

ADCARE HEALTH SYSTEMS INC

Form 10QSB

August 14, 2007

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**UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-QSB**

(Mark One)

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

For the quarterly period ended June 30, 2007

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

For the transition period from _____ to _____

Commission file number 333-131542

AdCare Health Systems, Inc.

(Exact name of small business issuer as specified in its charter)

Ohio

(State or other jurisdiction of incorporation or organization)

31-1332119

(I.R.S. Employer Identification No.)

5057 Troy Rd, Springfield, OH 45502-9032

(Address of principal executive offices)

(937) 964-8974

(Issuer's telephone number)

NA

(Former name, former address, or former fiscal year, if changed since last report)

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

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

State the number of shares outstanding of each of the issuer's classes of common equity, as of the latest practicable date:

3,786,129 no par common stock

Transitional Small Business Disclosure Format (Check one): Yes No

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Item 1. Financial Statements

ADCARE HEALTH SYSTEMS, INC. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS

| | June 30, 2007 (Unaudited) | December 31, 2006 |
|---|---------------------------------|-------------------------|
| ASSETS | | |
| Current Assets: | | |
| Cash | \$ 1,302,378 | \$ 2,136,414 |
| Certificate of deposit, restricted | 202,769 | 198,266 |
| Accounts receivable: | | |
| Long-term care resident receivables, net | 2,081,163 | 1,949,745 |
| Management, consulting and development receivables, net | 217,794 | 254,321 |
| Advances and receivables from affiliates | 27,631 | 35,897 |
| Assets of discontinued operations | 5,933 | 4,677 |
| Prepaid expenses and other | 605,478 | 337,638 |
| Total current assets | 4,443,146 | 4,916,958 |
| Restricted Cash | | |
| 906,693 | 914,941 | |
| Property and Equipment, Net | | |
| 13,977,909 | 13,750,870 | |
| Note Receivable, Net | | |
| 239,413 | 257,413 | |
| License, Net | | |
| 1,189,306 | 1,189,306 | |
| Goodwill | | |
| 2,638,193 | 2,638,193 | |
| Assets of Discontinued Operations, Net of Current Portion | | |
| 859,428 | 880,430 | |
| Other Assets | | |
| 848,103 | 838,283 | |
| Total assets | | |
| \$25,102,191 | \$25,386,394 | |

LIABILITIES AND STOCKHOLDERS EQUITY

Current Liabilities:

Current portion of notes payable and other debt

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\$766,835 \$744,131
Current portion of note payable to stockholder
9,466 828,344
Accounts payable and accrued expenses
3,739,382 3,804,590
Liabilities of discontinued operations
21,525 22,177

Total current liabilities
4,537,208 5,399,242

Notes Payable and Other Debt, Net of Current Portion
12,743,748 12,909,162
Note Payable to Stockholder, Net of Current Portion
814,232
Other Liabilities
293,104 262,597
Forward Purchase Contract
900,000 900,000
Liabilities of Discontinued Operations
854,342 848,394
Minority Interest in Equity of Consolidated Entities
224,267 160,259

Total liabilities
20,366,901 20,479,654

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 and 3,778,129 shares issued and outstanding
14,033,373 13,857,166
Accumulated deficit
(9,298,083) (8,950,426)

Total stockholders' equity
4,735,290 4,906,740

Total liabilities and stockholders' equity
\$25,102,191 \$25,386,394

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

| | Three-Months Ended June 30, | | Six-Months Ended June 30, | |
|---|--------------------------------|--------------|------------------------------|---------------|
| | 2007 | 2006 | 2007 | 2006 |
| Revenues: | | | | |
| Patient care revenues | \$ 5,457,475 | \$ 5,159,850 | \$ 10,824,117 | \$ 10,125,515 |
| Management, consulting and development fee revenue | 414,902 | 407,732 | 872,609 | 837,673 |
| Total revenue | 5,872,377 | 5,567,582 | 11,696,726 | 10,963,188 |
| Expenses: | | | | |
| Payroll and related payroll costs | 3,653,871 | 3,476,800 | 7,342,447 | 6,999,432 |
| Other operating expenses | 1,924,627 | 1,859,647 | 3,704,381 | 3,511,837 |
| Depreciation and amortization | 237,093 | 198,597 | 409,283 | 372,544 |
| Total expenses | 5,815,591 | 5,535,044 | 11,456,111 | 10,883,813 |
| Income from Continuing Operations | 56,786 | 32,538 | 240,615 | 79,375 |
| Other Income (Expense): | | | | |
| Interest income | 16,728 | 430 | 33,308 | 2,448 |
| Interest expense, others | (221,963) | (640,245) | (500,749) | (1,350,507) |
| Interest expense, related parties | (17,726) | (20,578) | (35,683) | (42,116) |
| Minority interest in (earnings) losses of consolidated entities | (36,134) | 36,119 | (64,008) | 57,534 |
| | (259,095) | (624,274) | (567,132) | (1,332,641) |
| Loss Before Discontinued Operations | (202,309) | (591,736) | (326,517) | (1,253,266) |
| Discontinued Operations: | | | | |
| Loss from discontinued operations | (10,571) | (31,042) | (21,140) | (24,596) |
| Net Loss | (212,880) | (622,778) | (347,657) | (1,277,862) |
| Net Loss Per Share, Basic and Diluted: | | | | |
| Continuing operations | \$ (0.05) | \$ (0.30) | \$ (0.09) | \$ (0.63) |
| Discontinued operations | 0.00 | (0.02) | 0.00 | (0.01) |
| | \$ (0.05) | \$ (0.32) | \$ (0.09) | \$ (0.64) |

