ADCARE HEALTH SYSTEMS, INC
Form 10-Q
November 13, 2014

UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

(Mark One)

ý QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended September 30, 2014

o TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from to

Commission File Number 001-33135

AdCare Health Systems, Inc.
(Exact name of registrant as specified in its charter)

Georgia	31-1332119
(State or other jurisdiction of incorporation)	(I.R.S. Employer Identification Number)

1145 Hembree Road, Roswell, GA 30076
(Address of principal executive offices)

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

Not Applicable
(Former name, former address and former fiscal year, if changed since last report)

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

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company. See definition of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer o	Accelerated filer o

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

Smaller reporting company x

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

As of October 31, 2014: 18,878,571 shares of common stock with no par value were outstanding.

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AdCare Health Systems, Inc.

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Forward-Looking Statements

This Quarterly Report on Form 10-Q (this "Quarterly Report") and certain information incorporated herein by reference contain forward-looking statements and information within the “safe harbor” provisions of the Private Securities Litigation Reform Act of 1995, Section 27A of the Securities Act of 1933, as amended (the "Securities Act"), and Section 21E of the Securities Exchange Act of 1934, as amended (the “Exchange Act”). This information includes assumptions made by, and information currently available to management, including statements regarding future economic performance and financial condition, liquidity and capital resources, and management’s plans and objectives. In addition, certain statements included in this Quarterly Report, in the Company’s future filings with the Securities and Exchange Commission (“SEC”), in press releases, and in oral and written statements made by us or with our approval, which are not statements of historical fact, are forward-looking statements. Words such as “may,” “could,” “should,” “would,” “believe,” “expect,” “anticipate,” “estimate,” “intend,” “seeks,” “plan,” “project,” “continue,” “predict,” “w other words or expressions of similar meaning are intended by us to identify forward-looking statements, although not all forward-looking statements contain these identifying words. Forward-looking statements are based on the Company’s current expectations about future events or results and information that is currently available to us, involve assumptions, risks, and uncertainties, and speak only as of the date on which such statements are made.
All forward-looking statements are subject to the risks and uncertainties inherent in predicting the future. The Company’s actual results may differ materially from those projected, stated or implied in these forward-looking statements as a result of many factors, including the Company’s critical accounting policies and risks and uncertainties related to, but not limited to, overall industry environment, regulatory delays, negative clinical results, and the Company’s financial condition. These and other risks and uncertainties are described in more detail in the Company’s most recent Annual Report on Form 10-K, as well as other reports that the Company files with the SEC.
Forward-looking statements speak only as of the date they are made and should not be relied upon as representing the Company’s views as of any subsequent date. The Company undertakes no obligation to update or revise such statements to reflect new circumstances or unanticipated events as they occur, except as required by applicable laws, and you are urged to review and consider disclosures that the Company makes in this Quarterly Report and other reports that the Company files with the SEC that discuss factors germane to the Company’s business.

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Part I. Financial Information
Item 1. Financial Statements
ADCARE HEALTH SYSTEMS, INC. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS
(Amounts in 000's)

	September 30, 2014 (Unaudited)	December 31, 2013
ASSETS		
Current assets:		
Cash and cash equivalents	$12,867	$19,374
Restricted cash and investments	921	3,801
Accounts receivable, net of allowance of $6,202 and $4,989	25,771	23,598
Prepaid expenses and other	2,198	483
Assets of disposal group held for use	—	5,135
Assets of disposal groups held for sale	7,045	400
Assets of variable interest entity held for sale	5,894	5,945
Total current assets	54,696	58,736
Restricted cash and investments	7,773	11,606
Property and equipment, net	136,572	138,233
Intangible assets - bed licenses	2,471	2,471
Intangible assets - lease rights, net	4,254	4,889
Goodwill	4,224	4,224
Lease deposits	1,832	1,715
Deferred loan costs, net	3,948	4,542
Other assets	93	12
Total assets	$215,863	$226,428
LIABILITIES AND EQUITY		
Current liabilities:		
Current portion of notes payable and other debt	$24,249	$12,027
Current portion of convertible debt, net of discounts	14,000	11,389
Revolving credit facilities and lines of credit	6,894	2,738
Accounts payable	17,729	23,783
Accrued expenses	15,644	13,264
Liabilities of disposal group held for sale	5,197	—
Liabilities of variable interest entity held for sale	5,954	6,034
Total current liabilities	89,667	69,235
Notes payable and other debt, net of current portion:		
Senior debt, net of discounts	86,832	107,858
Bonds, net of discounts	7,007	6,996
Revolving credit facilities	1,121	5,765
Convertible debt	—	7,500
Other liabilities	1,916	1,589

