

HEALTHSOUTH CORP
Form 10-Q
July 27, 2012

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, DC 20549

FORM 10-Q

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

For the quarterly period ended June 30, 2012

OR

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

Commission File Number 001-10315

HealthSouth Corporation
(Exact name of Registrant as specified in its Charter)

Delaware 63-0860407
(State or Other Jurisdiction of (I.R.S. Employer
Incorporation or Organization) Identification No.)

3660 Grandview Parkway, Suite 200 35243
Birmingham, Alabama (Zip Code)
(Address of Principal Executive Offices)

(205) 967-7116
(Registrant's telephone number)

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

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 during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes ☑ No ○

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

Large accelerated filer ☑ Accelerated filer ○ Non-Accelerated filer ○ Smaller reporting company ○

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

The registrant had 95,661,302 shares of common stock outstanding, net of treasury shares, as of July 23, 2012.

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CAUTIONARY STATEMENT REGARDING FORWARD-LOOKING STATEMENTS

This quarterly report contains historical information, as well as forward-looking statements that involve known and unknown risks and relate to, among other things, future events, changes to Medicare reimbursement and other healthcare regulations from time to time, our business strategy, our financial plans, our future financial performance, our projected business results, or our projected capital expenditures. In some cases, you can identify forward-looking statements by terminology such as “may,” “will,” “should,” “expects,” “plans,” “anticipates,” “believes,” “estimates,” “predicts,” “potential,” or “continue” or the negative of these terms or other comparable terminology. Such forward-looking statements are necessarily estimates based upon current information and involve a number of risks and uncertainties, many of which are beyond our control. Any forward-looking statement is based on information current as of the date of this report and speaks only as of the date on which such statement is made. Actual events or results may differ materially from the results anticipated in these forward-looking statements as a result of a variety of factors. While it is impossible to identify all such factors, factors that could cause actual results to differ materially from those estimated by us include, but are not limited to, the following:

- each of the factors discussed in Item 1A, Risk Factors, of our Annual Report on Form 10-K for the year ended December 31, 2011 (the “2011 Form 10-K”);
- uncertainties and factors discussed elsewhere in this Form 10-Q, in our other filings from time to time with the SEC, or in materials incorporated therein by reference;
- changes in the regulations of the healthcare industry at either or both of the federal and state levels, including those contemplated now and in the future as part of national healthcare reform and deficit reduction, and related increases in the costs of complying with such changes;
- reductions or delays in, or suspension of, reimbursement for our services by governmental or private payors, including our ability to obtain and retain favorable arrangements with third-party payors;
- increased costs of regulatory compliance and compliance monitoring in the healthcare industry, including the costs of investigating and defending asserted claims, whether meritorious or not;
- our ability to attract and retain nurses, therapists, and other healthcare professionals in a highly competitive environment with often severe staffing shortages and the impact on our labor expenses from potential union activity and staffing recruitment and retention;
- competitive pressures in the healthcare industry and our response to those pressures;
- our ability to successfully complete and integrate de novo developments, acquisitions, investments, and joint ventures consistent with our growth strategy, including realization of anticipated revenues, cost savings, and productivity improvements arising from the related operations;
- any adverse outcome of various lawsuits, claims, and legal or regulatory proceedings involving us;
- increased costs of defending and insuring against alleged professional liability and other claims and the ability to predict the costs related to such claims;
- potential disruptions or incidents affecting the proper operation, availability, or security of our information systems;
- the price of our common stock as it affects our willingness and ability to repurchase shares under the program discussed further in Part I, Item 2, Management’s Discussion and Analysis of Financial Condition and Results of Operations, “Executive Overview,” of this Form 10-Q;
- our ability to attract and retain key management personnel; and
- general conditions in the economy and capital markets.

The cautionary statements referred to in this section also should be considered in connection with any subsequent written or oral forward-looking statements that may be issued by us or persons acting on our behalf. We undertake no duty to update these forward-looking statements, even though our situation may change in the future. Furthermore, we cannot guarantee future results, events, levels of activity, performance, or achievements.

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements (Unaudited)

HealthSouth Corporation and Subsidiaries

Condensed Consolidated Statements of Operations

(Unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2012	2011	2012	2011
	(In Millions, Except Per Share Data)			
Net operating revenues	\$533.4	\$505.1	\$1,072.0	\$1,011.1
Less: Provision for doubtful accounts	(6.5	) (5.0	) (12.8	) (9.8
Net operating revenues less provision for doubtful accounts	526.9	500.1	1,059.2	1,001.3
Operating expenses:				
Salaries and benefits	257.4	241.6	518.4	485.6
Other operating expenses	74.4	75.4	147.4	146.3
General and administrative expenses	28.0	27.4	58.0	54.3
Supplies	25.9	26.2	52.4	52.0
Depreciation and amortization	20.0	19.6	39.5	39.1
Occupancy costs	12.3	12.1	24.8	23.7
Loss on disposal of assets	0.6	1.0	1.4	1.1
Government, class action, and related settlements	—	(10.6	) —	(10.6
Professional fees—accounting, tax, and legal	5.5	8.4	9.1	12.2
Total operating expenses	424.1	401.1	851.0	803.7
Loss on early extinguishment of debt	—	26.1	—	26.1
Interest expense and amortization of debt discounts and fees	23.0	34.9	46.3	70.0
Other income	(0.4	) (0.7	) (1.3	) (1.3
Equity in net income of nonconsolidated affiliates	(3.1	) (3.2	) (6.4	) (5.7
Income from continuing operations before income tax expense	83.3	41.9	169.6	108.5
Provision for income tax expense	26.9	11.2	56.0	3.8
Income from continuing operations	56.4	30.7	113.6	104.7
Income from discontinued operations, net of tax	3.5	1.6	3.1	19.1
Net income	59.9	32.3	116.7	123.8
Less: Net income attributable to noncontrolling interests	(13.2	) (10.4	) (25.8	) (22.1
Net income attributable to HealthSouth	46.7	21.9	90.9	101.7
Less: Convertible perpetual preferred stock dividends	(6.0	) (6.5	) (12.4	) (13.0
Less: Repurchase of convertible perpetual preferred stock	(0.3	) —	(0.8) —
Net income attributable to HealthSouth common shareholders	\$40.4	\$15.4	\$77.7	\$88.7
Weighted average common shares outstanding:				
Basic	94.6	93.3	94.5	93.2
Diluted	108.0	109.5	108.3	109.3
Basic and diluted earnings per common share:				
Income from continuing operations attributable to HealthSouth common shareholders	\$0.39	\$0.14	\$0.79	\$0.74

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Income from discontinued operations, net of tax, attributable to HealthSouth common shareholders	0.04	0.03	0.03	0.21
Net income attributable to HealthSouth common shareholders	\$0.43	\$0.17	\$0.82	\$0.95
Amounts attributable to HealthSouth common shareholders:				
Income from continuing operations	\$43.2	\$19.4	\$87.8	\$81.6
Income from discontinued operations, net of tax	3.5	2.5	3.1	20.1
Net income attributable to HealthSouth	\$46.7	\$21.9	\$90.9	\$101.7

The accompanying notes to condensed consolidated financial statements are an integral part of these condensed statements.

