954	-
Loss from continuing operations before income taxes	(906,171)	(805,967)
Income Tax Benefit (Expense)	(170,007)	178,415
Loss from Continuing Operations	(1,076,178)	(627,552)
<b>Discontinued Operations:</b>		
Income from discontinued operations (including gain on disposal of \$619,605 in 2007)	-	587,039
Provision for income taxes	-	(178,415)



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Income on discontinued operations	-	408,624
Net loss	\$(1,076,178)	\$ (218,928)
Net (Loss) Income Per Share, Basic and Diluted:		
Continuing operations	\$ (0.28)	\$ (0.16)
Discontinued operations	-	0.11
	\$ (0.28)	\$ (0.05)
Weighted Average Common Shares Outstanding,		
Basic	3,786,129	3,786,129
Diluted	3,786,129	3,786,129
See notes to consolidated financial statements		

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**ADCARE HEALTH SYSTEMS, INC. AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF STOCKHOLDERS EQUITY**

	<u>Shares</u>	<u>Common Stock and Additional Paid-in Capital Amount</u>	<u>Accumulated Deficit</u>	<u>Total</u>
Balance, January 1, 2007	3,778,129	13,857,166	(8,950,426)	4,906,740
Year Ended December 31, 2007:				
Stock issued upon exercise of warrants	8,000	20,000	-	20,000
Warrants issued in connection with consulting agreement	-	170,846	-	170,846
Stock option compensation expense	-	27,326	-	27,326
Purchase of minority interest investment	-	(11,382)	-	(11,382)
Net loss	-	-	(218,928)	(218,928)
Balance, December 31, 2007	3,786,129	\$ 14,063,956	\$ (9,169,354)	\$ 4,894,602
Warrants issued in connection with consulting agreement	-	61,559	-	61,559
Stock option compensation expense	-	641,004	-	641,004
Purchase of minority interest investment	-	448	-	448
Net loss	-	-	(1,076,178)	(1,076,178)
Balance, December 31, 2008	3,786,129	\$14,766,967	\$(10,245,532)	\$4,521,943

See notes to consolidated financial statements



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**ADCARE HEALTH SYSTEMS, INC. AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**

	Year Ended December 31,	
	2008	2007
Cash flows from operating activities:		
Net Loss	\$ (1,076,178)	\$ (218,928)
Add back: income from discontinued operations	-	(587,039)
Net loss from continuing operations	\$ (1,076,178)	\$ (805,967)
Adjustments to reconcile net loss from continuing operations to net cash provided by (used in) operating activities:		
Depreciation and amortization	882,900	847,440
Warrants issued for services	150,831	58,149
Stock option compensation expense	641,004	27,326
Minority interest	57,919	94,811
Note receivable forgiveness exchanged for rent	9,000	36,000
Gain on acquisition	(413,952)	-
Changes in certain assets and liabilities:		
Accounts receivable	111,805	(162,737)
Prepaid expenses and other	(90,851)	(171,461)
Other assets	(24,982)	(50,737)
Accounts payable and accrued expenses	300,635	(350,232)
Income tax liability	170,007	-
Other liabilities	(278,696)	67,991
Net cash provided by (used in) operating activities of continuing operations	439,442	(409,417)
Net cash provided by operating activities of discontinued operations	-	302,080
Net cash provided by (used in) operating activities	439,442	(107,337)
Cash flow from investing activities:		
Increase (decrease) in restricted cash	47,829	(59,034)
Forward purchase contract buyout	(941,289)	-
Distribution to minority shareholders	(50,000)	-
Purchase of minority interest investment	(448)	(11,382)

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Purchase of property plant and equipment	(477,092)	(1,042,402)
Net cash used in investing activities of continuing operations	(1,421,000)	(1,112,818)
Net cash provided by investing activities of discontinued operations:		
Proceeds from sale of assets, net of associated costs	2,500	591,329
Net cash used in investing activities	(1,418,500)	(521,489)

See notes to consolidated financial statements

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

	Year Ended December 31,	
	2008	2007
Cash flows from financing activities:		
Proceeds from notes payable	6,469,171	91,197
Prepaid loan financing costs	-	(172,857)
Cash received upon exercise of warrants	-	20,000
Prepaid Financing Costs	159,130	-
Repayment of note payable to stockholder	(760,000)	(9,234)
Repayment on notes payable	(4,549,553)	(497,335)
Net cash provided by (used in) financing activities of continuing operations	1,318,748	(568,229)
Net cash used in financing activities of discontinued operations:		
Repayment on notes payable of discontinued operations	-	(12,734)
Net cash provided (used in) by financing activities	1,318,748	(580,963)
 Net Increase (Decrease) in Cash	 339,690	 (1,209,789)
 Cash, Beginning	 926,625	 2,136,414
 Cash, Ending	 \$ 1,266,315	 \$ 926,625
 Supplemental Disclosure of Cash Flow Information:		
Cash paid during the year for:		
Interest	\$ 1,012,813	\$ 1,044,755
 Supplemental Disclosure of Non-Cash Activities:		
Rent in exchange of note receivable repayment	\$ 9,000	\$ 36,000
Payoff of existing mortgage at closing of discontinued operations	-	\$ 609,839
Acquisition of assets in exchange for note forgiveness	\$ 2,740,584	-
Purchase of business assets in exchange for debt	\$ 266,300	\$ 337,361

See 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 ), formerly Passport Retirement, Inc., is a developer, owner and manager of retirement communities, assisted living facilities, skilled nursing facilities and home health care services in the state of Ohio. The Company manages sixteen facilities, comprised of six skilled nursing facilities, seven assisted living facilities and three independent living/senior housing facilities, totaling approximately 850 units. The Company also acquired a home health care business in 2005 and provides consulting and management services to various long-term care providers.

During December 1995, AdCare entered into a joint venture agreement with a hospital to build assisted living facilities in Ohio. AdCare subsequently formed Hearth & Home of Ohio, Inc. (Hearth & Home) to hold AdCare's 50% interest in this joint venture. Hearth & Home and the hospital then formed Community's Hearth & Home, Ltd. (Community's Hearth & Home), a limited liability company. This joint venture currently operates three Hearth & Home assisted living facilities.

Hearth & Home of Marion, LLC (Marion), a limited liability company, is a wholly-owned subsidiary of Hearth & Home of Ohio, Inc. Marion operated a long-term care facility. Operations for this project were discontinued in 2003 and the real property was disposed of in September 2007 (see Note 3).

In 1999, AdCare formed Hearth & Care of Greenfield, LLC (Greenfield), which owns and operates a 50-bed nursing facility. Greenfield is a wholly-owned subsidiary of AdCare.

In 1999, AdCare formed Hearth & Home of Van Wert Ltd. (Van Wert), which owns and operates an assisted living facility. In, July 2007, AdCare acquired an additional .4% of Van Wert for a total interest of 49.2% through October



2008. AdCare had agreed to offer to purchase the remaining 50.8% interests. In October of 2008, AdCare purchased the minority interest in Van Wert to obtain 100% ownership, as set forth in the forward purchase agreement (see Note 8).

In 2001, AdCare formed Hearth & Home of Vandalia, Inc. (Vandalia), which owns and operates an assisted-living facility. AdCare holds a 100% interest in Vandalia.

In 2002, AdCare formed The Pavilion Care Center, LLC (The Pavilion), which owns and operates a 62-bed nursing facility. The Pavilion is a wholly-owned subsidiary of Hearth & Home of Ohio, Inc.

In March 2003, AdCare entered into a lease agreement with Covington Realty, LLC (Covington) to lease the Covington Care Center, a 106-bed nursing facility.

In January 2005, AdCare acquired Assured Health Care, Inc. (Assured), which is a home healthcare agency (see Note 19).

Effective April 1, 2008, AdCare acquired 99% of The New Lincoln, Ltd. The sole asset of The New Lincoln, Ltd. is the New Lincoln Lodge Retirement Residence which is a 51 unit senior living residence located in Columbus, Ohio (see Note 18).

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**NOTE 1.**

**SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)**

***Principles of Consolidation***

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

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

AdCare has evaluated its relationship with Hearth & Home of Van Wert, LLC, and Community's Hearth & Home and has determined that these entities are variable interest entities and that AdCare holds variable interests in these entities. Furthermore, the Company determined that it is the primary beneficiary of these variable interests and that the entities are required to be consolidated in accordance with FIN 46R. See Note 1, Description of Business, for a description of these arrangements.

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



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

Presented below are the carrying amount and classification of the assets and liabilities of our variable interest entities as of December 31, 2008.

	December 31, 2008
Current assets	\$ 936,692
Property and equipment, net	3,859,247
Total assets	\$4,795,939
Current liabilities	\$ 347,828
Notes payable, net of current portion	3,970,132
Total liabilities	\$4,317,960
Owner s equity	477,979
Total liabilities and equity	\$4,795,939

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

*Use of Estimates*

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

from those estimates.

***Statement of Cash Flows***

For the purposes of reporting cash flows, the Company considers all short-term investments with original maturities less than three months, which are readily convertible into cash, to be cash equivalents.

***Patient Care Receivables and Revenues***

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

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

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**NOTE 1.**

**SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)**

***Patient Care Receivables and Revenues (continued)***

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

Potentially uncollectible patient accounts are provided for on the allowance method based on management's evaluation of outstanding accounts receivable at year-end and historical experience. For the years ended December 31, 2008 and 2007, management recorded an allowance for uncollectible accounts estimated at approximately \$79,000 and \$165,000, respectively.

***Management, Consulting and Development Fee Receivables and Revenue***

Management, consulting and development fee receivables and revenue are recorded in the month that services are provided. For the years ended December 31, 2008 and 2007, management recorded an allowance for uncollectible accounts estimated at approximately \$27,500 and \$10,000 respectively.

***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 included in income. Depreciation is recorded on a straight-line basis over the estimated useful lives of the respective assets.