Deferred tax liability	—	191
Total liabilities	186,543	199,134
Commitments and contingencies (Note 14)		
Preferred stock, no par value; 5,000 shares authorized; 950 shares issued and outstanding, redemption amount 23,750 at both September 30, 2014 and December 31, 2013	20,392	20,442
Stockholders’ equity:		
Common stock and additional paid-in capital, no par value; 55,000 shares authorized; 18,811 and 16,016 issued and outstanding at September 30, 2014 and December 31, 2013, respectively	61,251	48,370
Accumulated deficit	(50,141)	(39,884)
Total stockholders’ equity	11,110	8,486
Noncontrolling interest in subsidiary	(2,182)	(1,634)
Total equity	8,928	6,852
Total liabilities and equity	$215,863	$226,428

See accompanying notes to unaudited consolidated financial statements

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ADCARE HEALTH SYSTEMS, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF OPERATIONS
(Amounts in 000's, except per share data)
(Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
Revenues:				
Patient care revenues	$56,637	$53,126	$165,196	$160,471
Management revenues	354	521	1,140	1,529
Rental revenues	88	—	88	—
Total revenues	57,079	53,647	166,424	162,000
Expenses:				
Cost of services (exclusive of facility rent, depreciation and amortization)	47,198	43,802	137,743	134,392
General and administrative expenses	3,578	4,583	12,318	14,016
Audit committee investigation expense	—	302	—	2,284
Facility rent expense	1,695	1,702	5,085	5,077
Depreciation and amortization	1,906	1,779	5,716	5,245
Salary retirement and continuation costs	1,489	5	2,771	154
Total expenses	55,866	52,173	163,633	161,168
Income from Operations	1,213	1,474	2,791	832
Other Income (Expense):				
Interest expense, net	(2,644)	(3,204)	(7,916)	(9,459)
Acquisition costs, net of gains	(8)	(33)	(8)	(610)
Derivative gain	—	1,989	—	2,178
Loss on extinguishment of debt	(1,220)	(6)	(1,803)	(33)
Loss on disposal of assets	—	(6)	—	(10)
Other (expense) income	(444)	15	(636)	15
Total other expense, net	(4,316)	(1,245)	(10,363)	(7,919)
(Loss) Income from Continuing Operations Before Income Taxes	(3,103)	229	(7,572)	(7,087)
Income tax benefit (expense)	244	54	236	(24)
(Loss) Income from Continuing Operations	(2,859)	283	(7,336)	(7,111)
Loss from Discontinued Operations, Net of Tax	(690)	(696)	(1,531)	(2,998)
Net Loss	(3,549)	(413)	(8,867)	(10,109)
Net Loss Attributable to Noncontrolling Interests	218	195	548	629
Net Loss Attributable to AdCare Health Systems, Inc.	(3,331)	(218)	(8,319)	(9,480)
Preferred stock dividend	(646)	(306)	(1,938)	(918)
Net Loss Attributable to AdCare Health Systems, Inc. Common Stockholders	$(3,977)	$(524)	$(10,257)	$(10,398)

Net loss per Common Share attributable to AdCare Health Systems, Inc. Common Stockholders -				
Basic:				
Continuing Operations	$(0.18)	$0.01	$(0.50)	$(0.50)
Discontinued Operations	(0.04)	(0.04)	(0.09)	(0.20)
	$(0.22)	$(0.03)	$(0.59)	$(0.70)
Diluted:				
Continuing Operations	$(0.18)	$0.01	$(0.50)	$(0.50)
Discontinued Operations	(0.04)	(0.04)	(0.09)	(0.20)
	$(0.22)	$(0.03)	$(0.59)	$(0.70)
Weighted Average Common Shares Outstanding:				
Basic	18,134	14,962	17,539	14,805
Diluted	18,134	14,962	17,539	14,805

See accompanying notes to unaudited consolidated financial statements

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ADCARE HEALTH SYSTEMS, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY
(Amounts in 000's)
(Unaudited)

	Common Stock Shares	Common Stock and Additional Paid-in Capital	Accumulated Deficit	Noncontrolling Interests	Total
Balances, December 31, 2013	16,016	$48,370	$(39,884)	$(1,634)	$6,852
Stock-based compensation expense	—	983	—	—	983
Exercises of options and warrants	934	3,105	—	—	3,105
Stock issued for converted debt and interest	1,861	8,706	—	—	8,706
Nonemployee warrants issued in conjunction with debt offering	—	87	—	—	87
Preferred stock dividend	—	—	(1,938)	—	(1,938)
Net loss	—	—	(8,319)	(548)	(8,867)
Balances, September 30, 2014	18,811	$61,251	$(50,141)	$(2,182)	$8,928