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HealthSouth Corporation and Subsidiaries
 Condensed Consolidated Statements of Comprehensive Income
 (Unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2012	2011	2012	2011
	(In Millions)			
COMPREHENSIVE INCOME				
Net income	\$59.9	\$32.3	\$116.7	\$123.8
Other comprehensive income, net of tax:				
Net change in unrealized gain on available-for-sale securities:				
Unrealized net holding gain arising during the period	0.2	0.2	1.0	0.9
Reclassifications to net income	—	—	—	(0.5)
Other comprehensive income, net of tax	0.2	0.2	1.0	0.4
Comprehensive income	60.1	32.5	117.7	124.2
Less: Comprehensive income attributable to noncontrolling interests	(13.2)	(10.4)	(25.8)	(22.1)
Comprehensive income attributable to HealthSouth	\$46.9	\$22.1	\$91.9	\$102.1

The accompanying notes to condensed consolidated financial statements are an integral part of these condensed statements.

HealthSouth Corporation and Subsidiaries
Condensed Consolidated Balance Sheets
(Unaudited)

	June 30, 2012 (In Millions)	December 31, 2011
Assets		
Current assets:		
Cash and cash equivalents	\$41.1	\$30.1
Accounts receivable, net of allowance for doubtful accounts of \$24.6 in 2012; \$21.4 in 2011	245.7	222.8
Other current assets	137.7	138.1
Total current assets	424.5	391.0
Property and equipment, net	718.9	664.4
Goodwill	421.7	421.7
Intangible assets, net	69.0	57.7
Deferred income tax assets	552.8	608.1
Other long-term assets	128.8	128.3
Total assets	\$2,315.7	\$2,271.2
Liabilities and Shareholders' Equity		
Current liabilities:		
Accounts payable	\$59.6	\$45.4
Accrued expenses and other current liabilities	265.0	267.8
Total current liabilities	324.6	313.2
Long-term debt, net of current portion	1,219.4	1,235.8
Other long-term liabilities	135.8	133.2
	1,679.8	1,682.2
Commitments and contingencies		
Convertible perpetual preferred stock	342.2	387.4
Shareholders' equity:		
HealthSouth shareholders' equity	195.8	117.0
Noncontrolling interests	97.9	84.6
Total shareholders' equity	293.7	201.6
Total liabilities and shareholders' equity	\$2,315.7	\$2,271.2

The accompanying notes to condensed consolidated financial statements are an integral part of these condensed balance sheets.

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HealthSouth Corporation and Subsidiaries
 Condensed Consolidated Statements of Shareholders' Equity
 (Unaudited)

Six Months Ended June 30, 2012 (In Millions)									
HealthSouth Common Shareholders									
	Number of Common Shares Outstanding	Common Stock	Capital in Excess of Par Value	Accumulated Deficit	Accumulated Other Comprehensive (Loss) Income	Treasury Stock	Noncontrolling Interests	Total	Comprehensive Income
Balance at beginning of period	95.2	\$ 1.0	\$ 2,874.7	\$ (2,609.7)	\$ (0.2)	\$(148.8)	\$ 84.6	\$ 201.6	
Comprehensive income:									
Net income	—	—	—	90.9	—	—	25.8	116.7	\$ 116.7
Other comprehensive income, net of tax	—	—	—	—	1.0	—	—	1.0	1.0
Comprehensive income									\$ 117.7
Receipt of treasury stock	(0.7)	—	—	—	—	(11.9)	—	(11.9)	
Dividends declared on convertible perpetual preferred stock	—	—	(12.4)	—	—	—	—	(12.4)	
Stock-based compensation	—	—	12.0	—	—	—	—	12.0	
Distributions declared	—	—	—	—	—	—	(20.5)	(20.5)	
Capital contributions from consolidated affiliates	—	—	—	—	—	—	9.8	9.8	
Other	1.2	—	0.9	—	—	(1.7)	(1.8)	(2.6)	
Balance at end of period	95.7	\$ 1.0	\$ 2,875.2	\$ (2,518.8)	\$ 0.8	\$(162.4)	\$ 97.9	\$ 293.7	

Six Months Ended June 30, 2011
(In Millions)

HealthSouth Common Shareholders

	Number of Common Shares Outstanding	Common Stock	Capital in Excess of Par Value	Accumulated Deficit	Accumulated Other Comprehensive Income	Treasury Stock	Noncontrolling Interests	Total	Comprehensive Income
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Balance at beginning of period	93.4	\$ 1.0	\$2,873.5	\$ (2,818.4)	\$ 0.5	\$(141.8)	\$ 83.0	\$(2.2)	
Comprehensive income:									
Net income	—	—	—	101.7	—	—	22.1	123.8	\$ 123.8
Other comprehensive income, net of tax	—	—	—	—	0.4	—	—	0.4	0.4
Comprehensive income									\$ 124.2
Receipt of treasury stock	(0.2)	—	—	—	—	(4.3)	—	(4.3)	
Dividends declared on convertible perpetual preferred stock	—	—	(13.0)	—	—	—	—	(13.0)	
Stock-based compensation	—	—	9.5	—	—	—	—	9.5	
Stock options exercised	0.2	—	4.4	—	—	—	—	4.4	
Distributions declared	—	—	—	—	—	—	(20.2)	(20.2)	
Other	1.9	—	1.7	—	—	(1.7)	(1.8)	(1.8)	
Balance at end of period	95.3	\$ 1.0	\$2,876.1	\$ (2,716.7)	\$ 0.9	\$(147.8)	\$ 83.1	\$96.6	

The accompanying notes to condensed consolidated financial statements are an integral part of these condensed statements.

HealthSouth Corporation and Subsidiaries
Condensed Consolidated Statements of Cash Flows
(Unaudited)

	Six Months Ended June 30,	
	2012	2011
	(In Millions)	
Cash flows from operating activities:		
Net income	\$116.7	\$123.8
Income from discontinued operations	(3.1	) (19.1
Adjustments to reconcile net income to net cash provided by operating activities—)
Provision for doubtful accounts	12.8	9.8
Provision for government, class action, and related settlements	—	(10.6
Depreciation and amortization	39.5	39.1
Loss on early extinguishment of debt	—	26.1
Equity in net income of nonconsolidated affiliates	(6.4	) (5.7
Distributions from nonconsolidated affiliates	5.5	5.5
Stock-based compensation	12.0	9.5
Deferred tax expense	51.7	5.2
Other	3.0	3.0
Increase in assets—		
Accounts receivable	(35.7	) (15.9
Other assets	(7.0	) (12.3
Increase (decrease) in liabilities—		
Accounts payable	10.3	0.8
Accrued payroll	(15.8	) 4.3
Other liabilities	5.5	11.5
Premium on bond issuance	—	4.1
Premium paid on redemption of bonds	—	(18.0
Refunds due patients and other third-party payors	4.3	(16.7
Government, class action, and related settlements	—	6.5
Net cash provided by operating activities of discontinued operations	1.7	7.2
Total adjustments	81.4	53.4
Net cash provided by operating activities	195.0	158.1

(Continued)

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HealthSouth Corporation and Subsidiaries
Condensed Consolidated Statements of Cash Flows (Continued)
(Unaudited)