Weighted Average Common Shares

Outstanding,

| | | | | |
|-------|-----------|-----------|-----------|-----------|
| Basic | 3,786,129 | 1,996,072 | 3,786,129 | 1,996,072 |
|-------|-----------|-----------|-----------|-----------|

| | | | | |
|---------|-----------|-----------|-----------|-----------|
| Diluted | 3,786,129 | 1,996,072 | 3,786,129 | 1,996,072 |
|---------|-----------|-----------|-----------|-----------|

See notes to consolidated financial statements

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

| | Six-Months Ended June 30, 2007 | 2006 |
|--|-----------------------------------|----------------|
| Cash flows from operating activities: | | |
| Net loss | \$ (347,657) | \$ (1,277,862) |
| Adjustments to reconcile net loss to net cash provided by (used in) operating activities | | |
| Depreciation and amortization | 409,283 | 395,449 |
| Warrants issued for services | 8,123 | |
| Stock option compensation expense | 6,330 | |
| Minority interest | 64,008 | (57,513) |
| Discount on convertible debentures | | 756,000 |
| Note receivable forgiveness exchanged for rent | 18,000 | |
| Changes in certain assets and liabilities: | | |
| Accounts receivable | (86,624) | 65,777 |
| Prepaid expenses and other | (192,513) | (148,101) |
| Other assets | (9,645) | (708,310) |
| Accounts payable and accrued expenses | (65,862) | 1,310,086 |
| Other liabilities | 61,077 | 5,305 |
| Total adjustments | 212,177 | 1,618,693 |
| Net cash provided by (used in) operating activities | (135,480) | 340,831 |
| Cash flow from investing activities: | | |
| (Increase) decrease in restricted cash | 8,248 | (44,530) |
| Purchase of property plant and equipment | (569,895) | (874,837) |
| Net cash used in investing activities | (561,647) | (919,367) |
| Cash flows from financing activities: | | |
| Proceeds from notes payable | 54,000 | 545,395 |
| Cash received upon exercise of warrants | 20,000 | |
| Proceeds from note payable to stockholder | | 835,000 |
| Repayment of note payable to stockholder | (4,646) | (123,166) |
| Repayment on notes payable | (206,263) | (1,053,114) |
| Net cash provided by (used in) financing activities | (136,909) | 204,115 |
| Net Decrease in Cash | (834,036) | (374,421) |
| Cash, Beginning | 2,136,414 | 1,403,877 |

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| | | |
|---|--------------|--------------|
| Cash, Ending | \$ 1,302,378 | \$ 1,029,456 |
| Supplemental Disclosure of Cash Flow Information: | | |
| Cash paid during the period for interest | \$ 523,939 | \$ 553,884 |

See notes to consolidated financial statements

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AdCare Health Systems, Inc.
Notes to Unaudited
Consolidated Financial Statements

NOTE 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation

The accompanying unaudited consolidated financial statements have been prepared in accordance with U.S. generally accepted accounting principles for interim financial information and with the instructions to Form 10-QSB and Article 10 of Regulation S-X. Accordingly they do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. In the opinion of the management of AdCare Health Systems, Inc., all adjustments considered for a fair presentation are included and are of a normal recurring nature. Operating results for the six months ended June 30, 2007 are not necessarily indicative of the results that may be expected for the year ending December 31, 2007.

For further information, refer to the consolidated financial statements and footnotes thereto included in AdCare Health Systems, Inc.'s annual report on Form 10-KSB, as amended, filed April 30, 2007.