See accompanying notes to unaudited consolidated financial statements

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ADCARE HEALTH SYSTEMS, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
(Amounts in 000's)
(Unaudited)

	Nine Months Ended September 30, 2014	2013
Cash flows from operating activities:		
Net loss	$(8,867)	$(10,109)
Loss from discontinued operations, net of tax	1,531	2,998
Loss from continuing operations	(7,336)	(7,111)
Adjustments to reconcile net loss from continuing operations to net cash (used in) provided by operating activities:		
Depreciation and amortization	5,716	5,245
Warrants issued for services	87	9
Stock-based compensation expense	983	737
Lease expense in excess of cash	166	121
Amortization of deferred financing costs	1,460	1,727
Amortization of debt discounts and premiums	(13)	502
Derivative gain	—	(2,178)
Loss on debt extinguishment	1,803	33
Deferred tax benefit	(191)	(27)
Loss on disposal of assets	—	10
Provision for bad debts	2,995	3,156
Changes in certain assets and liabilities, net of acquisitions:		
Accounts receivable	(5,430)	(3,163)
Prepaid expenses and other	(1,660)	(965)
Other assets	(198)	387
Accounts payable and accrued expenses	(3,056)	4,698
Net cash (used in) provided by operating activities - continuing operations	(4,674)	3,181
Net cash used in operating activities - discontinued operations	(1,441)	(493)
Net cash (used in) provided by operating activities	(6,115)	2,688
Cash flows from investing activities:		
Change in restricted cash and investments and escrow deposits for acquisitions	5,785	(5,632)
Proceeds from notes receivable	—	3,240
Purchase of property and equipment	(3,420)	(3,049)
Net cash provided by (used in) investing activities - continuing operations	2,365	(5,441)
Net cash (used in) provided by investing activities - discontinued operations	(778)	886
Net cash provided by (used in) investing activities	1,587	(4,555)
Cash flows from financing activities:		
Proceeds from debt	17,750	7,372
Proceeds from convertible debt	6,022	—
Repayment on notes payable	(18,484)	(5,295)
Repayment on bonds payable	(3,049)	—
Repayment on convertible debt	(4,014)	—

Change in lines of credit	(335)	8
Debt issuance costs	(945)	(407)
Exercise of warrants and options	3,105	67
Preferred stock offering costs	(50)	—
Dividends paid on preferred stock	(1,938)	(918)
Net cash flows (used in) provided by financing activities - continuing operations	(1,938)	827
Net cash flows used in financing activities - discontinued operations	(41)	(2,173)
Net cash flows used in financing activities	(1,979)	(1,346)
Net Change in Cash	(6,507)	(3,213)
Cash, Beginning	19,374	15,937
Cash, Ending	$12,867	$12,724
Supplemental disclosure of cash flow information:		
Cash paid during the year for:		
Interest	$7,340	$7,984
Supplemental disclosure of Non-cash Activities:		
Conversions of debt and other liabilities to equity	$6,942	$2,331
2011 Notes surrendered and cancelled in payment for 2014 Notes	$445	$—
Warrants issued for financing costs	$—	$9
Warrants issued in conjunction with debt offering	$87	$—

See accompanying notes to unaudited consolidated financial statements

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ADCARE HEALTH SYSTEMS, INC. AND SUBSIDIARIES
Notes to Unaudited Consolidated Financial Statements
For the Three and Nine Months Ended September 30, 2014 and 2013

NOTE 1. SIGNIFICANT ACCOUNTING POLICIES

See Note 1 to our Consolidated Financial Statements included in the Company's Annual Report on Form 10-K for the year ended December 31, 2013 for a description of all significant accounting policies.
Description of Business

AdCare Health Systems, Inc. ("AdCare") and its controlled subsidiaries (collectively with AdCare, the "Company" or "we"), owns and operates skilled nursing and assisted living facilities in the states of Alabama, Arkansas, Georgia, Missouri, North Carolina, Ohio, Oklahoma and South Carolina. The Company, through wholly owned separate operating subsidiaries, as of September 30, 2014, operates 37 facilities comprised of 34 skilled nursing facilities, two assisted living facilities and one independent living/senior housing facility totaling approximately 4,200 beds. The Company's facilities provide a range of health care services to their patients and residents including, but not limited to, skilled nursing and assisted living services, social services, various therapy services and other rehabilitative and healthcare services for both long-term residents and short-stay patients. As of September 30, 2014, of the total 37 facilities, the Company owned and operated 25 facilities, leased and operated eight facilities, and managed four facilities for third parties.