*Licenses*

The Company has capitalized the cost of acquiring operating licenses in connection with the acquisitions of The Pavilion and Greenfield. In accordance with Statement of Financial Accounting Standards No. 142, *Goodwill and Other Intangible Assets* (SFAS 142), the Company stopped amortizing these costs on January 1, 2003. The fair value of the operating licenses for the years ended December 31, 2008 and 2007 exceeded the carrying amount; therefore, no impairment loss was recognized. The fair value of the operating licenses was estimated using the present value of future cash flows. For the years ended December 31, 2008 and 2007, the total carrying amount of the operating licenses was approximately \$1,200,000. The operating licenses are tested for impairment in December of each year.

Table of Contents**NOTE 1.****SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES** (Continued)*Income Taxes*

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

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

*Segments*

For the years ended December 31, 2008 and 2007, the Company operated in two segments: management and facility based care and home based care. The management and facility based care segment provides services to individuals needing long term care in a nursing home or assisted living setting and management of those facilities. The home based care segment provides home health care services to patients while they are living in their own homes. All the Company's revenues and assets are within the State of Ohio.

	(Amounts in 000s)					
	Manage- ment and Facility Based Care	Home Based Care	Total Segments	Discon- tinued operations (see note 3)	Cor- porate	Total
Year ended December 31, 2008:						
Net Revenue	23,782	2,804	26,586	-	(1,793)	24,793



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Net Profit (Loss)	(1,252)	176	(1,076)	-	-	(1,076)
Total Assets	24,280	2,545	26,825	-	-	26,825
Capital Spending	468	9	477	-	-	477

Year ended December 31, 2007:

Net Revenue	22,125	3,218	25,343	-	(1,675)	23,668
Net Profit (Loss)	(980)	174	(806)	587	-	(219)
Total Assets	22,134	2,357	24,491	-	-	24,491
Capital Spending	1,374	6	1,380	-	-	1,380

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**NOTE 1.**

**SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)**

***Concentrations of Credit Risk***

Financial instruments which potentially expose the Company to concentrations of credit risk consist primarily of cash and cash equivalents and notes and accounts receivable.

**Cash and cash equivalents**

The Company maintains its cash with 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. On October 3, 2008 the Emergency Economic Stabilization Act was passed raising the covered limit to \$250,000 per depositor. In addition, our primary financial institution participated in the FDIC Transaction Account Guarantee Program, which provides unlimited coverage. For the years ended December 31, 2008 and 2007 approximately \$0 and \$925,000, respectively, was in excess of the federal depository insurance coverage limit.

**Certificate of Deposit**

As of December 31, 2008 and 2007 the Company had a certificate of deposit in the amount of \$0 and \$209,637, respectively, which 2007 was pledged as collateral on a bank loan of \$190,000 (see Note 6). The certificate of deposit was liquidated in July 2008.

**Notes and Accounts Receivable**

Notes and accounts receivable are recorded at net realizable value. The Company records interest income on interest-bearing loans using an appropriate rate of interest over the life of the loan.

Interest income accruals are suspended for interest-bearing loans receivable that are in default during the period of time that collection is uncertain. Payments received on non-accrual loans are first applied against any accrued interest balance outstanding. Once collection is considered to be certain, interest income accruals are resumed.

The Company performs ongoing evaluations of its residents and significant third party payers with which they contract, generally not requiring collateral. Management believes that credit risk with respect to accounts receivable 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 notes and account receivable are charged against the allowance for doubtful accounts once likelihood of collection has been determined. Notes and accounts receivable are considered to be past due and placed on delinquent status based on contractual terms, as well as how frequently payments are received, on an individual account basis.

***Restricted Cash***

The Regulatory Agreement established with the financing secured through the Department of Housing and Urban Development (HUD) for The Pavilion, Hearth & Home of Vandalia, Community s Hearth & Home, Hearth & Home of Urbana, Lincoln Lodge and Hearth & Care of Greenfield requires monthly escrow deposits for taxes, insurance and replacement of project assets. For the years ended December 31, 2008 and 2007, these deposits

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**NOTE 1.**

**SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)**

***Restricted Cash (continued)***

were \$926,700 and \$317,990 respectively. These facilities also agreed to Fair Housing Administration (FHA) restrictions as to rental charges, operation policies and expenditures, and distributions to its member.

The Company agreed to deposit \$625,000 in an interest bearing savings account with The Huntington National Bank (Huntington) in order to secure a letter of credit associated with the financing for Community's Hearth & Home. The debt was refinanced in June of 2008 resulting in the full release of these funds.

In 2008, the Company agreed to deposit \$60,000 in an interest bearing CD with The Huntington National Bank as collateral for a loan associated with Assured Home Health.

In the State of Ohio, 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. For the years ended December 31, 2008 and 2007, the balance in these accounts was approximately \$53,300 and \$23,000 respectively.

Lincoln Lodge collects security deposits on their units. This cash is held in a separate account as required. In 2008, this amounted to \$28,200.

The Company collects from its various facilities and submits on their behalf payments to the Ohio Bureau of Worker's Compensation. At the end of 2008, \$86,400 was held on deposit for these payments.

***Goodwill***

Effective January 1, 2003, the Company adopted Statement of Financial Accounting Standards (SFAS) No. 142, *Goodwill and Other Intangible Assets*. SFAS No. 142 requires, among other things, that companies no longer amortize goodwill, but instead test goodwill for impairment at least annually. In addition, SFAS 142 requires that the Company identify reporting units for the purpose of assessing potential future impairments of goodwill, reassess the useful lives of other existing recognized intangible assets and cease amortization of intangible assets with an indefinite useful life. An intangible asset with an indefinite useful life will be tested for impairment in accordance with the guidance in SFAS 142. The principal effect of the adoption of SFAS 142 was to eliminate amortization of the Company's indefinite lived intangibles. Goodwill is tested for impairment in accordance with SFAS 142 in the fourth quarter of each year. Based on the Company's impairment test, the Company determined that no impairment of goodwill existed at December 31, 2008. Goodwill is part of our Management and Facility Based Care segment.

In November, 2008, the Company completed a forward purchase contract to acquire the outstanding partnership interest in Hearth & Home of Van Wert. The value of the forward purchase contract was approximately \$900,000. The Company paid approximately \$941,000 to satisfy the contract resulting in the acquisition of an additional \$41,000 in goodwill.

#### ***Impairment of Long-Lived Assets***

The Company accounts for long-lived assets in accordance with the provisions of Statement of Financial Accounting Standard (SFAS) No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*. This statement requires that long-lived assets and certain identifiable intangibles be reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable.

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**NOTE 1.**

**SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)**

***Impairment of Long-Lived Assets (continued)***

Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to future undiscounted net cash flows expected to be generated by the asset. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the assets exceeds the fair value of the assets. Assets to be disposed of are reported at the lower of the carrying amount or fair value less costs to sell.

***Advertising***

Advertising costs are expensed as incurred. Advertising costs for the years ended December 31, 2008 and 2007 were approximately \$284,000 and \$253,000, respectively.

***Fair Value of Financial Instruments***

The respective carrying value of certain on-balance sheet financial instruments approximated their fair value. These instruments include cash and cash equivalents, accounts receivable, notes and loans receivable, notes and loans payable, lines of credit, accounts payable and accrued expenses. 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.

***Earnings per Share***

Financial Accounting Standards Board Statement No. 128, *Earnings per Share* (SFAS 128) requires the presentation of basic and diluted earnings per share. Basic earnings per share exclude any dilutive effects of options, warrants and convertible securities and is computed using the weighted average number of common shares outstanding. Earnings

available to common stockholders include preferential distributions to Members in a manner similar to the treatment of dividends to preferred stockholders. Diluted earnings per share reflects the potential dilution if securities or other contracts to issue common units were exercised or converted into common units.

In May 2008, the Financial Accounting Standards Board ( FASB ) issued Statement of Financial Accounting Standards ( SFAS ) SFAS No. 162, The Hierarchy of Generally Accepted Accounting Principles. SFAS No. 162 identifies the sources of accounting principles and the framework for selecting the principles to be used in the preparation of financial statements of non-governmental entities that are presented in conformity with generally accepted accounting principles. SFAS No. 162 is effective 60 days following the Securities and Exchange Commission 's approval of the Public Company Accounting Oversight Board Auditing amendments to AU Section 411, The Meaning of Present Fairly in Conformity with Generally Accepted Accounting Principles. The Company has not yet evaluated the impact that SFAS No. 162 will have on its consolidated financial statements.

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**NOTE 1.**

**SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)**

***Recent Accounting Pronouncements***

In December 2007, the FASB issued SFAS No. 160, Noncontrolling Interests in Consolidated Financial Statements an amendment of ARB No. 51 ("SFAS 160"). SFAS 160 establishes accounting and reporting standards that require noncontrolling interests to be reported as a component of equity, changes in a parent's ownership interest while the parent retains its controlling interest be accounted for as equity transactions, and any retained noncontrolling equity investment upon the deconsolidation of a subsidiary be initially measured at fair value. SFAS 160 is to be applied prospectively to business combinations consummated on or after the beginning of the first annual reporting period on or after December 15, 2008. The Company has evaluated SFAS 160 and does not believe it will have a material impact on its consolidated financial position, results of operations and cash flows. SFAS 160 will be adopted by the Company in January, 2009.

In December 2007, The FASB issued SFAS No. 141 (revised 2007), Business Combinations ("SFAS 141R"). SFAS 141R establishes the principles and requirements for how an acquirer: 1) recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree; 2) recognizes and measures the goodwill acquired in the business combination or gain from a bargain purchase; and 3) determines what information to disclose to enable users of the financial statements to evaluate the nature and financial effects of the business combination. SFAS 141R is to be applied prospectively to business combinations consummated on or after the beginning of the first annual reporting period on or after December 15, 2008 (fiscal year 2009 for the Company). The Company is currently evaluating the impact SFAS 141R will have on any potential future business combinations.