	Six Months Ended June 30,		
	2012	2011	
	(In Millions)		
Cash flows from investing activities:			
Purchases of property and equipment	(82.8	) (31.7)
Capitalized software costs	(11.6	) (3.8)
Purchase of restricted investments	(4.4	) (7.9)
Net change in restricted cash	4.6	5.3	
Net settlements on interest rate swaps	—	(10.9)
Other	(1.8	) 0.1	
Net cash provided by (used in) investing activities of discontinued operations	7.7	(0.3)
Net cash used in investing activities	(88.3	) (49.2)
Cash flows from financing activities:			
Principal borrowings on term loan	—	100.0	
Proceeds from bond issuance	—	120.0	
Principal payments on debt, including pre-payments	(4.7	) (335.9)
Borrowings on revolving credit facility	40.0	190.0	
Payments on revolving credit facility	(50.0	) (128.0)
Principal payments under capital lease obligations	(5.7	) (6.8)
Repurchase of convertible perpetual preferred stock	(46.0) —	
Debt issue costs	—	(4.2)
Dividends paid on convertible perpetual preferred stock	(13.1	) (13.0)
Distributions paid to noncontrolling interests of consolidated affiliates	(24.0	) (23.3)
Contributions from consolidated affiliates	7.9	—	
Other	—	4.2	
Net cash used in financing activities	(95.6	) (97.0)
Increase in cash and cash equivalents	11.1	11.9	
Cash and cash equivalents at beginning of period	30.1	48.3	
Cash and cash equivalents of facilities in discontinued operations at beginning of period	—	0.1	
Less: Cash and cash equivalents of facilities in discontinued operations at end of period	(0.1) —	
Cash and cash equivalents at end of period	\$41.1	\$60.3	

The accompanying notes to condensed consolidated financial statements are an integral part of these condensed statements.

HealthSouth Corporation and Subsidiaries
Notes to Condensed Consolidated Financial Statements

1. Basis of Presentation

HealthSouth Corporation, incorporated in Delaware in 1984, including its subsidiaries, is the largest owner and operator of inpatient rehabilitation hospitals in the United States. We operate inpatient rehabilitation hospitals and provide specialized rehabilitative treatment on both an inpatient and outpatient basis. References herein to "HealthSouth," the "Company," "we," "our," or "us" refer to HealthSouth Corporation and its subsidiaries unless otherwise stated or indicated by context.

The accompanying unaudited condensed consolidated financial statements of HealthSouth Corporation and Subsidiaries should be read in conjunction with the consolidated financial statements and accompanying notes filed with the United States Securities and Exchange Commission in HealthSouth's Annual Report on Form 10-K filed on February 23, 2012 (the "2011 Form 10-K"). The unaudited condensed consolidated financial statements have been prepared in accordance with the rules and regulations of the SEC applicable to interim financial information. Certain information and note disclosures included in financial statements prepared in accordance with generally accepted accounting principles in the United States of America have been omitted in these interim statements, as allowed by such SEC rules and regulations. The condensed consolidated balance sheet as of December 31, 2011 has been derived from audited financial statements, but it does not include all disclosures required by GAAP. However, we believe the disclosures are adequate to make the information presented not misleading.

The unaudited results of operations for the interim periods shown in these financial statements are not necessarily indicative of operating results for the entire year. In our opinion, the accompanying condensed consolidated financial statements recognize all adjustments of a normal recurring nature considered necessary to fairly state the financial position, results of operations, and cash flows for each interim period presented.

Reclassifications—

Effective January 1, 2012, we adopted Accounting Standards Update 2011-07, Healthcare Entities (Topic 954), "Presentation and Disclosure of Patient Service Revenue, Provision for Bad Debts, and the Allowance for Doubtful Accounts for Certain Healthcare Entities," which requires certain healthcare entities to present the provision for doubtful accounts relating to patient service revenue as a deduction from patient service revenue in the statement of operations rather than as an operating expense. All periods presented have been reclassified to conform to this presentation. Our adoption of this standard had no net impact on our financial position, results of operations, or cash flows.

This standard also requires healthcare entities to provide enhanced disclosure about their policies for recognizing revenue and assessing bad debts, as well as qualitative and quantitative information about changes in the allowance for doubtful accounts. See the "Net Operating Revenues" and "Allowance for Doubtful Accounts" sections of this note.

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HealthSouth Corporation and Subsidiaries
Notes to Condensed Consolidated Financial Statements

Net Operating Revenues—

During the three and six months ended June 30, 2012 and 2011, we derived consolidated Net operating revenues from the following payor sources:

	Three Months Ended June 30,		Six Months Ended June 30,		
	2012	2011	2012	2011	
Medicare	72.9	% 72.0	% 73.3	% 71.7	%
Medicaid	1.3	% 1.8	% 1.2	% 1.7	%
Workers' compensation	1.5	% 1.7	% 1.5	% 1.7	%
Managed care and other discount plans	19.6	% 19.8	% 19.5	% 19.8	%
Other third-party payors	1.8	% 2.0	% 1.7	% 2.1	%
Patients	1.3	% 1.1	% 1.3	% 1.1	%
Other income	1.6	% 1.6	% 1.5	% 1.9	%
Total	100.0	% 100.0	% 100.0	% 100.0	%

We recognize net patient service revenues in the reporting period in which we perform the service based on our current billing rates (i.e., gross charges), less actual adjustments and estimated discounts for contractual allowances (principally for patients covered by Medicare, Medicaid, and managed care and other health plans). We record gross service charges in our accounting records on an accrual basis using our established rates for the type of service provided to the patient. We recognize an estimated contractual allowance to reduce gross patient charges to the amount we estimate we will actually realize for the service rendered based upon previously agreed to rates with a payor. Our patient accounting system calculates contractual allowances on a patient-by-patient basis based on the rates in effect for each primary third-party payor. Other factors that are considered and could further influence the level of our reserves include the patient's total length of stay for in-house patients, each patient's discharge destination, the proportion of patients with secondary insurance coverage and the level of reimbursement under that secondary coverage, and the amount of charges that will be disallowed by payors. Such additional factors are assumed to remain consistent with the experience for patients discharged in similar time periods for the same payor classes, and additional reserves are provided to account for these factors. Payors include federal and state agencies, including Medicare and Medicaid, managed care health plans, commercial insurance companies, employers, and patients. Management continually reviews the contractual estimation process to consider and incorporate updates to laws and regulations and the frequent changes in managed care contractual terms that result from contract renegotiations and renewals. Due to complexities involved in determining amounts ultimately due under reimbursement arrangements with third-party payors, which are often subject to interpretation, we may receive reimbursement for healthcare services authorized and provided that is different from our estimates, and such differences could be material. In addition, laws and regulations governing the Medicare and Medicaid programs are complex, subject to interpretation, and are routinely modified for provider reimbursement. All healthcare providers participating in the Medicare and Medicaid programs are required to meet certain financial reporting requirements. Federal regulations require submission of annual cost reports covering medical costs and expenses associated with the services provided by each hospital to program beneficiaries. Annual cost reports required under the Medicare and Medicaid programs are subject to routine audits, which may result in adjustments to the amounts ultimately determined to be due to HealthSouth under these reimbursement programs. These audits often require several years to reach the final determination of amounts earned under the programs. If actual results are not consistent with our assumptions and judgments, we may be exposed to gains or losses that could be material.