On June 12, 2013, the Company executed two sublease agreements to exit the skilled nursing business in Tybee Island, Georgia effective June 30, 2013 relating to two facilities. During the fourth quarter of 2013, Riverchase Village ADK, LLC ("Riverchase"), our consolidated variable interest entity (a "VIE"), entered into a sales listing agreement to sell Riverchase Village, a 105-bed assisted living facility located in Hoover, Alabama. Riverchase subsequently entered into a purchase sale agreement on April 1, 2014 to sell Riverchase Village but the purchase sale agreement was terminated on August 6, 2014 (see Note 13 - Variable Interest Entity). During the first quarter of 2014, the Company entered into a representation agreement to sell Companions Specialized Care Center ("Companions"), a 102-bed skilled nursing facility located in Tulsa, Oklahoma. On July 1, 2014, the Company entered into an agreement effective July 1, 2014 to sublease a 52-bed skilled nursing facility located in Thomasville, Georgia to a local nursing home operator. These five facilities are reported as discontinued operations (see Note 10—Discontinued Operations).

On July 23, 2014, the Company announced that the Board of Directors had approved, and management had begun to implement, a strategic plan to transition the Company to a healthcare property holding and leasing company. Through a series of leasing transactions, the operations of the Company's currently owned and operated healthcare facilities, which are principally skilled nursing facilities, will be transitioned to third parties, and the properties the Company leases will be sub-leased, effectively exiting the operations of these facilities, and will transition its business to the ownership, acquisition and leasing of healthcare-related properties.

On September 22, 2014, as part of its ongoing strategic plan to transition from an owner and operator of healthcare facilities to a healthcare property holding and leasing company, two wholly-owned subsidiaries of the Company entered into an agreement to lease two of its skilled nursing and rehabilitation facilities in Alabama to a local nursing home operator effective November 1, 2014.

On October 14, 2014, the Company held a special meeting of shareholders in Atlanta, Georgia, in which the shareholders approved the additional leasing transactions which transactions may constitute the lease of all or substantially all of the Company's property under Georgia law.
Basis of Presentation

The accompanying unaudited consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America ("GAAP") for interim financial information and with the instructions to Form 10-Q and Rule 8-03 of Article 8 of Regulations S-X. Accordingly, they do not include all of the information and footnotes required by GAAP for complete financial statements. Changes to GAAP are established by the Financial Accounting Standards Board (“FASB”) in the form of Accounting Standards Updates (“ASUs”) to the FASB’s Accounting Standards Codification (“ASC”). In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation of the results of operations for the periods presented have been included. Operating results for the three and nine months ended September 30, 2014 and 2013, are not necessarily indicative of the results that may be expected for the fiscal

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year. The balance sheet at December 31, 2013, has been derived from the audited consolidated financial statements at that date, but does not include all of the information and footnotes required by GAAP for complete financial statements.

You should read these consolidated financial statements together with the historical consolidated financial statements of the Company for the year ended December 31, 2013 included in the Company's Annual Report on Form 10-K for the year ended December 31, 2013, filed with the Securities and Exchange Commission ("SEC") on March 31, 2014.

The Company operates in one business segment. These statements include the accounts of AdCare Health Systems, Inc. and its controlled subsidiaries. Controlled subsidiaries include AdCare's majority owned subsidiaries and one variable interest entity (a "VIE") in which AdCare has control as primary beneficiary. All inter-company accounts and transactions were eliminated in the consolidation.

Use of Estimates

The preparation of consolidated financial statements in conformity with GAAP requires management to make certain estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported results of operations during the reporting period. Examples of significant estimates include allowance for doubtful accounts, contractual allowances for Medicaid, Medicare, and managed care reimbursements, deferred tax valuation allowance, fair value of derivative instruments, fair value of employee and nonemployee stock based awards, and valuation of goodwill and other long-lived assets. Actual results could differ materially from those estimates.

Reclassifications

Certain items previously reported in the consolidated financial statement captions have been reclassified to conform to the current financial statement presentation with no effect on the Company's consolidated financial position or results of operations. These reclassifications did not affect total assets, total liabilities, or stockholders' equity. Reclassifications were made to September 30, 2013 Consolidated Statements of Operations to reflect the same facilities in discontinued operations for both periods presented.

Revenue Recognition and Patient Care Receivables

The Company recognizes revenue when the following four conditions have been met: (i) there is persuasive evidence that an arrangement exists; (ii) delivery has occurred or service has been rendered; (iii) the price is fixed or determinable; and (iv) collection is reasonably assured. The Company's revenue is derived primarily from providing healthcare services to residents and is recognized on the date services are provided at amounts billable to the individual. For reimbursement arrangements with third-party payors, including Medicaid, Medicare and private insurers, revenue is recorded based on contractually agreed-upon amounts on a per patient, daily basis.