Earnings per Share

Financial Accounting Standards Board Statement No. 128, *Earnings per Share* (SFAS 128) requires the presentation of basic and diluted earnings per share. Basic earnings per share exclude any dilutive effects of options, warrants and convertible securities and is computed using the weighted average number of common shares outstanding. Diluted earnings per share reflects the potential dilution if securities or other contracts to issue common units were exercised or converted into common units.

Income Taxes

The Company and its subsidiaries file a consolidated federal income tax return. No tax provision was recorded for the loss incurred for the three and six months ended June 30, 2007 as we recorded a 100% valuation allowance against our otherwise recognizable deferred tax assets due to the uncertainty surrounding the timing of ultimate realization of the benefits of our net operating loss carry forwards in future periods. 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.

Recent Accounting Pronouncements

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 the 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

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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.

Adoption of New Accounting Pronouncement

In July 2006, the FASB issued FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes-an interpretation of FASB No. 109 (FIN 48)* , which clarifies the accounting for uncertainty in tax positions. FIN 48 requires the recognition in the condensed financial statements, the impact of a tax position, if that position is more likely than not of being sustained on audit, based on the technical merits of the position. The provisions of FIN 48 were effective as of January 1, 2007. The adoption of the standard had no effect on the Company's financial condition or results of operations.

NOTE 2. LIQUIDITY AND PROFITABILITY

The Company incurred a net loss of approximately \$348,000 for the six months ended June 30, 2007 and approximately \$1,278,000 for the six months ended June 30, 2006, and has negative working capital of approximately \$94,000 at June 30, 2007. The Company's ability to achieve sustained profitable operations is dependent on continued growth in revenue and controlling costs.

To improve liquidity and profitability, management has hired a full-time Vice President of Marketing and Business Development to work on marketing at all our facilities and look for new management contracts. Furthermore, management plans in future years encompass the following:

refinancing debt where possible to obtain more favorable terms.

increase facility occupancy.

add additional management contracts.

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.

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For the three and six months ended June 30, 2007 and 2006, 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)

| | Management and Facility Based Care | Home Based Care | Total Segments | Discontinued operations | Corporate | Total |
|--------------------|------------------------------------|-----------------|----------------|-------------------------|-----------|---------|
| Three-months ended | | | | | | |
| June 30, 2007: | | | | | | |
| Net Revenue | 5,463 | 846 | 6,309 | | (437) | 5,872 |
| Net Profit (Loss) | (266) | 64 | (202) | (11) | | (213) |
| Capital Spending | 440 | 2 | 442 | | | 442 |
| Three-months ended | | | | | | |
| June 30, 2006: | | | | | | |
| Net Revenue | 5,215 | 611 | 5,826 | | (258) | 5,568 |
| Net Profit (Loss) | (569) | (23) | (592) | (31) | | (623) |
| Capital Spending | 639 | 1 | 640 | | | 640 |
| Six-months ended | | | | | | |
| June 30, 2007: | | | | | | |
| Net Revenue | 10,862 | 1,660 | 12,522 | | (825) | 11,697 |
| Net Profit (Loss) | (437) | 110 | (327) | (21) | | (348) |
| Total Assets | 21,804 | 2,434 | 24,238 | 865 | | 25,103 |
| Capital Spending | 566 | 4 | 570 | | | 570 |
| Six-months ended | | | | | | |
| June 30, 2006: | | | | | | |
| Net Revenue | 10,382 | 1,239 | 11,621 | | (658) | 10,963 |
| Net Profit (Loss) | (1,175) | (78) | (1,253) | (25) | | (1,278) |
| Total Assets | 21,768 | 2,297 | 24,065 | 905 | | 24,970 |
| Capital Spending | 873 | 2 | 875 | | | 875 |

NOTE 4. INCENTIVE STOCK OPTIONS

In 2004, the Company established a stock option plan. Options are available to officers, directors, consultants and employees of the Company. The Board of Directors will select from eligible persons those to whom awards shall be granted, as well as determine the size of the awards. The total number of shares, which are available under the plan, is 120,000 with an option price of \$2.50 per share. The fair value of these options was determined to be \$.36 at the date of grant. Each stock option granted under the plan shall expire not more than 5 years from the date that the option is granted.

In May 2007, the Board of Directors granted 199,000 options to officers, directors, consultants and employees of the Company under a plan approved by the Board in 2005. The total number of shares, which

are available under the plan, is 200,000 with an option price of \$1.50 per share. The fair value of these options was determined to be \$.58 at the date of grant. Each stock option granted under the plan shall expire not more than 5 years from the date the option is granted.