The Centers for Medicare and Medicaid Services ("CMS") has been granted authority to suspend payments, in whole or in part, to Medicare providers if CMS possesses reliable information an overpayment, fraud, or willful misrepresentation exists. If CMS suspects payments are being made as the result of fraud or misrepresentation, CMS may suspend payment at any time without providing prior notice to us. The initial suspension period is limited to 180 days. However, the payment suspension period can be extended almost indefinitely if the matter is under investigation by the United States Department of Health and Human Services Office of Inspector General (the "HHS-OIG") or the

United States Department of Justice. Therefore, we are unable to predict if or when we may be subject to a suspension of payments by the Medicare and/or Medicaid

HealthSouth Corporation and Subsidiaries
Notes to Condensed Consolidated Financial Statements

programs, the possible length of the suspension period, or the potential cash flow impact of a payment suspension. Any such suspension would adversely impact our financial position, results of operations, and cash flows.

We provide care to patients who are financially unable to pay for the healthcare services they receive, and because we do not pursue collection of amounts determined to qualify as charity care, such amounts are not recorded as revenues.

Allowance for Doubtful Accounts—

We provide for accounts receivable that could become uncollectible by establishing an allowance to reduce the carrying value of such receivables to their estimated net realizable value. Additions to the allowance for doubtful accounts are made by means of the Provision for doubtful accounts. We write off uncollectible accounts (after exhausting collection efforts) against the allowance for doubtful accounts. Subsequent recoveries are recorded via the Provision for doubtful accounts.

The collection of outstanding receivables from Medicare, managed care payors, other third-party payors, and patients is our primary source of cash and is critical to our operating performance. While it is our policy to verify insurance prior to a patient being admitted, there are various exceptions that can occur. Such exceptions include instances where we are (1) unable to obtain verification because the patient's insurance company was unable to be reached or contacted, (2) a determination is made that a patient may be eligible for benefits under various government programs, such as Medicaid, and it takes several days, weeks, or months before qualification for such benefits is confirmed or denied, and (3) the patient is transferred to our hospital from an acute care hospital without having access to a credit card, cash, or check to pay the applicable patient responsibility amounts (i.e., deductibles and co-payments). Based on our historical collection trends, our primary collection risks relate to patient accounts for which the patient was the primary payor or the primary insurance carrier has paid the amounts covered by the applicable agreement, but patient responsibility amounts remain outstanding. Changes in the economy, such as increased unemployment rates or periods of recession, can further exacerbate our ability to collect patient responsibility amounts.

We estimate our allowance for doubtful accounts based on the aging of our accounts receivable, our historical collection experience for each type of payor, and other relevant factors so that the remaining receivables, net of allowances, are reflected at their estimated net realizable values. Accounts requiring collection efforts are reviewed via system-generated work queues that automatically stage (based on age and size of outstanding balance) accounts requiring collection efforts for patient account representatives. Collection efforts include contacting the applicable party (both in writing and by telephone), providing information (both financial and clinical) to allow for payment or to overturn payor decisions to deny payment, and arranging payment plans with self-pay patients, among other techniques. When we determine all in-house efforts have been exhausted or it is a more prudent use of resources, accounts may be turned over to a collection agency. Accounts are written off after all collection efforts (internal and external) have been exhausted.

We have experienced denials of certain diagnosis codes by Medicare contractors based on medical necessity. We dispute, or "appeal," most of these denials, and we have historically collected approximately 58% of all amounts denied. The resolution of these disputes can take in excess of one year, and we cannot provide assurance as to our ongoing and future success of these disputes. As such, we make provisions against these receivables in accordance with our accounting policy that necessarily considers the age and historical collection trends of the receivables in this review process as part of our Provision for doubtful accounts. Because we do not write-off receivables until all collection efforts have been exhausted, we do not write-off receivables related to denied claims while they are in this review process. When the amount collected related to denied claims differs from the net amount previously recorded, these collection differences are recorded in the Provision for doubtful accounts. As a result, the timing of these denials by Medicare contractors and their subsequent collection can create volatility in our Provision for doubtful accounts. If actual results are not consistent with our assumptions and judgments, we may be exposed to gains or losses that could be material. Changes in general economic conditions, business office operations, payor mix, or trends in federal or state governmental and private employer healthcare coverage could affect our collection of accounts receivable, financial position, results of operations, and cash flows.

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Share-Based Payments—

In February and May 2012, we issued 0.9 million and 0.2 million, respectively, of restricted stock awards to members of our management team and our board of directors. Approximately 0.6 million of these awards contain only a service condition, while the remainder contain both a service and a performance condition. For the awards that include a performance condition, the number of shares that will ultimately be granted to employees may vary based on the Company's performance during the applicable two-year performance measurement period. Additionally, in February 2012, we granted 0.2 million stock options to members of our management team. The fair value of these awards and options was determined using the policies described in Note 1, Summary of Significant Accounting Policies, and Note 16, Share-Based Payments, to the consolidated financial statements accompanying the 2011 Form 10-K.

We use the with-and-without method to determine when we will recognize excess tax benefits from stock-based compensation. Under this method, we recognize these excess tax benefits only after we fully realize the tax benefits of net operating losses. See Note 6, Income Taxes.

Recent Accounting Pronouncements—

In May 2011, the Financial Accounting Standards Board amended its guidance to clarify its intent about the application of existing fair value measurement and disclosure requirements. The primary impact to us resulted from additional disclosure requirements included in the amended guidance, including the requirements to categorize by level of the fair value hierarchy items not measured at fair value in our balance sheet but for which fair value is required to be disclosed. We adopted this guidance as of January 1, 2012. Our adoption of this standard primarily impacted our fair value disclosures related to our long-term debt and had no impact on our financial position, results of operations, or cash flows. See Note 5, Fair Value Measurements.

See also the "Reclassifications" section of this note.

Since the filing of the 2011 Form 10-K, we do not believe any other recently issued, but not yet effective, accounting standards will have a material effect on our consolidated financial position, results of operations, or cash flows.

2. Investments in and Advances to Nonconsolidated Affiliates

As of June 30, 2012 and December 31, 2011, we had \$29.5 million and \$29.0 million, respectively, of investments in and advances to nonconsolidated affiliates included in Other long-term assets in our condensed consolidated balance sheets. Investments in and advances to nonconsolidated affiliates represent our investments in 13 partially owned subsidiaries, of which 9 are general or limited partnerships, limited liability companies, or joint ventures in which HealthSouth or one of its subsidiaries is a general or limited partner, managing member, member, or venturer, as applicable. We do not control these affiliates but have the ability to exercise significant influence over the operating and financial policies of certain of these affiliates. Our ownership percentages in these affiliates range from approximately 1% to 51%. We account for these investments using the cost and equity methods of accounting.