Revenue from the Medicaid and Medicare programs accounted for 83.5% and 83.9% of the Company's revenue for the three and nine months ended September 30, 2014, respectively, and 82.8% and 84.1% of the Company's revenue for the three and nine months ended September 30, 2013. The Company records revenue from these governmental and managed care programs as services are performed at their expected net realizable amounts under these programs. The Company's revenue from governmental and managed care programs is subject to audit and retroactive adjustment by governmental and third-party agencies. Consistent with healthcare industry accounting practices, any changes to these governmental revenue estimates are recorded in the period the change or adjustment becomes known based on final settlement. The Company recorded retroactive adjustments to revenue which were not material to the Company's consolidated revenue for the three and nine months ended September 30, 2014 and 2013.

Potentially uncollectible patient accounts are provided for on the allowance method based upon management's evaluation of outstanding accounts receivable at period-end and historical experience. Uncollected accounts that are written off are charged against allowance. As of September 30, 2014 and December 31, 2013, management recorded an allowance for uncollectible accounts of $6.2 million and $5.0 million, respectively.

Management Fee Receivables and Revenues

Management fee receivables and revenue are recorded in the month that services are provided. As of September 30, 2014 and December 31, 2013, the Company evaluated collectibility of management fees and determined that no allowance was required.

Rental Revenues and Receivables

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The Company, as lessor, makes a determination with respect to each of its leases whether they should be accounted for as operating leases. The Company recognizes rental revenues on a straight-line basis over the term of the lease when collectibility is reasonably assured. Differences between rental income earned and amounts due under the lease are charged or credited, as applicable, to straight-line rent receivable, net. Payments received under operating leases are accounted for in the statements of operations as rental revenue for actual rent collected plus or minus a straight-line adjustment for estimated minimum lease escalators.

Fair Value Measurements and Financial Instruments

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

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

Level 2— Other observable market-based inputs or unobservable inputs that are corroborated by market data

Level 3— Significant unobservable inputs

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

Recent Accounting Pronouncements

Except for rules and interpretive releases of the SEC under authority of federal securities laws and a limited number of grandfathered standards, the FASB ASC is the sole source of authoritative GAAP literature recognized by the FASB and applicable to the Company. The Company has reviewed the FASB issued ASUs accounting pronouncements and interpretations thereof that have effectiveness dates during the periods reported and in future periods.

In April 2014, the FASB issued ASU 2014-08 that amends the definition of a discontinued operation to include only those disposals of components of an entity that represent a strategic shift that has (or will have) a major effect on an entity’s operations and financial results. This ASU should be applied prospectively and is effective for the Company for the 2015 annual and interim periods. Early adoption is permitted for disposals that have not been reported in financial statements previously issued. We have not adopted this ASU as of September 30, 2014.

In May 2014, the FASB issued ASU 2014-09 guidance requiring revenue to be recognized in an amount that reflects the consideration expected to be received in exchange for those goods and services. The guidance requires the disclosure of sufficient quantitative and qualitative information for financial statement users to understand the nature, amount, timing and uncertainty of revenue and associated cash flows arising from contracts with customers. The guidance is effective for annual reporting periods beginning after December 15, 2016, including interim periods within that reporting period, with early adoption precluded. The Company has not yet determined the impact, if any, that the adoption of this guidance will have on its consolidated financial position or results of operations.

In August 2014, the FASB issued ASU 2014-15 guidance regarding an entity’s ability to continue as a going concern, which requires management to assess a company’s ability to continue as a going concern and to provide related footnote disclosures in certain circumstances. Before this new standard, there was minimal guidance in United States GAAP specific to going concern. Under the new standard, disclosures are required when conditions give rise to substantial doubt about a company’s ability to continue as a going concern within one year from the financial statement issuance date. The guidance is effective for annual reporting periods beginning after December 15, 2016, including interim periods within that reporting period, with early adoption permitted. The Company has not yet determined the impact, if any, that the adoption of this guidance will have on its consolidated financial statements.

NOTE 2. EARNINGS PER SHARE

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Basic earnings per share is computed by dividing net income or loss by the weighted-average number of shares of common stock outstanding during the period. Diluted earnings per share is similar to basic earnings per share except net income or loss is adjusted by the impact of the assumed issuance of common shares and the weighted-average number of common shares outstanding and includes potentially dilutive securities, such as options, warrants, non-vested shares, and additional shares issuable under subordinated convertible promissory notes outstanding during the period when such potentially dilutive securities are not anti-dilutive. Potentially dilutive securities from options, warrants and unvested restricted shares are calculated in accordance with the treasury stock method, which assumes that proceeds from the exercise of all options and warrants with exercise prices exceeding the average market value are used to repurchase common stock at market value. The incremental shares remaining after the proceeds are exhausted represent the potentially dilutive effect of the securities. Potentially dilutive securities from subordinated convertible promissory notes are calculated based on the assumed issuance at the beginning of the period, as well as any adjustment to income that would result from their assumed issuance. For the nine months ended September 30, 2014 and 2013, potentially dilutive securities of 7.8 million and 11.5 million, respectively, were excluded from the diluted loss per share calculation because including them would have been anti-dilutive in both periods.