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The fair value of an option grant is estimated on the date of grant using the Black-Scholes option-pricing model with the following weighted-average assumptions used for grants:

| | |
|--------------------------|-------------|
| | 2007 Grants |
| Dividend yield | 0% |
| Expected volatility | 35.00% |
| Risk-free interest rates | 4.63% |
| Expected lives | 5 years |

A summary of the status of the Company's employee stock options was as follows as of June 30, 2007 and changes for the six months then ended is presented below:

| | June 30, | Weighted Average Exercise Price | Weighted Average Fair Value |
|---------------------|----------|--|--------------------------------------|
| | 2007 | \$ | \$ |
| Beginning | 99,400 | 2.50 | .36 |
| Granted | 199,000 | 1.50 | .58 |
| Forfeited | | | |
| Exercised | | | |
| Ending | 298,400 | \$ 1.83 | \$.51 |
| Options exercisable | 120,440 | | |

The weighted-average remaining contractual terms of stock options outstanding and stock options exercisable at June 30, 2007 was approximately 4 years.

In December 2004, the FASB issued SFAS No. 123R, Share-Based Payment. This statement is a revision of SFAS No. 123, Accounting for Stock-Based Compensation, supersedes Accounting Principles Board (APB) Opinion No. 25, Accounting for Stock Issued to Employees and amends SFAS No. 95, Statement of Cash Flows. The statement eliminates the alternative to use the intrinsic value method of accounting that was provided in SFAS No. 123, which generally resulted in no compensation expense recorded in the financial statements related to the issuance of equity awards to employees. The statement also requires that the cost resulting from all share-based payment transactions be recognized in the financial statements. It establishes fair value as the measurement objective in accounting for share-based payment arrangements and generally requires all companies to apply a fair-value-based measurement method in accounting for share-based payment transactions with employees. The Company adopted SFAS No. 123R effective January 1, 2006, using a modified version of the prospective application in accordance with the statement. This adoption requires the Company to record compensation expense using the fair-value measurement for all awards granted to employees and directors after the adoption date and for the unvested portion of awards that are outstanding at the date of adoption. The Company's consolidated financial statements as of and for the six months ended June 30, 2007 and 2006, reflect the impact of SFAS No. 123R.

NOTE 5. CONTINGENCIES

Certain claims and suits arising in the ordinary course of business in managing certain nursing facilities were filed or are pending against the Company. Management provides for loss contingencies where the possibility of a loss is probable. As of June 30, 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.

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

Results of Operations**Three months ended June 30, 2007 as compared to three months ended June 30, 2006****Revenue**

| | June 30, 2007 | June 30, 2006 | Increase/ (Decrease) | % Change |
|--|------------------|------------------|-------------------------|-------------|
| Patient care revenue | \$ 5,457,475 | \$ 5,159,850 | \$ 297,625 | 5.8% |
| Management, consulting and development fee revenue | 414,902 | 407,732 | 7,170 | 1.8% |
| | \$ 5,872,377 | \$ 5,567,582 | \$ 304,795 | 5.5% |

For the periods compared, patient care revenue increased approximately \$297,625 or 5.8%. Average occupancy levels in our assisted living properties increased nearly 13% while utilization of our home health services increased by approximately 19%. However, occupancy in our skilled nursing facilities declined by 7.6% partially offsetting the improvements in our assisted living and home health agency. Charges for privately paying residents at our assisted living and skilled nursing facilities were increased approximately 5% effective January 1, 2007. Management, consulting and development fee revenue increased \$7,170 or 1.8% primarily as a result of inflationary increases in fees charged for our third party management contracts.

We have implemented changes at our skilled nursing facilities to improve occupancy and revenue. We have recently completed renovations at all three facilities and continue to focus our attention towards providing care to more patients covered by Medicare where our profit margins are typically higher.

Operating Expenses

| | June 30, 2007 | June 30, 2006 | Increase/ (Decrease) | % Change |
|-----------------------------------|------------------|------------------|-------------------------|-------------|
| Payroll and related payroll costs | \$ 3,653,871 | \$ 3,476,800 | \$ 177,071 | 5.1% |
| Other operating expenses | 1,924,627 | 1,859,647 | 64,980 | 3.5% |
| Depreciation and amortization | 237,093 | 198,597 | 38,496 | 19.4% |
| | \$ 5,815,591 | \$ 5,535,044 | \$ 280,547 | 5.1% |

Operating expenses for the three months ended June 30, 2007 increased \$280,547 or 5.1%. Payroll and related payroll costs for the three months ended June 30, 2007 increased \$177,071 or 5.1%. This is due primarily to increased visits provided by our home health agency as well as increased occupancy at our assisted living properties. Additionally, employee wages have increased approximately 3% as a result of annual wage increases. Other operating expenses increased \$64,980 or 3.5%, the majority of which is due to increased expenses for audit services, public relations, board activities and directors and officer's liability insurance all a result of our public company status. The increase is also attributed to increased supply usage as a result of higher occupancy in our assisted living facilities and inflationary increases in supply costs.