The following summarizes the combined results of operations of our equity method affiliates (on a 100% basis, in millions):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2012	2011	2012	2011
Net operating revenues	\$22.6	\$21.2	\$45.6	\$41.6
Operating expenses	(13.8)	(12.7)	(27.9)	(25.8)
Income from continuing operations, net of tax	6.9	7.0	14.4	12.6
Net income	6.9	7.0	14.4	12.6

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3. Convertible Perpetual Preferred Stock

The following is a summary of the activity related to our Convertible perpetual preferred stock from December 31, 2011 to June 30, 2012 (in millions, except share data):

	Number of Shares Outstanding	Amount
Balance as of December 31, 2011	400,000	\$387.4
Repurchase of preferred stock	(46,645	) (45.2
Balance as of June 30, 2012	353,355	\$342.2

During the three and six months ended June 30, 2012, we repurchased 21,645 shares and 46,645 shares, respectively, of our 6.50% Series A Convertible Perpetual Preferred Stock for total cash consideration of \$21.5 million and \$46.5 million, respectively, including fees. No common stock was issued as part of these transactions. The allocation of the purchase price is as follows (in millions):

	Three Months Ended June 30, 2012	Six Months Ended June 30, 2012
Carrying value of shares repurchased	\$21.0	\$45.2
Cumulative dividends paid as part of purchase price	0.2	0.5
Excess paid in transaction	0.3	0.8
	\$21.5	\$46.5

The difference between the fair value of the consideration paid to the holders of the preferred stock, or \$21.5 million and \$46.5 million, and the carrying value of the preferred stock in our balance sheet, or \$21.0 million and \$45.2 million, resulted in a charge of \$0.5 million and \$1.3 million to Capital in excess of par value that was treated like a dividend and subtracted from Net income to arrive at Net income attributable to HealthSouth common shareholders in our condensed consolidated statements of operations for the three and six months ended June 30, 2012, respectively. Of these amounts, \$0.2 million and \$0.5 million, respectively, represent cumulative dividends through the date of the repurchase transactions.

As of June 30, 2012 and December 31, 2011, accrued dividends of \$5.7 million and \$6.5 million, respectively, were included in Accrued expenses and other current liabilities in our condensed consolidated balance sheets. These accrued dividends were paid in July 2012 and January 2012, respectively.

See Note 11, Convertible Perpetual Preferred Stock, to the financial statements accompanying the 2011 Form 10-K.

4. Guarantees

Primarily in conjunction with the sale of certain facilities, including the sale of our surgery centers, outpatient, and diagnostic divisions during 2007, HealthSouth assigned, or remained as a guarantor on, the leases of certain properties to certain purchasers and, as a condition of the lease, agreed to act as a guarantor of the purchaser's performance on the lease. In addition, HealthSouth guarantees one real estate lease for a joint venture entity which it accounts for using the equity method of accounting. Should the purchaser fail to pay the obligations due on these leases, the lessor would have contractual recourse against us.

As of June 30, 2012, we were secondarily liable for 14 such guarantees. The remaining terms of these guarantees ranged from one month to 84 months. If we were required to perform under all such guarantees, the maximum amount we would be required to pay approximated \$20.5 million.

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We have not recorded a liability for these guarantees, as we do not believe it is probable we will have to perform under these agreements. If we are required to perform under these guarantees, we could potentially have recourse against the purchaser or lessee for recovery of any amounts paid. In addition, the purchasers of our surgery centers, outpatient, and diagnostic divisions have agreed to seek releases from the lessors in favor of HealthSouth with respect to the guarantee obligations associated with these divestitures. To the extent the purchasers of these divisions are unable to obtain releases for HealthSouth, the purchasers remain obligated under the terms of the applicable purchase agreements to indemnify HealthSouth for damages incurred under the guarantee obligations, if any. These guarantees are not secured by any assets under the agreements.

5. Fair Value Measurements

Our financial assets and liabilities that are measured at fair value on a recurring basis are as follows (in millions):

As of June 30, 2012	Fair Value	Fair Value Measurements at Reporting Date Using			
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Valuation Technique ⁽¹⁾
Other current assets:					
Current portion of restricted marketable securities	\$21.2	\$—	\$21.2	\$—	M
Other long-term assets:					
Restricted marketable securities	29.3	—	29.3	—	M
As of December 31, 2011					
Other current assets:					
Current portion of restricted marketable securities	\$15.0	\$—	\$15.0	\$—	M
Other long-term assets:					
Restricted marketable securities	30.2	—	30.2	—	M

(1) The three valuation techniques are: market approach (M), cost approach (C), and income approach (I).

In addition to assets and liabilities recorded at fair value on a recurring basis, we are also required to record assets and liabilities at fair value on a nonrecurring basis. Generally, assets are recorded at fair value on a nonrecurring basis as a result of impairment charges or similar adjustments made to the carrying value of the applicable assets.

During the three and six months ended June 30, 2012 and 2011, we did not record any gains or losses related to our nonfinancial assets and liabilities that are recognized or disclosed at fair value in the financial statements on a nonrecurring basis as part of our continuing operations. During the six months ended June 30, 2011, we recorded an impairment charge of \$1.3 million as part of our results of discontinued operations. This charge related to a hospital that was closed in 2008. We determined the fair value of the impaired long-lived assets at the hospital primarily based on the assets' estimated fair value using valuation techniques that included third-party appraisals and offers from potential buyers.

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As discussed in Note 1, Summary of Significant Accounting Policies, to the consolidated financial statements accompanying the 2011 Form 10-K, the carrying value equals fair value for our financial instruments that are not included in the table below and are classified as current in our condensed consolidated balance sheets. The carrying amounts and estimated fair values for all of our other financial instruments are presented in the following table (in millions):

	As of June 30, 2012		As of December 31, 2011	
	Carrying Amount	Estimated Fair Value	Carrying Amount	Estimated Fair Value
Long-term debt:				
Advances under \$500 million revolving credit facility	\$ 100.0	\$ 100.0	\$ 110.0	\$ 110.0
Term Loan Facility	95.0	95.0	97.5	97.5
7.25% Senior Notes due 2018	336.6	355.9	336.7	330.0
8.125% Senior Notes due 2020	286.0	316.8	285.8	290.0
7.75% Senior Notes due 2022	311.9	331.7	312.0	301.1
Other bonds payable	—	—	1.5	1.5
Other notes payable	38.9	38.9	35.3	35.3
Financial commitments:				
Letters of credit	—	44.4	—	44.6

Fair values for our long-term debt and financial commitments are determined using inputs, including quoted prices in non-active markets, that are observable either directly or indirectly, or Level 2 inputs within the fair value hierarchy. See Note 1, Summary of Significant Accounting Policies, "Fair Value Measurements," to the consolidated financial statements accompanying the 2011 Form 10-K.

6. Income Taxes

Our Provision for income tax expense of \$26.9 million and \$56.0 million for the three and six months ended June 30, 2012, respectively, primarily resulted from the application of our estimated effective blended federal and state income tax rate of approximately 39% to our pre-tax income from continuing operations attributable to HealthSouth.

We have significant federal and state net operating loss carryforwards ("NOLs") that expire in various amounts at varying times through 2031. Our utilization of our federal NOL could be subject to limitations under Internal Revenue Code Section 382 ("Section 382") and may be limited in the event of certain cumulative changes in ownership interests of significant stockholders over a three-year period in excess of 50%. Section 382 imposes an annual limitation on the use of these losses to an amount equal to the value of a company at the time of an ownership change multiplied by the long-term tax exempt rate. At this time, we do not believe these limitations will restrict our ability to use our federal NOL before it expires. However, no such assurances can be provided.