On February 15, 2007, the Financial Accounting Standards Board ( FASB ) issued Statement of Financial Accounting Standards No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities Including an Amendment of FASB Statement No. 115* ( FASB 159 ). This standard permits an entity to measure financial instruments and certain other items at estimated fair value. Most of the provisions of SFAS No. 159 are elective; however, the amendment to FASB No. 115, Accounting for Certain Investments in Debt and Equity Securities, applies to all entities that own trading and available-for-sale securities. The fair value option created by SFAS 159 permits an entity to measure eligible items at fair value as of specified election dates. The fair value option (a) may generally be applied instrument by instrument, (b) is irrevocable unless a new election date occurs, and (c) must be applied to the entire instrument and not to only a portion of the instrument. SFAS 159 is effective as of the beginning of the first fiscal year that begins after November 15, 2007. Early adoption is permitted as of the beginning of the previous fiscal year provided that the entity (i) makes that choice in the first 120 days of that year, (ii) has not yet issued financial statements for any interim period of such year, and (iii) elects to apply the provisions of FASB 157. We are currently evaluating the impact of SFAS 159, if any, on our consolidated financial statements.



In March 2008, the FASB issued SFAS No. 161, Disclosures about Derivative Instruments and Hedging Activities, an amendment of FASB Statement No. 133 ( SFAS 161 ), which requires enhanced disclosures about (i) how and why an entity uses derivative instruments, (ii) how derivative instruments and related hedged items are accounted for under SFAS No. 133, Accounting for Derivative Instruments and Hedging Activities, as amended and its related interpretations, and (iii) how derivative instruments and related hedged items affect an entity's financial position, financial performance, and cash flows. SFAS No. 161 also requires that objectives for using derivative instruments be disclosed in terms of underlying risk and accounting designation and requires cross-referencing within the footnotes. This statement also suggests disclosing the fair values of derivative instruments and their gains and losses in a tabular format. This statement is effective for financial statements issued for fiscal years and interim periods beginning after November 15, 2008 and therefore is effective for our first quarter in fiscal 2009. The Company does not expect the adoption of SFAS No. 161 to have a material impact on the Company's consolidated financial position, results of operations or cash flows.

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**NOTE 1.**

**SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)**

***Recent Accounting Pronouncements (Continued)***

In September 2006, the FASB issued SFAS No. 157 ( SFAS 157 ), *Fair Value Measurements* . This statement establishes a single authoritative definition of fair value, sets out a framework for measuring fair value, and requires additional disclosures about fair-value measurements. SFAS 157 defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date . For the Company, SFAS 157 is effective for the fiscal year beginning January 1, 2008. The adoption of this standard did not have a material impact on the Company's financial condition, results of operations, or liquidity.

In February 2008, the Financial Accounting Standards Board ( FASB ) issued FASB Staff Position No. FAS 157-2, Effective Date of FASB Statement No. 157 , which provides a one-year deferral of the effective date of SFAS 157 for non-financial assets and non-financial liabilities, except for those that are recognized or disclosed in the financial statements at fair value at least annually. Therefore, the Company has adopted the provisions of SFAS 157 only with respect to financial assets and liabilities, as well as any other assets and liabilities carried at fair value. SFAS 157 defines fair value, establishes a framework for measuring fair value under generally accepted accounting principles and enhances disclosures about fair value measurements. Fair value is defined under SFAS 157 as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. Valuation techniques used to measure fair value under SFAS 157 must maximize the use of observable inputs and minimize the use of unobservable inputs. The standard describes how to measure fair value based on a three-level hierarchy of inputs, of which the first two are considered observable and the last unobservable.

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

Level 2 Inputs other than Level 1 that are observable, either directly or indirectly, such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities.

Level 3 Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities

In February 2008, the FASB issued Staff Position 157-2 ( FSP 157-2 ). FSP 157-2 permits delayed adoption of SFAS 157 for certain non-financial assets and liabilities, which are not recognized at fair value on a recurring basis, until fiscal years and interim periods beginning after November 15, 2008. As permitted by FSP 157-2, the Company has elected to delay the adoption of SFAS 157 for qualifying non-financial assets and liabilities, such as fixed assets and intangibles. The Company does not expect the adoption of FSP 157-2 to have a material impact on the on the Company s consolidated financial position, results of operations or cash flows.

***Reclassification***

Certain reclassifications have been made to the 2007 financial information to conform to the 2008 presentation.

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**NOTE 2.**

**LIQUIDITY AND PROFITABILITY**

The Company incurred a net loss of approximately \$1,076,000 and \$219,000 for the years ended December 31, 2008 and 2007, respectively, and has negative working capital of approximately \$540,000 at December 31, 2008. The Company's ability to achieve sustained profitable operations is dependent on continued growth in revenue and controlling costs.

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

.

refinancing debt where possible to obtain more favorable terms.

.

increase facility occupancy.

.

add additional management contracts.

.

acquire existing cash flowing operations to expand our operations and branch out into other related areas of business.

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

**NOTE 3.**

**DISCONTINUED OPERATIONS**

The Company discontinued the operations of Hearth & Home of Marion during 2003 and formed a plan to sell the property. In January 2004, the land, building and majority of the equipment were sold pursuant to a five-year land contract. The land contract calls for title to transfer to the purchaser once all terms and conditions have been met, including payment of all amounts owed. The sales price was \$1,600,000. The original terms of the land contract require interest to be paid monthly at 8% on the outstanding balance. During 2004, principal payments of approximately \$100,000 were made to AdCare. Principal payments of \$25,000 were to be due to AdCare in January 2006, 2007, 2008 and the remaining principal in January 2009. At certain times under certain conditions, the purchaser had the right to vacate the property prior to July 1, 2006 with no further obligation to the Company. As of July 1, 2005, the land contract was amended to reduce the annual rate of interest to 4.8% paid in monthly installments of \$6,000 beginning July 1, 2005, and continuing for 12 consecutive months. These arrangements were extended one additional year on July 1, 2006. Monthly installments of interest after July 1, 2007, are subject to negotiation and the remaining unpaid principal balance shall be due and payable no later than December 31, 2008 unless the purchaser elects to vacate the property prior to July 1, 2007.

In July 2006, the Company concluded that the land contract did not satisfy all the criteria set forth in SFAS 66, *Accounting for Sales of Real Estate* relating to determining if a sale has been consummated. As a result, the Company concluded it should use the deposit method in accounting for that land contract. The deposit method requires that the seller not recognize any profit until the sale is consummated. The accompanying consolidated financial statements reflect the property and equipment on the balance sheet and revenue is recognized only to the extent the Company incurs interest and property tax expense.

Table of Contents**NOTE 3.****DISCONTINUED OPERATIONS** (Continued)

In September, 2007, the Company completed the sale of the property and a gain on the sale of \$619,600 resulted.

The results of the discontinued operations, as presented in the accompanying consolidated statements of operations, are as follows:

	December 31,	
	<u>2008</u>	<u>2007</u>
Revenue	\$ -	\$ -
Gain from Discontinued Operations	\$ -	\$587,039
Gain on Disposal	\$ -	\$619,605

There were no remaining assets or liabilities of discontinued operations as of December 31, 2007.

**NOTE 4.****PROPERTY AND EQUIPMENT**

	Estimated Useful Lives (Years)	December 31,	
		<u>2008</u>	<u>2007</u>
Buildings and improvements	5 to 40	\$15,729,206	\$13,315,045
Equipment	2-10	2,776,999	2,551,873
Land	-	2,922,712	2,580,201
Furniture and fixtures	2-5	642,195	622,889
Construction in process	-	<u>143,863</u>	<u>16,042</u>
		22,214,975	19,086,050
Less: accumulated depreciation		<u>5,442,315</u>	<u>4,660,182</u>
		<u>\$16,772,660</u>	<u>\$14,425,868</u>

For the years ended December 31, 2008 and 2007 depreciation expense was approximately \$868,000 and \$696,000, respectively.

**NOTE 5.**

**NOTE RECEIVABLE**

In connection with the transfer of the Company's interest in an independent living facility in 1999, the Company received a promissory note in the amount of \$1,425,000. The promissory note earns interest at 10%. Principal payments were to be made as defined with the remaining balance to be paid December 31, 2004. In late 1999, the Company discontinued accruing interest due to uncertainty of collection. In addition, the Company began evaluating the promissory note as to likelihood of collection. At December 31, 2004, the outstanding principal balance was \$1,389,935. The Company granted an extension of the due date to December 31, 2005.

Table of Contents**NOTE 5.****NOTE RECEIVABLE (Continued)**

In October, 2005, the terms of the promissory note were retroactively amended. The amended terms call for interest at 10%, and a lump sum payment of the outstanding principal and accrued interest on December 31, 2006, the maturity date. The promissory note is personally guaranteed by the owner of the general and limited partnership interests which own the facility. This note was subsequently extended to December 31, 2007.

In May 2006, the Company executed a lease to begin July 1, 2006, for office space for its home health operation at this facility. The rent is \$3,000 per month for a period of 10 years. The rental payments owed will be offset against amounts due under the note receivable.

Based on financial information which became available to the Company during the first quarter of 2007, the Company determined that additional reserves were required in connection with this receivable. The decision was based on year end results of New Lincoln Lodge and the Company's inability, based on that information, to determine when this note might be repaid. The Company has determined the present value of the rental agreement to be approximately \$257,000. As a result of the analysis, reserves were increased by approximately \$437,000, to reduce the note receivable to its net realizable value which is represented by the present value of the 10 year rental agreement.