Depreciation and amortization expense increased \$38,496 or 19.4% primarily due to the amortization of increased letter of credit fees. One of our properties, Community's Hearth & Home, is financed with adjustable rate demand taxable notes secured by a letter of credit from our primary lender, WesBanco. The letter of credit was renewed in December, 2006; however, WesBanco increased their fees for the letter of credit by nearly 100%. Consequently, the amortization of these fees was more in 2007 than in 2006. These increased fees will continue through the third quarter of 2007. We have secured an alternate source

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for the letter of credit from The Huntington National Bank which will replace WesBanco's letter of credit in September, 2007. While The Huntington's fees are less than those of WesBanco, they will still be more than those experienced during 2006.

Income from Continuing Operations

Income from continuing operations for the three months ended June 30, 2007 was \$56,786. Compared to the three months ended June 30, 2006 of \$32,538, this represents an increase of \$24,248 or 74.5%. This is primarily due to increased revenue as a result of higher occupancies in our assisted living facilities and increased visits provided by our home health agency. These increases were partially offset by increased amortization of letter of credit fees of approximately \$30,000 and lower occupancy at two of our skilled nursing facilities.

Other Income and Expense

For the three months ended June 30, 2007 compared to the three months ended June 30, 2006, interest income increased \$16,298 as a result of interest earned on the proceeds of the initial public offering. Interest expense for the three months ended June 30, 2007 compared to the three months ended June 30, 2006, decreased \$418,282 or 65.3%. As of September 2006, expenses related to the mezzanine loan were completely recognized and therefore none were recorded in 2007. Interest expense for the three months ended June 30, 2006, included approximately \$400,000 in mezzanine loan related expense. Interest expense to related parties decreased \$2,852 or 13.9%. Related party loans were repaid with proceeds from our initial public offering but an additional loan was established with a shareholder to refinance the debt of our home health care agency in May, 2006. This loan matured in May, 2007 but has been extended to May 2009.

Summary

Net loss for the three months ended June 30, 2007 was \$212,880 compared to a net loss of \$622,778 for the three months ended June 30, 2006, an improvement of approximately \$410,000. This is the result of improved occupancy at our assisted living properties, increased visits by our home health agency and lower interest expense as a result of expenses related to the mezzanine loan being fully recognized by September 2006.

Six months ended June 30, 2007 as compared to six months ended June 30, 2006***Revenue***

| | June 30, 2007 | June 30, 2006 | Increase/ (Decrease) | % Change |
|--|------------------|------------------|-------------------------|-------------|
| Patient care revenue | \$ 10,824,117 | \$ 10,125,515 | \$ 698,602 | 6.9% |
| Management, consulting and development fee revenue | 872,609 | 837,673 | 34,936 | 4.2% |
| | \$ 11,696,726 | \$ 10,963,188 | \$ 733,538 | 6.7% |

Year-to-date, patient care revenue increased approximately \$698,602 or 6.9%. Occupancy rates in our assisted living properties increased nearly 11% while visits by our home health agency increased by approximately 14%. However, occupancy in our skilled nursing facilities declined by 5%. Charges for privately paying residents at our assisted living and skilled nursing facilities were increased approximately 5% effective January 1, 2007. Management, consulting and development fee revenue increased \$34,936 or 4.2% primarily as a result of inflationary increases in fees charged for our third party management contracts. Total revenue has increased \$733,538 or 6.7%.

Table of Contents**Operating Expenses**

| | June 30, 2007 | June 30, 2006 | Increase/ (Decrease) | % Change |
|-----------------------------------|------------------|------------------|-------------------------|-------------|
| Payroll and related payroll costs | \$ 7,342,447 | \$ 6,999,432 | \$ 343,015 | 4.9% |
| Other operating expenses | 3,704,381 | 3,511,837 | 192,544 | 5.5% |
| Depreciation and amortization | 409,283 | 372,544 | 36,739 | 9.9% |
| | \$ 11,456,111 | \$ 10,883,813 | \$ 572,298 | 5.3% |

Operating expenses for the six months ended June 30, 2007 increased \$572,298 or 5.3%. Payroll and related payroll costs for the six months ended June 30, 2007 increased \$343,015 or 4.9%. This is due primarily to increased visits provided by our home health agency as well as increased occupancy at our assisted living properties. Additionally, employee wages have increased approximately 3% as a result of annual wage increases. Other operating expenses increased \$192,544 or 5.5%, due to increased expenses for audit services, public relations, board activities and directors and officer's liability insurance all a result of our public company status. This increase can also be attributed to higher occupancy in our assisted living facilities and to increased visits provided by our home health agency. Depreciation and amortization expense increased \$36,739 or 9.9% primarily due to the amortization of increased letter of credit fees as explained above.