The \$579.3 million of net deferred tax assets included in the accompanying condensed consolidated balance sheet as of June 30, 2012 (\$26.5 million included in Other current assets) reflects management's assessment it is more likely than not we will be able to generate sufficient future taxable income to utilize those deferred tax assets based on our current estimates and assumptions. As of June 30, 2012, we maintained a valuation allowance of approximately \$50.0 million due to uncertainties related to our ability to utilize a portion of our deferred tax assets, primarily related to state NOLs, before they expire. The amount of the valuation allowance has been determined for each tax jurisdiction based on the weight of all available evidence including management's estimates of taxable income for each jurisdiction in which we operate over the periods in which the related deferred tax assets will be recoverable. It is possible we may be required to increase or decrease our valuation allowance at some future time if our forecast of future earnings varies from actual results on a consolidated basis or in the applicable state tax jurisdictions, or if the timing of future tax deductions differs from our expectations.

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Our NOLs exclude approximately \$8.3 million related to operating loss carryforwards resulting from excess tax benefits related to share-based awards, the tax benefits of which, when recognized, will be accounted for as a credit to Capital in excess of par value in the period they reduce taxes payable.

Our Provision for income tax expense of \$11.2 million for the three months ended June 30, 2011 included the following: (1) estimated income tax expense of approximately \$12 million based on the application of our estimated effective blended federal and state income tax rate of approximately 39% to our pre-tax income from continuing operations attributable to HealthSouth offset by (2) a reduction in unrecognized tax benefits due to settlements with state taxing authorities.

Our Provision for income tax expense of \$3.8 million for the six months ended June 30, 2011 included the following: (1) estimated income tax expense of approximately \$33 million based on the application of our estimated effective blended federal and state income tax rate of approximately 39% to our pre-tax income from continuing operations attributable to HealthSouth offset by (2) the settlement of federal income tax claims with the Internal Revenue Service for tax years 2007 and 2008 which resulted in an income tax benefit of approximately \$24 million and (3) other items, primarily related to a reduction in unrecognized tax benefits due to the lapse of the applicable statute of limitations for certain federal and state claims, which resulted in a tax benefit of approximately \$5 million. We recognize the financial statement effects of uncertain tax positions when it is more likely than not, based on the technical merits, a position will be sustained upon examination by and resolution with the taxing authorities. Total remaining gross unrecognized tax benefits were \$79.5 million and \$6.0 million as of June 30, 2012 and December 31, 2011, respectively, all of which would affect our effective tax rate if recognized. The amount of gross unrecognized tax benefits changed during the three and six months ended June 30, 2012 based on ongoing discussions with taxing authorities as part of our continued pursuit of the maximization of our tax benefits, primarily related to our federal NOL, as discussed below. Total accrued interest expense related to unrecognized tax benefits as of June 30, 2012 and December 31, 2011 was \$0.1 million.

A reconciliation of the beginning and ending liability for unrecognized tax benefits is as follows (in millions):

	Gross Unrecognized Income Tax Benefits	Accrued Interest and Penalties
Balance at December 31, 2011	\$6.0	\$0.1
Gross amount of increases in unrecognized tax benefits related to prior periods	74.1	—
Decreases in unrecognized tax benefits relating to settlements with taxing authorities	(0.6) —
Balance at June 30, 2012	\$79.5	\$0.1

Our continuing practice is to recognize interest and/or penalties related to income tax matters in income tax expense. Net interest income recorded as part of our income tax provision during the three and six months ended June 30, 2012 and 2011 was not material. Accrued interest income related to income taxes as of June 30, 2012 and December 31, 2011 was not material.

HealthSouth and its subsidiaries' federal and state income tax returns are periodically examined by various regulatory taxing authorities. In connection with such examinations, we have settled federal income tax examinations with the IRS for all tax years through 2008. We are currently under audit by the IRS for the 2009 and 2010 tax years and by one state for tax years 2008 through 2010.

For the tax years that remain open under the applicable statutes of limitations, amounts related to unrecognized tax benefits have been considered by management in its estimate of our potential net recovery of prior years' income taxes. It is reasonably possible a decrease in our unrecognized tax benefits of approximately \$0.5 million will occur within the next 12 months due to the closing of the applicable statutes of limitations.

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In addition, we continue to actively pursue, through ongoing discussions with taxing authorities, the maximization of our income tax benefits, primarily related to our federal NOL. As part of our pursuit of these benefits, we requested a pre-filing agreement with the IRS, the primary purpose of which was to consider whether certain amounts related to the restatement of our financial statements for periods prior to 2003 result in net increases to our federal NOL and adjustments to other tax attributes. The pre-filing agreement program permits taxpayers to resolve certain tax issues in advance of filing their corporate income tax returns. Due to the unique nature of our claims and uncertainties around this process, we did not recognize any amounts associated with our request as of June 30, 2012. In July 2012, the IRS granted our request to utilize the pre-filing agreement process. Depending upon the process undertaken by the IRS to audit and settle these matters, the accounting recognition criteria for these positions could be met either in part or in total as the process continues or upon completion of the process. Therefore, as we continue this process with the IRS, it is reasonably possible that over the next twelve-month period we may experience an increase or decrease to our unrecognized tax benefits, our NOLs, other tax attributes, or any combination thereof that could have a material net favorable impact on income tax expense and our effective income tax rate. Due to the aforementioned uncertainties regarding the outcome of this process, it is not possible to determine the range of any impact at this time.

7. Earnings per Common Share

The calculation of earnings per common share is based on the weighted-average number of our common shares outstanding during the applicable period. The calculation for diluted earnings per common share recognizes the effect of all dilutive potential common shares that were outstanding during the respective periods, unless their impact would be antidilutive. The following table sets forth the computation of basic and diluted earnings per common share (in millions, except per share amounts):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2012	2011	2012	2011
Numerator:				
Income from continuing operations	\$56.4	\$30.7	\$113.6	\$104.7
Less: Net income attributable to noncontrolling interests included in continuing operations	(13.2)	(11.3)	(25.8)	(23.1)
Less: Convertible perpetual preferred stock dividends	(6.0)	(6.5)	(12.4)	(13.0)
Less: Repurchase of convertible perpetual preferred stock	(0.3)	—	(0.8)	—
Income from continuing operations attributable to HealthSouth common shareholders	36.9	12.9	74.6	68.6
Income from discontinued operations, net of tax, attributable to HealthSouth common shareholders	3.5	2.5	3.1	20.1
Net income attributable to HealthSouth common shareholders	\$40.4	\$15.4	\$77.7	\$88.7
Denominator:				
Basic weighted average common shares outstanding	94.6	93.3	94.5	93.2
Diluted weighted average common shares outstanding	108.0	109.5	108.3	109.3
Basic and diluted earnings per common share:				
Income from continuing operations attributable to HealthSouth common shareholders	\$0.39	\$0.14	\$0.79	\$0.74
Income from discontinued operations, net of tax, attributable to HealthSouth common shareholders	0.04	0.03	0.03	0.21
Net income attributable to HealthSouth common shareholders	\$0.43	\$0.17	\$0.82	\$0.95

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Diluted earnings per share report the potential dilution that could occur if securities or other contracts to issue common stock were exercised or converted into common stock. These potential shares include dilutive stock options, restricted stock awards, restricted stock units, and convertible perpetual preferred stock. For the three and six months ended June 30, 2012, the number of potential shares approximated 13.4 million and 13.8 million, respectively. For the three and six months ended June 30, 2011, the number of potential shares approximated 16.2 million and 16.1 million, respectively. For the three and six months ended June 30, 2012, approximately 12.0 million and 12.5 million of the potential shares, respectively, related to our Convertible perpetual preferred stock. For the three and six months ended June 30, 2011, approximately 13.1 million of the potential shares related to our Convertible perpetual preferred stock. For the three and six months ended June 30, 2012 and 2011, adding back the dividends for the Convertible perpetual preferred stock to our Income from continuing operations attributable to HealthSouth common shareholders causes a per share increase when calculating diluted earnings per common share resulting in an anti-dilutive per share amount. Therefore, basic and diluted earnings per common share are the same for all periods presented.