As of December 31, 2007, the outstanding balance of the note receivable is comprised of the following:

	December 31, 2007
Principal	\$1,353,935
Accrued interest	124,500
	1,478,435
Allowance for collectability	(1,257,022)
	\$ 221,413

On March 7, 2008, the Company entered into a letter of intent to acquire 99% of the New Lincoln Lodge ( NLL ) in exchange for the outstanding note receivable, \$12,500 in cash as consideration and 1% ownership to the prior owner of NLL. The transaction was completed effective April 1, 2008. The prior owner retained 1% ownership.



**NOTE 6.**

**NOTES PAYABLE AND OTHER DEBT**

	December 31,	
	2008	2007

Promissory note payable to a financial institution in the original principal amount of \$96,000 executed on June 18, 2004. The note bears interest indexed to the Wall Street Journal Prime Rate plus 1.50% per annum (8.75% at December 31, 2007) with monthly principal and interest payments of approximately \$1,138. The note matures on June 1, 2013. The note is secured by a \$150,000 open-end mortgage and an interest in all inventory, equipment, accounts and general intangibles of AdCare Health Systems. The note is personally guaranteed by certain stockholders. This note was repaid with proceeds from refinancing in November, 2008.

	\$ -	\$ 66,288
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Table of Contents**NOTE 6.****NOTES PAYABLE AND OTHER DEBT (Continued)**

	December 31,	
	2008	2007
Promissory note payable to a financial institution in the original principal amount of \$190,000 executed on July 23, 2004. The note bears interest at the rate of 4.13% per annum and is due and payable monthly. The note is due on demand. The note is secured by a certificate of deposit in the amount of approximately \$209,600. In July, 2008, the certificate of deposit was liquidated with proceeds use to repay this loan.	-	\$ 190,000
Promissory note payable to a financial institution in the original principal amount of \$300,000 executed June 30, 2003. The note bears interest indexed to the Federal Home Loan Bank of Cincinnati 5 year Advance Rate plus 3.375% (6.75% at December 31, 2007), with monthly principal and interest payments of approximately \$3,384. The note matures on June 1, 2013. The note is secured by real property located in Clark County, State of Ohio. The promissory note payable is personally guaranteed by certain stockholders. In November, 2008, this loan was repaid with proceeds from refinancing.	-	191,287
Open-end mortgage note payable for a maximum amount of indebtedness of \$1,412,000 on July 23, 2004. The note bears interest indexed to the Wall Street Journal Prime Rate plus 1.00% (8.25% at December 31, 2007) with monthly payments of interest only during the construction phase. The note matures on March 1, 2030. The note is secured by inventory, accounts, equipment, general intangibles and fixtures, and land of Hearth & Care of Greenfield. The note is subject to various financial and restrictive covenants. This loan was refinanced in July, 2008.	-	1,412,000
Promissory note payable to a financial institution in the original principal amount of \$2,041,000, executed on December 22, 2003. The note bears interest indexed to the Wall Street Journal Prime Rate plus 1.00% per annum (3.25% at December 31, 2008 and 7.00% at December 31, 2007) with monthly principal and interest payments of approximately \$11,590. The note matures on January 1, 2026. The note is secured by inventory, accounts, equipment,	1,878,794	\$ 1,934,900

general intangibles and fixtures. The note is subject to various financial and restrictive covenants.

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Table of Contents**NOTE 6.****NOTES PAYABLE AND OTHER DEBT (Continued)**

	2008	December 31, 2007
Adjustable rate demand taxable notes, series 2002 Bonds in the original principal amount of \$4,200,000 executed in December 2002. The note bears interest indexed at the LIBOR rate (4.46% at December 31, 2007), which at the option of the Company, upon certain conditions, the interest rate may be converted on one or more occasions to a Weekly Interest Rate, a One Month Interest Rate, a One Year Interest Rate, a Five Year Interest Rate unless or until converted to a Fixed Interest Rate for the remaining term of the bonds. The note matures in December 2022. The bonds are secured by real property and a \$4,200,000 letter of credit with a bank. This loan was refinanced in June, 2008.	-	\$3,585,000
Mortgage note payable, insured by HUD, to a financial institution in the original principal amount of \$3,721,500 executed on February 17, 2000. The note bears interest at the rate of 8.50% per annum with monthly principal and interest payments of approximately \$27,309. The note matures on May 1, 2041. The note has various restrictive covenants imposed by HUD.	\$3,607,918	3,628,020
On January 26, 2005, AdCare issued a promissory note to the major stockholder of Assured Home Health, Inc. The face value of the note is \$450,000 and accrues interest during 2005 which adds to the note balance. The note then bears interest of 5% and is payable in 36 monthly payments of \$14,161 beginning February 2006 and maturing February 2009.	28,173	178,747
Mortgage note payable, insured by HUD, to a financial institution in the original principal amount of \$2,108,800 executed on November 27, 2007. The note bears interest at the rate of 5.95% per annum with monthly principal and interest payments of approximately \$15,047. The note matures on December 1, 2027. The note is subject to various covenants and is collateralized by real estate and rental income.	2,052,178	2,108,874
Note payable to an unrelated third party executed on June 1, 2005. - The note bears interest of prime plus 1.0%. (3.25% at December		\$46,557

31, 2008 and 8.25% at December 31, 2007) The note matured in March 2008. The note is unsecured.

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Table of Contents**NOTE 6.****NOTES PAYABLE AND OTHER DEBT (Continued)**

	2008	December 31, 2007
Note payable to a financial institution executed on October 1, 2007. The note bears interest of 8.5%. The note matured on April 5, 2008. The note is unsecured. The Company replaced this note with a long term lease in February, 2008.	-	\$250,000
Mortgage note payable, insured by HUD, to a financial institution in the original principal amount of \$2,524,800 executed on September 1, 2008 to refinance a construction loan at Greenfield. The note bears interest at the rate of 6.50% per annum with monthly principal and interest payments of approximately \$15,960. The note matures on August 1, 2038. The note has various restrictive covenants imposed by HUD.	\$2,515,596	-
Lease payable to a financial institution executed on February 15, 2008. The note bears interest of 8.616%. The note matures on February 15, 2012. The note is secured by computer equipment.	200,043	-
Mortgage note payable to a financial institution in the principal amount of \$300,000 executed on October 17, 2008. The note bears interest at the rate of 7.359% per annum with monthly principal and interest payments of approximately \$4,144. The note matures on February 1, 2017. The note is collateralized by real estate.	300,000	-
Notes payable to unrelated third parties executed on November 15, 2008 related to the purchase of Hearth & Home of Van Wert. The notes mature in November 2010 and bear interest of 5%. The notes are unsecured.	134,400	-
Line of credit payable to a financial institution with a maximum limit of \$100,000. The note bears interest at 4.45% and is revolving.	96,700	-
Line of credit payable to a financial institution with a maximum limit of \$50,000. The note bears interest at 4.25% and is revolving.	49,687	-

Assumed mortgage note payable, insured by HUD, to a financial institution in the original principal amount of \$2,162,500 executed on June 1, 1995. The note bears interest at the rate of 7.25% per annum with monthly principal and interest payments of approximately \$13,800. The note matures on July 1, 2036. The note has various restrictive covenants imposed by HUD. \$1,963,225 -

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Table of Contents**NOTE 6.****NOTES PAYABLE AND OTHER DEBT (Continued)**

	2008	December 31,	2007
Mortgage note payable, insured by HUD, to a financial institution in the original principal amount of \$1,863,800 executed on August 1, 2008 to refinance bonds. The note bears interest at the rate of 6.65% per annum with monthly principal and interest payments of approximately \$11,450. The note matures on July 1, 2043. The note has various restrictive covenants imposed by HUD.	\$1,858,116		-
Mortgage note payable, insured by HUD, to a financial institution in the original principal amount of \$2,142,700 executed on August 1, 2008 to refinance bonds. The note bears interest at the rate of 6.65% per annum with monthly principal and interest payments of approximately \$13,170. The note matures on July 1, 2043. The note has various restrictive covenants imposed by HUD.	2,136,165		-
Note payable to a financial institution executed on July 24, 2008. The note bears interest of 6.50% and is interest only payments until March 2009. The note matures on May 1, 2013. The note is secured with receivables from Assured.	748,372		-
Other	118,744		_ 106,927
	17,688,111		13,698,600
Less unamortized discount	-		111,984
Less current portion of long term debt	713,323		_ 773,278
Total long-term debt	\$16,974,788		_ \$12,813,338

The lending agreements are subject to various financial covenants. The Company is in compliance with all respective covenants at December 31, 2008.

Maturities on the Company's debt obligations for each of the next five years and thereafter are as follows:



2009	713,323
2010	677,761
2011	592,449
2012	552,641
2013	446,443
Thereafter	14,705,494
	\$17,688,111

Table of Contents**NOTE 7.****NOTES PAYABLE STOCKHOLDERS**

	December 31,	
	2008	2007
Promissory note payable to a stockholder in the original principal amount of \$835,000 executed on April 27, 2006. The note bears interest equal to the prime rate (3.25% at December 31, 2008 and 7.25% at December 31, 2007) per annum and requires interest only payments monthly. The note originally matured on May 1, 2007, but was extended to May 1, 2009. A portion of this note was refinanced in July 2008 and \$760,000 of the note was repaid.	44,058	819,110
Less current portion of shareholder debt	9,432	9,026
Total long-term shareholder debt	\$34,626	\$810,084

**NOTE 8. FORWARD PURCHASE CONTRACT**

In October 2003, the Company amended a purchase agreement with certain minority interest holders in one of its subsidiaries. As a result of that amendment, the Company became subject to the accounting pursuant to SFAS 150, *Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity*, which was effective for agreements entered into or amended after May 31, 2003. The amendment contained a forward purchase contract which was accounted for as a liability. The amount of the liability, at the date of the amendment, measured as set forth in SFAS 150, was approximately \$985,000, which has been recorded using purchase accounting as required by SFAS 150, EITF 00-6, *Accounting for Freestanding Derivative Financial Instruments Indexed to and Potentially Settled in the Stock of a Consolidated Subsidiary* and FASB 141, *Business Combinations*. This resulted in an increase to the carrying value of the real property of \$250,000 and the recording of goodwill of approximately \$865,000. This purchase accounting adjustment was related to the minority interest being reduced by previously incurred net losses attributable to those minority interests prior to the date of adoption of SFAS 150. The resulting goodwill has been tested for impairment annually. No impairment charge has been recognized. In periods subsequent to 2003, the liability has been reduced for payments made to the minority interests as a result of the forward purchase contract and adjusted by changes in the present value of the amount to be paid under the forward purchase contract as required by SFAS 150. The liability is recorded at the greater of the interest holders' cash basis or fair value. There were no payments made to minority interests or adjustments required due to changes in fair value in 2008 and 2007. In November 2008, the Company completed the forward purchase contract to obtain 100% ownership of Hearth & Home of Van Wert at a total cost of \$941,289 of which \$800,664 was in cash while the remaining \$140,625 was issued in

the form of notes payable which mature in 2010 (see Note 6).