Income from Continuing Operations

Income from continuing operations for the six months ended June 30, 2007 compared to the six months ended June 30, 2006, increased \$161,240 or 203.1%. This is due primarily to increased revenue as a result of higher occupancies in our assisted living facilities and increased visits provided by our home health agency partially offset by increased operating costs.

Other Income and Expense

For the six months ended June 30, 2007 compared to the six months ended June 30, 2006, interest income increased \$30,860 as a result of interest earned on the proceeds of the initial public offering. Interest expense for the six months ended June 30, 2007 compared to the six months ended June 30, 2006, decreased \$849,758 or 62.9%. As of September 2006, expenses related to the mezzanine loan were completely recognized and therefore none were recorded in 2007. Interest expense for the six months ended June 30, 2006, included approximately \$800,000 in mezzanine loan related expense. Interest expense to related parties decreased \$6,433 or 15.3%. Certain related party loans were repaid with proceeds from our initial public offering.

Summary

Net loss for the six months ended June 30, 2007 was \$347,657 compared to a net loss of \$1,277,862 for the six months ended June 30, 2006, an improvement of approximately \$930,000 or 72.8%. This is the result of improved occupancy at our assisted living properties, increased visits by our home health agency and lower interest expense as a result of expenses related to the mezzanine loan being fully recognized by September 2006.

Liquidity and Capital Resources

As a new public company, we have incurred increased expenses related to auditing our books and records, public relations, directors and officer's liability insurance, board activities, legal expenses and other related consulting fees. We will also incur substantial expense related to our complying with the Sarbanes Oxley act by the end of 2007 and additional expense for key man life insurance. We expect to fund these additional costs using cash flows from expanded operations and financing activities such as equity offerings and additional indebtedness such as a new line of credit.

Overview

We had negative net working capital as of June 30, 2007 of approximately \$94,000 as compared to negative net working capital of approximately \$482,000 for the year ended December 31, 2006, an improvement of approximately \$388,000. The decrease in negative net working capital is due to a two year loan extension on our note payable to a stockholder partially offset by the use

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of cash for the acquisition of property, plant and equipment to complete the renovations at Hearth & Care of Greenfield. We plan to replace the cash used in the renovation of Hearth & Care of Greenfield by increasing the loan on the property during the fourth quarter of 2007.

We currently do not have a line of credit available to assist with cash flow. We are currently working with lenders to secure a line of credit but we have not received firm commitments in this regard. We anticipate that our cash flow from our subsidiaries will continue to be sufficient to fund their operating cash needs.

We plan to improve liquidity by 1) refinancing debt where possible to obtain more favorable terms, 2) increasing facility occupancy, and 3) adding additional management contracts. We have a full time Vice President of Marketing and Business Development to assist in marketing all our facilities as well as looking for new management contracts. In 2003, we entered into an agreement with a building contractor for the renovation and the expansion of ten additional private rooms to our Hearth & Care of Greenfield nursing facility. This project is currently complete however it was over budget and substantially behind schedule. Due to several change orders, weather delays and increased costs of construction due to increasing the size of the original project, an additional \$620,000 was required to complete the expansion. We terminated our contract with the initial project contractor and engaged a new contractor to have the building completed. Subsequently, the former contractor has filed a claim against us alleging damages of \$376,000 for terminating the contract. In addition, a subcontractor has also filed a claim against Hearth & Care of Greenfield in the amount of approximately \$57,000. We believe the claims are without merit and intend to vigorously defend our position. Furthermore, we believe we have a claim against the contractor.

Notes Payable and Other Debt

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 three loans at December 31, 2006: In connection with the financing and loan agreement used to re-finance two assisted living properties located in Springfield, Ohio and one in Urbana, Ohio, the properties are required on an annual basis to maintain a minimum tangible net worth which shall be increased each year by the cumulative net earnings of the properties. As of December 31, 2006, the minimum requirement was \$720,800 and the actual tangible net worth was \$319,320, and therefore, not in compliance. The tangible net worth covenant requirement was waived by WesBanco on March 19, 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, 2006, the minimum requirement was \$308,846 and the actual tangible net worth was \$233,469. Also, 10% of the total assets were \$343,903 as compared to the actual tangible net worth of \$233,469; and therefore, both covenants were not in compliance. However, both net worth covenants were waived by WesBanco on March 19, 2007.