Options to purchase approximately 1.8 million and 1.1 million shares of common stock were outstanding as of June 30, 2012 and 2011, respectively, but were not included in the computation of diluted weighted-average shares because to do so would have been antidilutive.

See Note 3, Convertible Perpetual Preferred Stock, to these financial statements and Note 11, Convertible Perpetual Preferred Stock, and Note 20, Earnings per Common Share, to the consolidated financial statements accompanying the 2011 Form 10-K for additional information related to common stock, common stock warrants, and convertible perpetual preferred stock.

8. Contingencies

We operate in a highly regulated and litigious industry. As a result, various lawsuits, claims, and legal and regulatory proceedings have been and can be expected to be instituted or asserted against us. The resolution of any such lawsuits, claims, or legal and regulatory proceedings could materially and adversely affect our financial position, results of operations, and cash flows in a given period.

Derivative Litigation—

All lawsuits purporting to be derivative complaints filed in the Circuit Court of Jefferson County, Alabama since 2002 have been consolidated and stayed in favor of the first-filed action captioned Tucker v. Scrushy and filed August 28, 2002. Derivative lawsuits in other jurisdictions have been stayed. The Tucker complaint asserted claims on our behalf against, among others, a number of our former officers and directors and Ernst & Young LLP, our former auditor. When originally filed, the primary allegations in the Tucker case involved self-dealing by Richard M. Scrushy, our former chairman and chief executive officer, and other insiders through transactions with various entities allegedly controlled by Mr. Scrushy. The complaint was amended four times to add additional defendants and include claims of accounting fraud, improper Medicare billing practices, and additional self-dealing transactions. The Tucker derivative litigation, including a \$2.9 billion judgment against Mr. Scrushy, and the related settlements to date are more fully described in “Litigation By and Against Richard M. Scrushy” and “Litigation By and Against Former Independent Auditor” below and in Note 21, Settlements, “UBS Litigation Settlement,” and Note 22, Contingencies and Other Commitments, to the consolidated financial statements accompanying the 2011 Form 10-K.

Litigation By and Against Richard M. Scrushy—

On December 9, 2005, Mr. Scrushy filed a complaint in the Circuit Court of Jefferson County, Alabama, captioned Scrushy v. HealthSouth. The complaint alleged that, as a result of Mr. Scrushy’s removal from the position of chief executive officer in March 2003, we owed him “in excess of \$70 million” pursuant to an employment agreement dated as of September 17, 2002. On December 28, 2005, we counterclaimed against Mr. Scrushy, asserting claims for breaches of fiduciary duty and fraud arising out of Mr. Scrushy’s tenure with us, and seeking compensatory damages, punitive damages, and disgorgement of wrongfully obtained benefits. We also asserted that any employment agreements with Mr. Scrushy should be void and unenforceable. On July 7, 2009, we filed a motion for summary judgment on all claims by Mr. Scrushy based upon the Tucker court’s June 18, 2009 ruling that Mr. Scrushy’s employment agreements are void and rescinded.

On June 18, 2009, the Circuit Court of Jefferson County, Alabama ruled on our derivative claims against Mr. Scrushy presented during a non-jury trial held May 11 to May 26, 2009. The court held Mr. Scrushy responsible for fraud and breach of

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fiduciary duties and awarded us \$2.9 billion in damages. On July 24, 2009, Mr. Scrushy filed a notice of appeal of the trial court's decision, and the parties subsequently submitted their briefs to the Supreme Court of Alabama. On January 28, 2011, the Supreme Court upheld the trial court's decision in its entirety. On April 15, 2011, the Alabama Supreme Court denied Mr. Scrushy's application for a rehearing of its initial decision. On September 2, 2011, we renewed our prior motion for summary judgment on all claims by Mr. Scrushy based on the Alabama Supreme Court's ruling. On March 5, 2012, the court conditionally granted summary judgment in our favor, and that has since become final. We will pursue collection aggressively and to the fullest extent permitted by law. We, in coordination with derivative plaintiffs' counsel, are attempting to locate, in order to collect the judgment, Mr. Scrushy's current assets and other assets we believe were improperly disposed. Part of this effort is a fraudulent transfer complaint filed on July 2, 2009 against Mr. Scrushy and a number of related entities by derivative plaintiffs for the benefit of HealthSouth in the Circuit Court of Jefferson County, Alabama, captioned Tucker v. Scrushy et al. While these collection efforts continue, some of Mr. Scrushy's assets have been seized and sold at auction pursuant to the state law procedure for collection of a judgment. Other assets will likewise be sold from time to time. On May 3, 2011, the Circuit Court of Jefferson County entered an order for distribution of amounts collected and liquidated. After reimbursement of reasonable out-of-pocket expenses incurred by HealthSouth and the attorneys for the derivative shareholder plaintiffs for property maintenance of and fees incurred to locate Mr. Scrushy's assets and after recording a liability for the federal plaintiffs' 25% apportionment of any net recovery from Mr. Scrushy as required in our consolidated securities action settlement, we recorded a \$12.3 million net gain in Government, class action, and related settlements in our consolidated statement of operations for the year ended December 31, 2011 in connection with our receipt of cash distributions. For further discussion of our consolidated securities action settlement that previously resolved claims brought against us by former stockholders and bondholders, see Note 21, Settlements, "Securities Litigation Settlement" to the consolidated financial statements accompanying the 2011 Form 10-K. We are obligated to pay 35% of any recovery from Mr. Scrushy along with reasonable out-of-pocket expenses to the attorneys for the derivative shareholder plaintiffs. In connection with those obligations, during 2011, \$5.2 million of the amounts previously collected were distributed to attorneys for the derivative shareholder plaintiffs. We recorded this cash distribution as part of Professional fees—accounting, tax, and legal in our consolidated statement of operations for the year ended December 31, 2011.

Litigation By and Against Former Independent Auditor—

In March 2003, claims on behalf of HealthSouth were brought in the Tucker derivative litigation against Ernst & Young, alleging that from 1996 through 2002, when Ernst & Young served as our independent auditor, Ernst & Young acted recklessly and with gross negligence in performing its duties, and specifically that Ernst & Young failed to perform reviews and audits of our financial statements with due professional care as required by law and by its contractual agreements with us. The claims further allege Ernst & Young either knew of or, in the exercise of due care, should have discovered and investigated the fraudulent and improper accounting practices being directed by certain officers and employees, and should have reported them to our board of directors and the audit committee. The claims seek compensatory and punitive damages, disgorgement of fees received from us by Ernst & Young, and attorneys' fees and costs. On March 18, 2005, Ernst & Young filed a lawsuit captioned Ernst & Young LLP v. HealthSouth Corp. in the Circuit Court of Jefferson County, Alabama. The complaint alleges we provided Ernst & Young with fraudulent management representation letters, financial statements, invoices, bank reconciliations, and journal entries in an effort to conceal accounting fraud. Ernst & Young claims that as a result of our actions, Ernst & Young's reputation has been injured and it has and will incur damages, expenses, and legal fees. On April 1, 2005, we answered Ernst & Young's claims and asserted counterclaims related or identical to those asserted in the Tucker action. Upon Ernst & Young's motion, the Alabama state court referred Ernst & Young's claims and our counterclaims to arbitration pursuant to a clause in the engagement agreements between HealthSouth and Ernst & Young. On July 12, 2006, we and the derivative plaintiffs filed an arbitration demand on behalf of HealthSouth against Ernst & Young. On August 7, 2006, Ernst & Young filed an answering statement and counterclaim in the arbitration reasserting the claims made in state court. In August 2006, we and the derivative plaintiffs agreed to jointly prosecute the claims against Ernst & Young in arbitration.