Table of Contents**NOTE 9.****STOCK BASED COMPENSATION**

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

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

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

In August 2008, the Company granted 436,920 options with a weighted-average fair value estimated at \$1.35 per share. The options have a term of 10 years and the options were at an exercise price per share less than the fair market value on the grant date. Half of the stock options granted vest on January 1, 2009 with the remainder on January 1, 2010. The options are exercisable until the term expires in August 2018.

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

	2008	2007
Dividend Yield	0.0%	0.0%
Expected Volatility	43.0%	35.0%
Risk-Free Interest Rate	3.13%	4.00%

Expected Term

4.5 years

5 years

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

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

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

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

Table of Contents**NOTE 9.****STOCK BASED COMPENSATION (Continued)**

Total share-based compensation expense of \$641,004 and \$27,326 was recognized for the periods ending December 31, 2008 and 2007, respectively.

The following summarizes the Company's stock option activity for the period ending December 31, 2008:

	Number of Shares	Weighted Average Exercise Price	Weighted Average Remaining Contract Life	Aggregate Intrinsic Value
Outstanding at January 1, 2008	294,200	\$1.84		
Options granted	436,920	\$1.73		
Options exercised	-	\$ -		
Options forfeited	(15,200)	_\$1.79		
Outstanding at December 31, 2008	715,920	_\$1.77	6.1 years	\$ -
Exercisable at December 31, 2008	170,880	_\$2.05	1.9 years	\$ -

At December 31, 2008, the Company has \$290,823 of unrecognized compensation expense related to outstanding stock options. Assuming no pre-vesting forfeitures, this expense will be recognized as a charge to earnings over a weighted-average remaining service period of 0.9 years.

**NOTE 10.****INCOME TAXES**

The provision for income taxes attributable to continuing operations for the years ended December 31, 2008 and December 31, 2007 is presented below.

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	December 31,	
	2008	2007
Current Tax Expense (Benefit):		
Federal	-	\$(268,683)
State	-	(15,805)
		(284,488)
Deferred Tax Expense (Benefit):		
Federal	170,007	100,181
State	-	5,892
	170,007	106,073
Total income tax expense (benefit)	170,007	\$(178,415)

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Table of Contents**NOTE 10.****INCOME TAXES (Continued)**

At December 31, 2008 and December 31, 2007, the tax effect of significant temporary differences representing deferred tax assets are as follows:

	December 31,	
	2008	2007
Net current deferred tax asset:		
Allowance for doubtful accounts	33,841	535,047
Accrued expenses	82,293	107,679
	116,134	642,726
Net long-term deferred tax asset (liability):		
Net operating loss carry forwards, AdCare	\$ 3,096,503	\$2,058,527
Investment in New Lincoln Lodge	(140,744)	-
Income tax benefit-New Lincoln Lodge	(211,429)	
Depreciation and amortization	(266,375)	(234,227)
Stock based compensation	187,973	26,351
	2,665,928	1,850,651
Total deferred tax assets	2,782,062	2,493,377
Valuation allowance	(2,952,069)	(2,493,377)
Net deferred tax asset	\$ (170,007)	\$ -

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,	
	2008	2007
Income tax at statutory rate	34.00%	34.00%
State taxes, net of federal benefits	0.00%	(2.19)%
Stock options	(0.78)%	0.00%
Meals and entertainment	(0.26)%	(0.22)%
Penalties	(0.21)%	0.00%
Officers life insurance	(0.96)%	0.00%
Net taxable flow through income CHH	2.67%	(3.60)%
Net taxable flow through income HVW	(0.11)%	(1.47)%



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Change in valuation allowance	(50.62)%	(35.05)%
Change in effective tax rate	1.37%	(5.4)%
Adjust prior year deferred balances	0.00%	32.91%
Other	(3.87)%	0.00%
Effective tax rate	(18.77)%	18.98%

As of December 31, 2008, AdCare had consolidated federal net operating loss ( NOL ) carry forwards of approximately \$8,192,000. These NOLs begin to expire in 2011 through 2023.

Management determined that the deferred tax assets do not satisfy the recognition criteria set forth in SFAS No. 109. Accordingly, a full valuation allowance has been recorded for this amount.

Under Section 382 of the Internal Revenue Code of 1986, as amended (the Code), the utilization of net operating loss carry forwards may be limited under the change in stock ownership rules of the Code. As a result of ownership changes, which occurred in November 2006 in connection with the Company's public offering, the Company may have substantially limited or eliminated the availability of its net operating loss carry forwards.

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**NOTE 10.**

**INCOME TAXES (Continued)**

During 2006, the Financial Accounting Standards Board (FASB) issued FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* (FIN 48) - an interpretation of FASB Statement No. 109, *Accounting for Income Taxes*. FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with FASB No. 109. FIN 48 also prescribes a recognition threshold and measurement standard for the financial statement recognition and measurement of an income tax position taken or expected to be taken in a tax return. Effective January 1, 2007, the Company adopted the provisions of FIN 48, completed an analysis of their existing tax positions and determined the adoption of FIN 48 would not require a cumulative adjustment to beginning accumulated deficit. In addition, the Company determined FIN 48 had no material impact to the Company's December 31, 2008 financial statements.

**NOTE 11.**

**COMMITMENTS AND CONTINGENCIES**

***Employment Agreements***

Commencing on September 1, 2008, the Company entered into employment agreements with three executive officers. The employment agreements provide for an initial employment term of three years expiring on August 31, 2011 with base salaries ranging from \$10,000 to \$12,500 per month, a minimum salary increase of five percent per year, fringe benefits such as health and life insurance and inclusion in any option program that the Company may institute in the future. In addition, the employment agreements provide that if the executive is terminated for any reason other than cause (which is defined as dishonest in transactions with the Company, material disloyalty and/or the express refusal to perform services for the Company which may be properly requested), the Company is required to compensate said executive for the remaining term of the respective employment agreement plus one additional year. The employment agreements also include a non-compete agreement restricting said executive from competing with the Company for a period of one year following the termination.

***Operating Leases***

The Company has various non-cancelable operating leases for office space, Covington Care Center nursing facility and equipment which expire through August 2012. During 2008, the lease was renegotiated for Covington Care

Center resulting in lower lease payments. Rent expense under this agreement for 2008 and 2007 was approximately \$528,000 and \$676,000 respectively.

Future minimum lease payments as of December 31, 2008 are as follows:

2009	504,000
2010	546,000
2011	610,000
2012	620,000
2013	150,000
	\$2,430,000

***Legal Matters***

Certain claims and suits arising in the ordinary course of business in managing certain nursing facilities were filed or are pending against the Company. Management provides for loss contingencies where the possibility of a loss is probable. For the years ended December 31, 2008 and 2007, no estimated loss liabilities due to litigation were recorded. Management believes that the liability, if any, which may result would not have a material adverse effect on the financial position or results of operations of the Company. The Company carries liability insurance that is available to fund certain defined losses, should any arise, net of a deductible amount.

Table of Contents**NOTE 12.****COMMON STOCK WARRANTS**

A summary of the status of the common stock warrants as of December 31, 2008 and December 31, 2007 is presented below:

	December 31, 2008	2007
Beginning balance	2,760,710	1,541,000
Issued	197,000	1,227,710
Exercised	-	(8,000)
Expired	_(133,388)	-
Ending balance	_2,824,322	2,760,710

In November, 2007, the Board of Directors of the Company granted warrants to officers and directors of the Company equal to two warrants for every share of stock owned. The warrants vest over five years and mature in ten years. The exercise price of the warrants in each of the five years following the issuance of the warrants is determined as follows: warrants vesting in 2008 are exercisable at \$1.21; warrants vesting in 2009 are exercisable at \$2.25; warrants vesting in 2010 through 2012 are exercisable at a price equal to the greater of (i) the average closing price of the Company's common stock on NYSE Alternext US exchange during the month of January each year or (ii) \$3.00. The value of the warrants issued during 2008 was \$1.59 and was determined using the Black Scholes Option Pricing Model.

**NOTE 13.****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 and 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 Ohio Department of Job and Family Services (ODJFS) has the opportunity to audit the cost report used to establish the prospective rate. If the ODJFS discovers non-allowable or misclassified costs that resulted in overpayments to the Company, then the funds will be recovered by the ODJFS through the final rate recalculation process.

For the years ended December 31, 2008 and 2007, management estimated that no amounts are due to the Medicaid program resulting from non-allowable or misclassified costs for any open Medicaid reimbursement years.

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**NOTE 13.**

**THIRD-PARTY REIMBURSEMENT (Continued)**

*Third-Party Overpayments*

ODJFS overpaid the Company on certain of its Medicaid residents. Medicaid overpayments were approximately \$128,600 and \$48,400 for the years ended December 31, 2008 and 2007, respectively, and are included in accrued expense in the accompanying consolidated balance sheet. The Company received Medicaid payments for residents who were previously discharged or for residents who were covered by the Medicare program or other payers. The overpayments are primarily due to the ODJFS lack of processing status changes on a timely basis despite the Company's submission of such changes.