In connection with the financing and loan agreements used to re-finance the corporate office building and to re-finance miscellaneous debt, we were required to not have a change of ownership of AdCare of more than 25%. As a result of the initial public offering, we were in violation of this covenant. However, the default was waived by WesBanco on March 19, 2007.

Cash Flow

Our cash requirements are satisfied primarily with cash generated from operating activities and financing activities such as equity offerings and additional indebtedness. 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. The majority of our revenue is from Medicaid and Medicare programs. These are reliable payment sources which make our likelihood of collection very high. However, the time it takes to receive payment on a claim from these sources can be long. On average, accounts receivable were outstanding 35.6 days before collection as of June 30, 2007 and December 31, 2006. The status of accounts receivable collections is monitored very closely by our senior management.

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Six months ended June 30, 2007 as compared to six months ended June 30, 2006

Net cash used in operating activities for the six months ended June 30, 2007 was \$135,480. Net cash provided by operating activities for the six months ended June 30, 2006 was \$340,831. For the six months ended June 30, 2007, cash flow used in operating activities consisted primarily of net operating losses. A decrease in accounts payable and accrued expenses was compounded by an increase in accounts receivable, prepaid expenses offset by non-cash expenses for depreciation and amortization and minority interest. For the six months ended June 30, 2006, cash flow provided by operating activities consisted primarily of net operating losses offset by a substantial increase in accounts payable and accrued liabilities. Net operating losses were a result of lower occupancies at the properties and amortization of the mezzanine loan financing costs. These were partially offset by an increase in accounts payable and other accrued expenses. The increase in other assets was the result of deferred offering costs for our initial public offering.

Net cash used in investing activities for the six months ended June 30, 2007 and June 30, 2006 was \$561,647 and \$919,367, respectively. For the six months ended June 30, 2007, cash used in investing activities was primarily the result of property and equipment additions. Additionally, the decrease in restricted cash was the result of cash used from our HUD escrowed reserves for the payment of property taxes and liability insurance as well as renovations at one of the skilled nursing facilities, The Pavilion. This was somewhat offset by additional deposits to the reserves. For the six months ended June 30, 2006, purchases of property, plant and equipment was the result of renovation activity at Hearth & Care of Greenfield. There were also additional deposits to our HUD escrowed reserve funds resulting in an increase in restricted cash.

Net cash used in financing activities was \$136,909 for the six months ended June 30, 2007. This is primarily the result of routine repayments on notes payable offset by proceeds from notes payable for additional equipment purchases and by cash received upon the exercise of warrants. Net cash provided by financing activities was \$204,115 for the six months ended June 30, 2006 as a result of proceeds from the note payable established to fund the renovations at our Hearth & Care of Greenfield facility and proceeds from additional note payable to stockholder. The note payable to stockholder was incurred in May 2006 to refinance debt at our home health agency. Offsetting these increases were repayments on notes payable as a result of refinancing the home health agency debt, routine repayments on notes payable and repayments on stockholder loans.

Special Note Regarding Forward Looking Statements

Certain statements in this report constitute forward-looking statements. These forward-looking statements involve known or unknown risks, uncertainties and other factors that may cause the actual results, performance, or achievements of AdCare to be materially different from any future results, performance or achievements expressed or implied by the forward-looking statements. Specifically, the actions of competitors and customers and our ability to execute our business plan, and our ability to increase revenues is dependent upon our ability to continue to expand our current business and to expand into new markets, general economic conditions, and other factors. You can identify forward-looking statements by terminology such as may, will, should, expects, intends, plans, anticipates, estimates, predicts, potential, continues, or the negative of these terms or other comparable terminology. Although we believe that the expectations reflected in the forward-looking statements are reasonable, we cannot guarantee future results, levels of activity, performance or achievements. We undertake no obligation to publicly update or review any forward-looking statements, whether as a result of new information, future developments or otherwise.

Item 3. 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

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of the design and operation of our disclosure controls and procedures as of the end of the period covered by this report. Based on the foregoing, our chief executive officer and chief financial officer concluded that our disclosure controls and procedures were effective at the reasonable assurance level.