The following tables provide a reconciliation of net loss for continuing and discontinued operations and the number of common shares used in the computation of both basic and diluted earnings per share:

	Three Months Ended September 30,					
	2014			2013		
(Amounts in 000’s, except per share data)	Income (loss)	Shares	Per Share	Income (loss)	Shares	Per Share
Continuing Operations:						
(Loss) income from continuing operations	$(2,859)			$283		
Net loss attributable to noncontrolling interests	218			195		
Basic (loss) income from continuing operations	$(2,641)	18,134	$(0.14)	$478	14,962	$0.03
Preferred stock dividend	(646)	18,134	$(0.04)	(306)	14,962	$(0.02)
Effect of dilutive securities: Stock options, warrants outstanding and convertible debt (a)						
Diluted (loss) income from continuing operations	$(3,287)	18,134	$(0.18)	$172	14,962	$0.01
Discontinued Operations:						
Basic loss from discontinued operations	(690)	18,134	$(0.04)	(696)	14,962	$(0.04)
Diluted loss from discontinued operations	(690)	18,134	$(0.04)	(696)	14,962	$(0.04)
Net Loss Attributable to AdCare:						
Basic loss	(3,977)	18,134	$(0.22)	(524)	14,962	$(0.03)
Diluted loss	(3,977)	18,134	$(0.22)	(524)	14,962	$(0.03)

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	Nine Months Ended September 30,					
	2014			2013		
(Amounts in 000's, except per share data)	Income (loss)	Shares	Per Share	Income (loss)	Shares	Per Share
Continuing Operations:						
Loss from continuing operations	$(7,336)			$(7,111)		
Net loss attributable to noncontrolling interests	548			629		
Basic loss from continuing operations	$(6,788)	17,539	$(0.39)	$(6,482)	14,805	$(0.44)
Preferred stock dividend	(1,938)	17,539	$(0.11)	(918)	14,805	$(0.06)
Effect of dilutive securities: Stock options, warrants outstanding and subordinated convertible promissory notes [(a)]						
Diluted loss from continuing operations	$(8,726)	17,539	$(0.50)	$(7,400)	14,805	$(0.50)
Discontinued Operations:						
Basic loss from discontinued operations	(1,531)	17,539	$(0.09)	(2,998)	14,805	$(0.20)
Diluted loss from discontinued operations	(1,531)	17,539	$(0.09)	(2,998)	14,805	$(0.20)
Net Loss Attributable to AdCare:						
Basic loss	(10,257)	17,539	$(0.59)	(10,398)	14,805	$(0.70)
Diluted loss	(10,257)	17,539	$(0.59)	(10,398)	14,805	$(0.70)

[(a)] Securities outstanding that were excluded from the computation, prior to the use of the treasury stock method, because they would have been anti-dilutive are as follows:

	September 30,	
(Amounts in 000's)	2014	2013
Outstanding Stock Options	1,144	1,357
Outstanding Warrants - employee	1,846	1,876
Outstanding Warrants - nonemployee	816	1,904
Subordinated Convertible Promissory Notes [(a)]	4,000	6,406
Total anti-dilutive securities	7,806	11,543

[(a)] The number of shares of common stock issuable upon conversion of the subordinated convertible promissory notes reflected in the tables above is 120% of the aggregate principal amount of the subordinated convertible promissory notes divided by the current conversion price, which is the number of shares required to be reserved for issuance by the Company under the applicable registration rights agreement.

NOTE 3. LIQUIDITY AND PROFITABILITY

For the nine months ended and as of September 30, 2014, we had a net loss of $8.9 million and negative working capital of $35.0 million. At September 30, 2014, we had $12.9 million in cash and cash equivalents and $151.3 million in indebtedness, including current maturities and discontinued operations, of which $56.3 million is current debt (including the Company's outstanding subordinated convertible promissory notes with a principal amount of $7.5 million and $6.5 million that mature in July 2015 and April 2015, respectively). Our ability to achieve profitable operations is dependent on continued growth in revenue and controlling costs.