*Laws and Regulations*

Laws and regulations governing the Medicare and Medicaid programs are complex and subject to interpretation. The Company believes that it is 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 14.**

**RELATED PARTY TRANSACTIONS**

On April 27, 2006, a stockholder loaned the Company \$835,000 that was used to repay the loan for Assured Health Care. The majority of this note was subsequently refinanced resulting in the current balance of \$44,000 in July 2008 (see Note 7).

**NOTE 15.**

## **CONSULTING AGREEMENTS**

On November 10, 2006, the Company entered into a consulting agreement with Newbridge Securities for financial advisory services to be provided over a period of eighteen months. The agreement was part of the Company's underwriting agreement with Newbridge Securities. Consideration in the form of \$75,000 in cash was paid as part of the closing costs of the initial public offering.

On December 29, 2006, the Company entered into an investment banking agreement with Capital City Partners to provide investment banking consulting over the proceeding twelve month period. Compensation to Capital City Partners consists of a non-refundable cash retainer of \$25,000 and 25,000 five year non-refundable retainer warrants to acquire 25,000 shares of the Company's stock at a price equal to the stock price as of December 29, 2006 plus 25%. The Company estimated the value of these warrants to be approximately \$21,000 using the Black-Scholes option-pricing model. This amount will be amortized over the term of this agreement.

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**NOTE 15.**

**CONSULTING AGREEMENT (Continued)**

On February 1, 2007, the Company entered into a consulting agreement with Booke and Company to provide public relations services over the proceeding twelve month period. Compensation to Booke and Company consists of \$6,000 per month plus 25,000 non-refundable retainer warrants to acquire 25,000 shares of the Company's stock as a price equal to the stock price as of June 5, 2007. The Company estimated the value of these warrants to be approximately \$14,000 using the Black-Scholes option-pricing model. This amount will be amortized over the term of this agreement.

On March 5, 2007, the Company entered a consulting agreement with The McKnight Group. The agreement requires The McKnight Group to market the Company's assisted living development services to clients of The McKnight Group. The agreement is for five years with an option to automatically extend in one year increments thereafter unless notice to terminate is given under the terms of the agreement. Compensation to The McKnight Group consists of 100,000 five year warrants to purchase 100,000 shares of common stock at a price equal to the stock price as of March 5, 2007 plus 25%. The warrants will vest over two years as follows: 50,000 on the date of the agreement, 25,000 on the first anniversary, and 25,000 on the second anniversary. The Company estimated the value of these warrants to be approximately \$67,000 using the Black-Scholes option-pricing model. This amount will be amortized over the term of this agreement. Homer McKnight, a principal of The McKnight Group, is a stockholder and therefore; The McKnight Group is considered to be a related party.

On May 18, 2007, the Company entered into a consulting agreement with Amothy Corporation to provide strategic consulting over the proceeding twenty-four month period. Compensation to Amothy Corporation consists of 100,000 non-refundable retainer warrants to acquire 100,000 shares of the Company's stock as a price equal to the stock price of \$1.85. The Company estimated the value of these warrants to be approximately \$72,000 using the Black-Scholes option-pricing model. This amount will be amortized over the term of this agreement.

On February 1, 2008, the Company engaged GCC-Prospect Corporation ( GCC ) for the purposes of providing certain investment banking and advisory services. Among other services, GCC will assist the Company in identifying, evaluating and securing alternative capital, financing and investment sources for the Company to fund its strategic business plan. In addition, they will help in identifying acquisition and joint venture transactions to further the expansion plans of the Company. In exchange for their services, the Company is paying GCC a total of \$10,000 per month and granting 30,000 warrants that will be expensed over the six month term of the engagement.

In November, 2008, the Company extended the agreement with GCC. In exchange for their services, the Company is granting 80,000 warrants with 30,000 expensed in the first month of the extension and the remaining 50,000 expensed



equally over the remaining five months. Additionally, the Company agreed to pay GCC \$10,000 beginning November 1, 2008, at the successful closing of a transaction.

**NOTE 16.**

**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, the ODJFS and the Ohio Department of Health and Aging. Such administrative directives, rules and regulations, including budgetary reimbursement funding, are subject to change by an act of Congress, the passage of laws by the Ohio 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.

Table of Contents**NOTE 16.****CURRENT VULNERABILITY DUE TO CERTAIN CONCENTRATIONS (Continued)**

The Company has 100% of its 218 nursing facility beds certified under the Medicaid and Medicare programs. A summary of occupancy utilization and net revenues for these nursing facility beds is as follows:

<u>For the Year Ended</u>	<u>Percent of Total Occupancy</u>	<u>Percent of Long-Term Care Receivables</u>	<u>Percent of Patient Care Revenue</u>
<i>Medicaid</i>			
December 31, 2008	63%	37%	53%
December 31, 2007	66%	35%	53%
<i>Medicare</i>			
December 31, 2008	14%	24%	25%
December 31, 2007	15%	19%	26%
<i>Other Payers</i>			
December 31, 2008	23%	39%	22%
December 31, 2007	19%	46%	21%

**NOTE 17.****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, 2008, the Company recorded an asset of approximately \$97,700 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 balance sheet). The underlying assets are recorded at fair value and primarily represent short term fixed income assets

invested at the participants' direction. Contributions to the plan in 2008 were not material.

In February, 2008, the Company withdrew \$150,000 from the plan and deposited it in a savings account to use as a line of credit. The Company will pay 8% interest on the funds withdrawn until such time funds are available to repay the \$150,000.

**NOTE 18.**

**SENIOR LIVING FACILITY ACQUISITIONS**

On March 7, 2008, the Company entered into an agreement to acquire 100% of The New Lincoln, Ltd. effective April 1, 2008. The sole asset of The New Lincoln, Ltd. is the New Lincoln Lodge Retirement Residence which is a 51 unit senior living residence located in Columbus, Ohio. The Company completed the transaction on May 15, 2008. The Company accounted for the transaction under guidance issued in EITF 04-01, *Accounting for Preexisting Relationships between the Parties to a Business Combination*. The Company's preexisting relationship consisted primarily of a note receivable as described in Note 5.

Table of Contents**NOTE 18.****SENIOR LIVING FACILITY ACQUISITIONS (Continued)**

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

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

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

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



Table of Contents**NOTE 18.****SENIOR LIVING FACILITY ACQUISITION (Continued)**

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

	March 31, 2008	December 31, 2007
Revenue	\$ 6,151,710	\$ 24,245,000
Expenses	6,304,851	25,200,655
Loss Before Discontinued Operations, Income Taxes and Gain	(153,141)	(955,655)
Income Tax Benefit	-	178,415
Income Tax Expense	(10,642)	-
Gain on Acquisition	413,593	419,552
Income (Loss) from continuing operations	249,810	(357,688)
Discontinued Operations:		
Income from discontinued operations (including gain on disposal)	-	587,039
Provision for income taxes	-	(178,415)
	-	408,624
Net Income	\$ 249,810	\$ 50,936
Net Income Per Share, Basic and Diluted:		
Continuing operations	\$ 0.07	\$ (0.09)
Discontinued operations	-	0.11
	\$ 0.07	\$ 0.02
Weighted Average Common Shares Outstanding,		
Basic	3,786,129	3,786,129
Diluted	3,786,129	3,786,129

In November, 2008, the Company acquired the remaining 50.8% ownership interest in Hearth & Home of Van Wert, LLC as required by our forward purchase contract (see Note 8). Through October 2008, the Company owned 49.2% of the limited liability company with the remaining 50.8% owned by individual investors. The total cost of the

acquisition was \$941,289 of which \$800,664 was satisfied in cash while the remaining \$140,625 was satisfied in the form of a seller's notes payable which mature in 2010 (see Note 6). Approximately \$41,000 was allocated to goodwill with the balance treated as an additional equity investment by the Company for the purpose of eliminating the liability for the forward purchase contract.

**NOTE 19.**

**BENEFIT PLANS**

The Company sponsors a 401(k) plan, which provides retirement benefits to eligible employees. All employees are eligible once they reach age 21. The Company matches employee contributions at 50% up to 2% of the employee's salary. Total matching contributions during 2008 and 2007 were approximately \$45,000 and \$36,000, respectively.

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**Item 9. Changes In and Disagreements With Accountants on Accounting and Financial Disclosure**

On May 16, 2008, the Audit Committee of the Board of Directors of AdCare Health Systems, Inc. (the Company) dismissed Rachlin LLP (Rachlin) as the Company's independent registered public accounting firm as previously reported on Form 8-K filed on May 19, 2008 and herein incorporated by reference.

There are no disagreements between the Company and either its current or former accounting firm on any matters of accounting principles or practices, financial statement disclosure, or auditing scope or procedure.

**Item 9A(T). Controls and Procedures**

**Evaluation of Disclosure Controls and Procedures**

We maintain disclosure controls and procedures that are designed to ensure that information required to be disclosed in our reports filed pursuant to the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in the rules and forms of the Securities and Exchange Commission (SEC) and that such information is accumulated and communicated to our management, including our chief executive officer and chief financial officer, as appropriate, to allow for timely decisions regarding required disclosure. In designing and evaluating the disclosure controls and procedures, management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives, and management is required to apply its judgment in evaluating the cost-benefit relationship of possible controls and procedures.

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

**Management's Report on Internal Control Over Financial Reporting**

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



(1) pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of our assets;

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

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

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

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Management assessed the effectiveness of our internal control over financial reporting as of December 31, 2008. In making this assessment, management used the framework set forth in the report entitled *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission, or COSO. The COSO framework summarizes each of the components of a company's internal control system, including (i) the control environment, (ii) risk assessment, (iii) control activities, (iv) information and communication, and (v) monitoring. Based on our assessment, management concluded that the Company maintained effective internal control over financial reporting as of December 31, 2008.