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

Part II. Other Information**Item 1. Legal Proceedings**

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

Item 2. Changes in Securities and Use of Proceeds

Our initial public offering was co-underwritten by Newbridge Securities Corporation and Joseph Gunnar & Co, LLC. Our offering consisted of 703,000 units. Each unit consisted of two shares of our common stock and two five-year warrants each to purchase one share of our common stock. Our net proceeds from the sale and issuance of 703,000 units was \$5,742,865, based upon an initial public offering price of \$9.50 per unit and after deducting the estimated underwriting discount, the non-accountable expense allowance and the estimated offering expenses payable by us. The following table contains a reasonable estimate of the expenses incurred in this offering and the subsequent use of proceeds at the conclusion of the offering:

| | June 30, 2007 | December 31, 2006 | |
|---|---------------|-------------------|-----------|
| Gross offering proceeds (703,000 units x \$9.50 per unit) | | 6,678,500 | 6,678,500 |
| Underwriting discounts and commissions | 534,280 | | 534,280 |
| Underwriter's expenses | 226,355 | | 226,354 |
| Other expenses (1) | 175,000 | | 175,000 |
| Total expenses | | 935,635 | 935,634 |
| Net offering proceeds | | 5,742,865 | 5,742,866 |
| Repayment of indebtedness | 2,082,152 | | 2,082,152 |
| Legal and accounting fees related to the offering | 696,702 | | 696,702 |
| Working capital (2) | 2,041,662 | | 936,146 |
| Cash held in money market account (2) | 422,349 | | 1,527,866 |
| Cash held in interest bearing saving account | 500,000 | | 500,000 |
| Net proceeds unaccounted for | | | |

(1) Other expenses consist of \$75,000 paid to Newbridge Securities Corporation as a consulting fee in connection with their Financial Advisory Agreement. \$100,000 represents our purchase of the warrants held by

Newbridge
Securities
Corporation
pursuant to the
underwriting
agreement.

- (2) Cash used for working capital increased \$1,105,517 as a result of payments for the continued renovations at Hearth & Care of Greenfield as well as additional payments for audit expenses. We plan to replace cash used for Hearth & Care of Greenfield upon the successful completion of refinancing the property. At this time, we have no commitments or guarantees of refinancing Hearth & Care of Greenfield.

In accordance with the terms and conditions contained in the underwriting agreement, we agreed to sell to the representatives of our initial public offering, for \$100, options to purchase up to a total of 5% of the units sold. Each unit consists of two shares of stock and two warrants for two shares of stock. Therefore, 35,150 unit options were issued at the closing of our initial public offering on November 9, 2006. These options are exercisable at an exercise price of \$11.875 (125% of the offering price) per

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unit commencing on November 9, 2007 and ending on November 9, 2011. We have valued the unit options, using the Black- Scholes option pricing model, at approximately \$102,000. The issuance of the options and the related expense, which was treated as a cost of the offering, were both offsetting adjustments to additional paid in capital. The warrants are exercisable commencing on November 9, 2007 and ending on November 9, 2011 at an exercise price equal to 125% of exercise price of the warrants in the units in the offering or \$6.75 per warrant.

Item 6. Exhibits and Reports on Form 8-K

a. The following Exhibits are attached:

Exhibit

| Number | Description |
|---------------------|--|
| 2.1 ⁽¹⁾ | Agreement and Plan of Merger, dated June 6, 2007, by and between Family Home Health Services, Inc. and AdCare Health Systems, Inc. |
| 31.1 ⁽²⁾ | Certification of CEO pursuant to Section 302 of the Sarbanes-Oxley Act |
| 31.2 ⁽²⁾ | Certification of CFO pursuant to Section 302 of the Sarbanes-Oxley Act |
| 32.1 ⁽²⁾ | Certification of CEO pursuant to Section 906 of the Sarbanes-Oxley Act |
| 32.2 ⁽²⁾ | Certification of CFO pursuant to Section 906 of the Sarbanes-Oxley Act |
| 99.1 ⁽¹⁾ | Issuance of warrants to officers and directors of AdCare Health Systems, Inc. on June 5, 2007. |

(1) Previously filed on Form 8-K and incorporated herein by reference.

(2) Filed herewith.

b. The Company filed the following Reports on Form 8-K during the three months ended June 30, 2007:

| Date | Description |
|--------------|--|
| June 7, 2007 | Agreement and Plan of Merger, dated June 6, 2007, by and between Family Home Health Services, Inc. and AdCare Health Systems, Inc. |
| June 8, 2007 | Issuance of warrants to officers and directors of AdCare Health Systems, Inc. on June 5, 2007. |

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SIGNATURES

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

AdCare Health Systems, Inc.
(Registrant)

Date: August 14, 2007

/s/ Gary L. Wade

Chief Executive Officer

Date: August 14, 2007

/s/ Scott Cunningham

Chief Financial Officer

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