On July 23, 2014, the Company announced that the Board of Directors had approved, and management has begun to implement, a strategic plan (the "New Plan") to transition the Company to a healthcare property holding and leasing company. On October 14, 2014, the Company held a special meeting of shareholders in Atlanta, Georgia, in which the shareholders approved the additional leasing transactions which transactions may constitute the lease of all or substantially all of the Company's property under Georgia law.

The Company's final assessment of liquidity and profitability under the New Plan is dependent on the timing of the leasing and sub-leasing transactions contemplated by the New Plan. However, the Company believes the New Plan, when fully

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implemented, will enhance cash flow from operations, reduce capital expenditure requirements, and require significantly less working capital.

We estimate that cash flow from operations and other working capital changes under the existing business model will be approximately $8.0 million and cash outlays for capital expenditures, dividends on our Series A Preferred Stock and income taxes will total approximately $3.1 million for the twelve months ending September 30, 2015. We anticipate that scheduled debt service (excluding approximately $21.0 million of bullet maturities due in February 2015 that the Company believes will be refinanced on a longer term basis and $6.5 million and $7.5 million in outstanding subordinated convertible promissory notes that mature in April 2015 and July 2015, respectively, but including principal and interest), will total approximately $16.1 million for the twelve months ending September 30, 2015. We anticipate the conversion to common stock of $6.5 million and $7.5 million of the Company's outstanding subordinated convertible promissory notes that mature in April 2015 and July 2015, respectively. These promissory notes are convertible into shares of common stock of the Company at $4.50 per share and $4.17 per share, respectively. The closing price of the common stock exceeded $4.17 per share from January 1, 2014 through November 7, 2014 and exceeded $4.50 per share from July 23, 2014 through October 9, 2014. As discussed further below, if we were unable to refinance the $21.0 million of bullet maturities due in February 2015, then the Company may be required to restructure its outstanding indebtedness, implement further cost reduction initiatives, or sell assets due to our limited liquidity in such an event.

During February and March 2014, the Company issued 693,761 shares of common stock to holders of the Company's warrants dated September 30, 2010 upon conversion at an exercise price of $3.57 per share. The Company received proceeds of approximately $2.3 million, net of broker commissions of approximately $0.1 million. On March 28, 2014, we received net proceeds of approximately $6.3 million from the issuance and sale of the Company's 10% subordinated convertible promissory notes due April 30, 2015.

We routinely have ongoing discussions with existing and potential new lenders to refinance current debt on a longer term basis and, in recent periods, have refinanced shorter term acquisition debt, including seller notes, with traditional longer term mortgage notes, some of which have been executed under government guaranteed lending programs. We have been successful in recent years in raising new equity capital and believe, based on recent discussions, that these markets will continue to be available to us for raising capital in 2015.

Based on existing cash balances, anticipated cash flows for the twelve months ending September 30, 2015, the anticipated refinancing $21.0 million of bullet maturities due February 2015, and the expected conversion of $2.9 million of the Company's outstanding subordinated convertible promissory notes that mature in July 2015, which excludes subordinated convertible promissory notes with a principal amount in the aggregate of $1.1 million that were converted into shares of common stock of the Company in July and August 2014 (see Note 8 - Notes Payable and Other Debt), and $6.5 million of subordinated convertible promissory notes due April 2015, into shares of common stock, we believe there will be sufficient funds for our operations, scheduled debt service, and capital expenditures at least through the next 12 months. On a longer term basis, at September 30, 2014 we have approximately $36.0 million of debt payments and maturities due between October 2015 and September 2018. We believe our long-term liquidity needs will be satisfied by these same sources, borrowings as required to refinance indebtedness and new sources of equity capital.

In order to satisfy our capital needs, we will seek to: (i) implement the New Plan and if there are delays in leasing and sub-leasing transactions contemplated by the New Plan, the Company will continue to improve our operating results by increasing facility occupancy, optimizing our payor mix by increasing the proportion of sub-acute patients within our skilled nursing facilities, and continuing our cost optimization and efficiency strategies; (ii) expand our borrowing arrangements with certain existing lenders; (iii) refinance current debt where possible to obtain more favorable terms; and (iv) raise capital through the issuance of debt or equity securities. We anticipate that these actions, if successful, will provide the opportunity for us to maintain liquidity on a short and long term basis, thereby permitting us to meet our operating and financing obligations for the next 12 months. However, there is no guarantee that such actions will be successful or that anticipated operating results will be achieved. We currently have limited borrowing availability under our existing revolving credit facilities. If the Company is unable to improve operating results, expand existing borrowing agreements, refinance current debt (including $21.0 million of bullet maturities due February 2015), the subordinated convertible promissory notes due July 2015 and April 2015 are not converted into shares of common stock and are required to be repaid by us in cash, then the Company may be required to restructure its outstanding indebtedness, implement further cost reduction initiatives, sell assets, or delay or modify its strategic plan.