This annual report does not include an attestation report of our registered public accounting firm regarding internal control over financial reporting. Management's report was not subject to attestation by our registered public accounting firm pursuant to temporary rules of the Securities and Exchange Commission that permits us to provide only management's report in this annual report.

**Item 9B. Other Information**

None

**PART III**

**Item 10. Directors, Executive Officers and Corporate Governance**

The information required by this item is included under the captions **Election of Directors**, **Executive Officers** and **Section 16(a) Beneficial Ownership Reporting Compliance** in our proxy statement relating to our 2009 Annual Meeting of Shareholders to be held June 5, 2009, and is incorporated herein by reference.

We have a Business Conduct Policy applicable to all employees of AdCare. Additionally, the Chief Executive Officer ( CEO ) and all senior financial officers, including the principal financial officer, the principal accounting officer or controller, or any person performing a similar function (collectively, the Senior Financial Officers ) are bound by the provisions of our code of ethics relating to ethical conduct, conflicts of interest, and compliance with the law.

We intend to satisfy the disclosure requirement under Item 10 of Form 8-K regarding any amendment to, waiver of, any provision of this code of ethics by posting such information on our website at the address and location specified.

**Item 11. Executive Compensation**

We incorporate by reference information on executive compensation under the heading **Executive Compensation** in our Proxy Statement, which we will file with the SEC on or prior to April 21, 2009.

**Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters**

We incorporate by reference information on security ownership of some beneficial owners under the heading Security Ownership of Certain Management and Beneficial Owners in our Proxy Statement, which we will file with the SEC on or prior to April 21, 2009.

**Item 13. Certain Relationships and Related Transactions, and Director Independence**

We incorporate by reference information on certain relationships and related transactions under the heading Certain Relationships and Related Transactions in our Proxy Statement, which we will file with the SEC on or prior to April 21, 2009.

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**Item 14. Principal Accountant Fees and Services**

We incorporate by reference information on principal accountant fees and services under the heading "Fees of the Registered Independent Public Accounting Firm for the Year Ended December 31, 2008" in our Proxy Statement, which we will file with the SEC on or prior to April 21, 2009.

**PART IV**

**Item 15. Exhibits and Financial Statement Schedules**

Reports on Form 8-K.

The Company filed the following Reports on Form 8-K during 2008:

<b>Date</b>	<b>Description</b>
February 5, 2008	Engagement of GCC Capital Group, LLC ( "Galen" ) and Prospect Financial Advisors, LLC ( "Prospect" ) for the purposes of providing certain investment banking and advisory services.
February 26, 2008	Amends the Form 8-K filed by the Company on November 21, 2007 to clarify that the warrants which were granted to the management team are exercisable for a period of ten years and vest equally over a period of five years.
April 1, 2008	Press release announcing earnings results for the year ended December 31, 2007.
May 19, 2008	Announcing the dismissal of Rachlin LLP as the Company's independent registered public accounting firm and the appointment of Battelle & Battelle LLP as its new independent registered public accounting firm.
May 19, 2008	Announcing the acquisition of the New Lincoln Lodge Retirement Residence and a press release announcing financial results for the quarter ended March 31, 2008.
May 30, 2008	Amends the Form 8-K filed on November 21, 2007, amended on February 26, 2008, disclosing that the Board of Directors no longer was seeking shareholder approval of Warrants granted at the June 6, 2008, shareholder meeting.
July 3, 2008	Press release announcing the refinance of three assisted living properties.
July 29, 2008	Amends Form 8-K filed May 19, 2008, to include financial statements of the New Lincoln Lodge Retirement Residence as well as pro forma financial information.
August 20, 2008	Press release announcing earnings results for the quarter ended June 30, 2008, and the departure of certain officers of the Company.
September 8, 2008	Announcing compensatory arrangements of certain officers of the Company.
November 24, 2008	Announcing the acquisition of our partners' interest in Hearth & Home of Van Wert, LLC.

The Company filed the following Reports on Form 8-K subsequent to December 31, 2008:

<b>Date</b>	<b>Description</b>
February 5, 2009	Announcing the termination of a material definitive agreement.

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Exhibits. Exhibits included or incorporated by reference herein: See Exhibit Index below.

<b>Exhibit</b>	<b>Description of Exhibit</b>	<b>Location</b>	
3.1	Amended and Restated Articles of Incorporation of Registrant	Exhibit 3.1	incorporated by reference from Exhibit 3.1 of the Company's Registration Statement Form SB (Registration No. 333-131542) filed February 3, 2006
3.2	Code of Regulations of the Registrant	Exhibit 3.2	incorporated by reference from Exhibit 3.2 of the Company's Registration Statement Form SB (Registration No. 333-131542) filed February 3, 2006
4.1	Specimen Common Share Certificate	Exhibit 4.1	incorporated by reference from Exhibit 4.1 of the Company's Registration Statement Form SB (Registration No. 333-131542) filed February 3, 2006
4.2	Specimen Unit Certificate	Exhibit 4.2	incorporated by reference from Exhibit 4.2 of the Company's Registration Statement Form SB (Registration No. 333-131542) filed February 3, 2006
4.3	Specimen Warrant Certificate	Exhibit 4.3	incorporated by reference from Exhibit 4.3 of the Company's Registration Statement Form SB (Registration No. 333-131542) filed February 3, 2006
4.4	Form of Warrant Agreement, dated _____, 2006	Exhibit 4.4	incorporated by reference from Exhibit 4.4 of the Company's Registration Statement Form SB (Registration No. 333-131542) filed February 3, 2006
4.5	2004 Non-Qualified and Incentive Stock Option Plan of Registrant	Exhibit 4.5	incorporated by reference from Exhibit 4.5 of the Company's Registration Statement Form SB (Registration No. 333-131542) filed February 3, 2006
4.6	Form of Representative's Warrant	Exhibit 4.6	incorporated by reference from Exhibit 4.6 of the Company's Registration Statement Form SB (Registration No. 333-131542) filed February 3, 2006
10.1	Employment Agreement between AdCare Health Systems, Inc. and David A. Tenwick, dated September 1, 2008	Exhibit 10.1	incorporated by reference from Exhibit 99 of the Company's Form 8-K filed September 8, 2008
10.2	Employment Agreement between AdCare Health Systems, Inc. and Gary L. Wade, dated September 1, 2008	Exhibit 10.2	incorporated by reference from Exhibit 99 of the Company's Form 8-K filed September 8, 2008
10.3		Exhibit 10.3	

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	Employment Agreement between AdCare Health Systems, Inc. and J. Scott Cunningham, dated September 1, 2008		incorporated by reference from Exhibit 99 of the Company's Form 8-K filed September 8, 2008
10.4	Form of Secured Promissory Debenture dated _____, 2005	Exhibit 10.4	incorporated by reference from Exhibit 10.4 of the Company's Registration Statement Form SB (Registration No. 333-131542) filed February 3, 2006

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<b>Exhibit</b>	<b>Description of Exhibit</b>	<b>Location</b>	
10.5	Form of Warrant to Purchase Common Stock dated _____, 2005	Exhibit 10.5	incorporated by reference from Exhibit 10.5 of the Company's Registration Statement Form SB (Registration No. 333-131542) filed February 3, 2006
10.6	Form of Subordinated Note dated October 31, 2004	Exhibit 10.6	incorporated by reference from Exhibit 10.6 of the Company's Registration Statement Form SB (Registration No. 333-131542) filed February 3, 2006
10.7	Form of Warrant to Purchase Shares of AdCare Health Systems, Inc. dated October 31, 2004	Exhibit 10.7	incorporated by reference from Exhibit 10.7 of the Company's Registration Statement Form SB (Registration No. 333-131542) filed February 3, 2006
10.8	Promissory Note between Assured Health Care, Inc., AdCare Health Systems, Inc. and WesBanco Bank, Inc., in the original amount of \$1,650,000	Exhibit 10.8	incorporated by reference from Exhibit 10.8 of the Company's Registration Statement Form SB (Registration No. 333-131542) filed February 3, 2006
10.9	Promissory Note between AdCare Health Systems, Inc. and WesBanco Bank, Inc., in the original amount of \$300,000	Exhibit 10.9	incorporated by reference from Exhibit 10.9 of the Company's Registration Statement Form SB (Registration No. 333-131542) filed February 3, 2006
10.10	Promissory Note between AdCare Health Systems, Inc. and Cornerstone Bank in the original amount of \$96,000	Exhibit 10.10	incorporated by reference from Exhibit 10.10 of the Company's Registration Statement Form SB (Registration No. 333-131542) filed February 3, 2006
10.11	Promissory Note between AdCare Health Systems, Inc. and Cornerstone Bank in the original amount of \$2,041,000	Exhibit 10.11	incorporated by reference from Exhibit 10.11 of the Company's Registration Statement Form SB (Registration No. 333-131542) filed February 3, 2006
10.12	Promissory Note between AdCare Health Systems, Inc. and Cornerstone Bank in the original amount of \$190,000	Exhibit 10.12	incorporated by reference from Exhibit 10.12 of the Company's Registration Statement Form SB (Registration No. 333-131542) filed February 3, 2006
10.13	Promissory Note between Hearth & Care of Greenfield, LLC and Cornerstone Bank in the original amount of \$1,412,000	Exhibit 10.13	incorporated by reference from Exhibit 10.13 of the Company's Registration Statement Form SB (Registration No. 333-131542) filed February 3, 2006
10.14	Reimbursement Agreement between Community's Hearth & Home, Ltd. and Cornerstone Bank dated December 1, 2002	Exhibit 10.14	incorporated by reference from Exhibit 10.14 of the Company's Registration Statement Form SB (Registration No. 333-131542) filed February 3, 2006
10.15		Exhibit 10.15	