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NOTE 4. RESTRICTED CASH AND INVESTMENTS

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

(Amounts in 000's)	September 30, 2014	December 31, 2013
Defeased bonds escrow	$—	$3,138
HUD escrow deposits	168	91
Property tax escrow	19	84
Lender's collection account	734	488
Total current portion	921	3,801
HUD replacement reserves	1,010	383
Repair and remediation/replacement reserves	54	18
Reserves for capital improvements	1,036	1,481
Restricted investments for other debt obligations	5,673	9,724
Total noncurrent portion	7,773	11,606
Total restricted cash and investments	$8,694	$15,407

NOTE 5. PROPERTY AND EQUIPMENT

The following table sets forth the Company's property and equipment:

(Amounts in 000's)	Estimated Useful Lives (Years)	September 30, 2014	December 31, 2013
Buildings and improvements	5-40	$132,856	$131,123
Equipment	2-10	13,849	11,987
Land	—	6,808	6,788
Computer related	2-10	2,952	2,980
Construction in process	—	108	270
		156,573	153,148
Less: accumulated depreciation and amortization expense		20,001	14,915
Property and equipment, net		$136,572	$138,233

Depreciation and amortization expense was approximately $1.9 million and $5.7 million for the three and nine months ended September 30, 2014, respectively, and $1.8 million and $5.2 million for the three and nine months ended September 30, 2013, respectively. Total depreciation and amortization expense excludes $0.1 million and $0.2 million for the three and nine months ended September 30, 2014, respectively, and $0.1 million and $0.3 million for the three and nine months ended September 30, 2013, respectively, that is recognized in loss from discontinued operations, net of tax.

During December 2013, the Company recognized a $0.5 million impairment charge to write down the carrying value of certain lease rights, equipment, and leasehold improvement values of a facility located in Thomasville, Georgia. The impairment charge represents a change in fair value from the carrying value.

During the three and nine months ended September 30, 2014, the Company recorded an impairment of $0.05 million and $0.2 million, respectively, related to an adjustment to the fair value less the cost to sell the 102-bed nursing facility located in Tulsa, Oklahoma, known as Companions Specialized Care Center ("Companions"). We compared the estimated fair value of the assets to their carrying value and recorded an impairment charge for the excess of carrying value over estimated fair value. The assets and liabilities of Companions are included in Assets and Liabilities Held for Sale as of September 30, 2014 (see Note 10 - Discontinued Operations).

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NOTE 6. INTANGIBLE ASSETS AND GOODWILL

There have been no impairment adjustments to intangible assets and goodwill during the three and nine months ended September 30, 2014. Intangible assets consist of the following:

(Amounts in 000's)	Bed Licenses (included in property and equipment)	Bed Licenses - Separable	Lease Rights	Total
Balances, December 31, 2013				
Gross	$38,407	$2,471	$7,407	$48,285
Accumulated amortization	(2,620)	—	(2,518)	(5,138)
Net carrying amount	$35,787	$2,471	$4,889	$43,147
Reclass to held for sale	(1,530)	—	—	(1,530)
Accumulated amortization reclass to held for sale	68	—	—	68
Amortization expense	(924)	—	(635)	(1,559)
Balances, September 30, 2014				
Gross	36,877	2,471	7,407	46,755
	—	—	—	—
Accumulated amortization	(3,476)	—	(3,153)	(6,629)
Net carrying amount	$33,401	$2,471	$4,254	$40,126

Amortization expense for bed licenses included in property and equipment was approximately $0.3 million and $0.9 million for the three and nine months ended September 30, 2014, respectively, and $0.3 million and $0.9 million for the three and nine months ended 2013. Amortization expense for lease rights was approximately $0.2 million and $0.6 million for the three and nine months ended September 30, 2014, respectively, and $0.2 million and $0.7 million for the three and nine months ended September 30, 2013.

Expected amortization expense for all definite lived intangibles for each of the years ended December 31 is as follows:

(Amounts in 000's)	Bed Licenses	Lease Rights
2014 [a]	$308	$166
2015	1,232	667
2016	1,232	667
2017	1,232	667
2018	1,232	667
Thereafter	28,165	1,420
Total expected amortization expense	$33,401	$4,254

[a] Estimated amortization expense for the year ending December 31, 2014 includes only amortization to be recorded after September 30, 2014.

The following table summarizes the carrying amount of goodwill at September 30, 2014 compared to December 31, 2013:

(Amounts in 000's)	September 30, 2014	December 31, 2013
Beginning balances	$5,023	$5,023

Accumulated impairment losses	(799)	(799)
Ending balances	$4,224	