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	Regulatory Agreement and Mortgage Note between Hearth and Home of Vandalia, Inc. and Banc One Capital Funding Corporation, in the original amount of \$ 3,721,500		incorporated by reference from Exhibit 10.15 of the Company s Registration Statement Form SB (Registration No. 333-131542) filed February 3, 2006
10.16	Regulatory Agreement and Mortgage Note between The Pavilion Care Center, LLC and Red Mortgage Capital, Inc, in the original amount of \$2,295,000	Exhibit 10.16	incorporated by reference from Exhibit 10.16 of the Company s Registration Statement Form SB (Registration No. 333-131542) filed February 3, 2006

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<b>Exhibit</b>	<b>Description of Exhibit</b>	<b>Location</b>	
10.17	Promissory Note between Covington Realty, LLC and AdCare Health Systems, Inc., in the original amount of \$100,000	Exhibit 10.17	incorporated by reference from Exhibit 10.17 of the Company's Registration Statement Form SB (Registration No. 333-131542) filed February 3, 2006
10.18	Promissory Note between AdCare Health Care Systems, Inc, and Assured Health Care, Inc. and Mary Fair, in the original amount of \$450,000	Exhibit 10.18	incorporated by reference from Exhibit 10.18 of the Company's Registration Statement Form SB (Registration No. 333-131542) filed February 3, 2006
10.19	Promissory Note between AdCare Health Care Systems, Inc, and Homer McKnight, in the original amount of \$835,000	Exhibit 10.19	incorporated by reference from Exhibit 10.19 of the Company's annual report on form 10-KSB as amended April 30, 2007.
10.20	Investment Banking Agreement entered into with Capital City Partners dated December 29, 2006	Exhibit 10.20	incorporated by reference from Exhibit 10.19 of the Company's annual report on form 10-KSB as amended April 30, 2007.
10.21	Consulting Agreement entered into with The McKnight Group dated March 5, 2007	Exhibit 10.21	incorporated by reference from Exhibit 10.19 of the Company's annual report on form 10-KSB as amended April 30, 2007.
10.22	Reimbursement Agreement between Community's Hearth & Home, Ltd. and The Huntington National Bank dated September 13, 2007	Exhibit 10-22	incorporated by reference from Exhibit 10.19 of the Company's annual report on form 10-KSB as amended March 31, 2008.
10.23	Form of Warrant granted to management to Purchase Shares of AdCare Health Systems, Inc. dated November 20, 2007	Exhibit 10-23	incorporated by reference from Exhibit 10.19 of the Company's annual report on form 10-KSB as amended March 31, 2008.
10.24	Regulatory Agreement and Mortgage Note between The Pavilion Care Center, LLC and Red Mortgage Capital, Inc, in the original amount of \$2,108,800 dated November 27, 2007	Exhibit 10.24	incorporated by reference from Exhibit 10.19 of the Company's annual report on form 10-KSB as amended March 31, 2008.
10.25	Letter Agreement with Prospect Financial Advisors and GCC Capital dated January 30, 2008	Exhibit 10.25	incorporated by reference from Exhibit 10.19 of the Company's annual report on form 10-KSB as amended March 31, 2008.
10.26	Regulatory Agreement and Mortgage Note between Hearth & Home of Urbana and Red Mortgage Capital, Inc, in the original amount of \$2,142,700 dated June 26, 2008	Exhibit 10.26	attached hereto
10.27	Regulatory Agreement and Mortgage Note between Community's Hearth & Home and Red Mortgage Capital, Inc, in the original amount of \$1,863,800 dated	Exhibit 10.27	attached hereto

June 26, 2008

10.28 Promissory Note between Assured Health Exhibit 10.28 attached hereto  
Care and Huntington National Bank in the  
original amount of \$760,000 dated July  
24, 2008

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<b>Exhibit</b>	<b>Description of Exhibit</b>	<b>Location</b>	
10.29	Promissory Note between AdCare Health Systems, Inc. and Huntington National Bank in the original amount of \$300,000 dated October 17, 2008	Exhibit 10.29	attached hereto
10.30	Promissory Note between AdCare Health Systems, Inc. and Huntington National Bank in the original amount of \$100,000 dated November 14, 2008	Exhibit 10.30	attached hereto
10.31	Regulatory Agreement and Mortgage Note between Hearth & Care of Greenfield and Red Mortgage Capital, Inc, in the original amount of \$2,524,800 dated July 29, 2008_	Exhibit 10.31	attached hereto
10.32	Promissory Note between AdCare Health Systems and the AdCare Deferred Compensation plan for a \$150,000 line of credit dated January 2008.	Exhibit 10.32	attached hereto
14	Code of Ethics	Exhibit 14	incorporated by reference from Exhibit 10.19 of the Company s annual report on form 10-KSB as amended April 30, 2007
21.1	Subsidiaries of the Registrant	Exhibit 21.1	incorporated by reference from Exhibit 21.1 of the Company s Registration Statement Form SB (Registration No. 333-131542) filed February 3, 2006
23.1	Consent of Battelle & Battelle LLP	Exhibit 23.1	attached hereto
23.2	Consent of Rachlin LLP	Exhibit 23.2	attached hereto
31.1	Certification of CEO pursuant to Section 302 of the Sarbanes-Oxley Act	Exhibit 31.1	attached hereto
31.2	Certification of CFO pursuant to Section 302 of the Sarbanes-Oxley Act	Exhibit 31.2	attached hereto
32.1	Certification of CEO pursuant to Section 906 of the Sarbanes-Oxley Act	Exhibit 32.1	attached hereto
32.2	Certification of CFO pursuant to Section 906 of the Sarbanes-Oxley Act	Exhibit 32.2	attached hereto
99.1	Audit Committee Charter	Exhibit 99.1	incorporated by reference from Exhibit 99.1 of the Company s Registration Statement Form SB (Registration No. 333-131542) filed February 3, 2006
99.2	Compensation Committee Charter	Exhibit 99.2	incorporated by reference from Exhibit 99.2 of the Company s Registration Statement Form

SB (Registration No. 333-131542) filed  
February 3, 2006

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**Signatures**

In accordance with Section 13 or 15(d) of the Exchange Act, the registrant caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

AdCare Health Systems, Inc. (Registrant)

by

/s/ Gary L. Wade

Gary L. Wade, President and Chief Executive Officer

March 31, 2009

March 31, 2009

In accordance with the Exchange Act, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

<b>SIGNATURE</b>	<b>TITLE</b>	<b>DATE</b>
/s/ David A. Tenwick David A. Tenwick	Director, Chairman	March 31, 2009
/s/ Gary L. Wade Gary L. Wade	Director, President and Chief Executive Officer	March 31, 2009
/s/ Scott Cunningham Scott Cunningham	Chief Financial Officer	March 31, 2009
/s/ Jeffrey L. Levine Jeffrey L. Levine	Director	March 31, 2009
/s/ Philip S. Radcliffe Philip S. Radcliffe	Director	March 31, 2009
/s/ Laurence E. Sturtz Laurence E. Sturtz	Director	March 31, 2009

/s/ Peter J. Hackett  
Peter J. Hackett

Director

March 31, 2009

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Exhibit 23.1

**CONSENT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

We hereby consent to the incorporation by reference in this Form 10-K, of AdCare Health Systems, Inc. for the year ended December 31, 2008 of our report dated March 31, 2009 into the Company's previously filed Registration Statement (No. 333-131542).

/s/Battelle & Battelle, LLP

Dayton, Ohio

March 31, 2009

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Exhibit 23.2

**CONSENT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

We hereby consent to the incorporation by reference in the Prospectus filed pursuant to Rule 424(b)(3) constituting part of the Registration Statement (No. 333-131542) of our report dated March 28, 2008, with respect to the consolidated financial statements of AdCare Health Systems, Inc. for the years ended December 31, 2007, which appears in this Form 10-K.

/s/RACHLIN, LLP

Miami, Florida

March 31, 2009

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Exhibit 31.1

**CERTIFICATIONS**

I, Gary L. Wade certify, that:

1.

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

2.

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

3.

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

4.

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

a.

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

b.

Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;

c.

Evaluated the effectiveness of the small business issuer's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period

covered by this report based on such evaluation; and

d.

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

5.

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

a.

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

b.

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

Date: March 31, 2009

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

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Exhibit 31.2

**CERTIFICATIONS**

I, Scott Cunningham, certify, that:

1.

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

2.

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

3.

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

4.

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

a.

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

b.

Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;

c.

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

d.

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

5.

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

a.

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

b.

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

Date: March 31, 2009

By /s/Scott Cunningham  
Chief Financial Officer

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Exhibit 32.1

CERTIFICATION PURSUANT TO

18 U.S.C. SECTION 1350,

AS ADDED BY

SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

In connection with the Annual Report of AdCare Health Systems, Inc. (the Company) on Form 10-K for the year ended December 31, 2008 as filed with the Securities and Exchange Commission (the Report), I, Gary L. Wade, Chief Executive Officer of the Company, certify, pursuant to 18 U.S.C. § 1350, as added by § 906 of the Sarbanes-Oxley Act of 2002, that:

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

Date: March 31, 2009

By: /s/ Gary L. Wade  
Gary L. Wade, Chief Executive Officer

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Exhibit 32.2

CERTIFICATION PURSUANT TO

18 U.S.C. SECTION 1350,

AS ADDED BY

SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

In connection with the Annual Report of AdCare Health Systems, Inc. (the Company ) on Form 10-K for the period ended December 31, 2008 as filed with the Securities and Exchange Commission (the Report ), I, Scott Cunningham, Chief Financial Officer of the Company, certify, pursuant to 18 U.S.C. § 1350, as added by § 906 of the Sarbanes-Oxley Act of 2002, that:

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

Date: March 31, 2009

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