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We are vigorously pursuing our claims against Ernst & Young and defending the claims against us. The three-person arbitration panel that is adjudicating the claims and counterclaims in arbitration was selected under rules of the American Arbitration Association (the "AAA"). The trial phase of the arbitration process began on July 12, 2010 and is continuing as schedules permit. However, pursuant to an order of the AAA panel, all aspects of the arbitration are confidential. Accordingly, we will not discuss the arbitration until there is a resolution. Based on the stage of arbitration, and review of the current facts and circumstances, we do not believe there is a reasonable possibility of a loss that might result from an adverse judgment or a settlement of this case.

General Medicine Action—

On August 16, 2004, General Medicine, P.C. filed a lawsuit against us captioned General Medicine, P.C. v. HealthSouth Corp. seeking the recovery of allegedly fraudulent transfers involving assets of Horizon/CMS Healthcare Corporation, a former subsidiary of HealthSouth. The lawsuit is pending in the Circuit Court of Jefferson County, Alabama (the "Alabama Action").

General Medicine's underlying claim against Horizon/CMS originates from a services contract entered into in 1995 between General Medicine and Horizon/CMS whereby General Medicine agreed to provide medical director services to skilled nursing facilities owned by Horizon/CMS for a term of three years. Horizon/CMS terminated the agreement for cause six months after it was executed, and General Medicine then initiated a lawsuit against Horizon/CMS in the United States District Court for the Eastern District of Michigan in 1996 (the "Michigan Action"). General Medicine's complaint in the Michigan Action alleged that Horizon/CMS breached the services contract by wrongfully terminating General Medicine. We acquired Horizon/CMS in 1997 and sold it to Meadowbrook Healthcare, Inc. in 2001 pursuant to a stock purchase agreement. In 2004, Meadowbrook, without the knowledge of HealthSouth, consented to the entry of a final judgment in the Michigan Action in favor of General Medicine against Horizon/CMS for the alleged wrongful termination of the contract with General Medicine in the amount of \$376 million, plus interest from the date of the judgment until paid at the rate of 10% per annum (the "Consent Judgment"). The \$376 million damages figure was unilaterally selected by General Medicine and was not tested or opposed by Meadowbrook. Additionally, the settlement agreement (the "Settlement") used as the basis for the Consent Judgment provided that Meadowbrook would pay only \$300,000 to General Medicine to settle the Michigan Action and that General Medicine would seek to recover the remaining balance of the Consent Judgment solely from us. We were not a party to the Michigan Action, the Settlement negotiated by Meadowbrook, or the Consent Judgment.

The complaint filed by General Medicine against us in the Alabama Action alleges that while Horizon/CMS was our wholly owned subsidiary, General Medicine was an existing creditor of Horizon/CMS by virtue of the Settlement. The complaint also alleges we caused Horizon/CMS to transfer its assets to us for less than a reasonably equivalent value or, in the alternative, with the actual intent to defraud creditors of Horizon/CMS, including General Medicine, in violation of the Alabama Uniform Fraudulent Transfer Act. General Medicine further alleges in its amended complaint that we are liable for the Consent Judgment despite not being a party to it because as Horizon/CMS's parent we failed to observe corporate formalities in our operation and ownership of Horizon/CMS, misused our control of Horizon/CMS, stripped assets from Horizon/CMS, and engaged in other conduct which amounted to a fraud on Horizon/CMS's creditors. General Medicine has requested relief including recovery of the unpaid amount of the Consent Judgment, the avoidance of the subject transfers of assets, attachment of the assets transferred to us, appointment of a receiver over the transferred properties, and a monetary judgment for the value of properties transferred.

We have denied liability to General Medicine and asserted counterclaims against General Medicine for fraud, injurious falsehood, tortious interference with business relations, conspiracy, unjust enrichment, abuse of process, and other causes of action. In our counterclaims, we alleged the Consent Judgment is the product of fraud, collusion and bad faith by General Medicine and Meadowbrook and, further, that these parties were guilty of a conspiracy to manufacture a lawsuit against HealthSouth in favor of General Medicine. Consequently, we assert that the Consent Judgment is not evidence of a legitimate debt owed by Horizon/CMS to General Medicine that is collectible from HealthSouth under any theory of liability.

In 2008, after we obtained discovery concerning the circumstances that lead to the entry of the Consent Judgment, we filed a motion in the Michigan Action asking the court to set aside the Consent Judgment on grounds that it was the product of fraud on the court and collusion by the parties. On May 21, 2009, the court granted our motion to set aside the Consent Judgment on grounds that it was the product of fraud on the court. On March 9, 2010, General Medicine filed an appeal of the court's decision to the Sixth Circuit Court of Appeals. The parties agreed to a voluntary stay of the Alabama Action pending the

HealthSouth Corporation and Subsidiaries
Notes to Condensed Consolidated Financial Statements

outcome of General Medicine's appeal to the Sixth Circuit Court of Appeals. On April 10, 2012, a three-judge panel of the Sixth Circuit Court of Appeals reversed the lower court's ruling and reinstated the Consent Judgment. On June 26, 2012, the Sixth Circuit Court of Appeals denied our application for rehearing by the full court. Due to the conclusion of the appeal in the Michigan Action, General Medicine has requested the Circuit Court of Jefferson County, Alabama to reactivate the Alabama Action.

Based on the stage of litigation, review of the current facts and circumstances as we understand them, the nature of the underlying claim, the results of the proceedings to date, and the nature and scope of the defense we continue to mount, we do not believe an adverse judgment or settlement is probable in this matter, and it is also not possible to estimate the amount of loss, if any, or range of possible loss that might result from an adverse judgment or settlement of this case. We intend to vigorously defend ourselves against General Medicine's claims and to vigorously prosecute our counterclaims against General Medicine.

Other Litigation—

We have been named as a defendant in a lawsuit filed March 28, 2003 by several individual stockholders in the Circuit Court of Jefferson County, Alabama, captioned Nichols v. HealthSouth Corp. The plaintiffs allege that we, some of our former officers, and our former investment bank engaged in a scheme to overstate and misrepresent our earnings and financial position. The plaintiffs are seeking compensatory and punitive damages. This case was consolidated with the Tucker case for discovery and other pretrial purposes and was stayed in the Circuit Court on August 8, 2005. The plaintiffs filed an amended complaint on November 9, 2010 to which we responded with a motion to dismiss filed on December 22, 2010. During a hearing on February 24, 2012, plaintiffs' counsel indicated his intent to dismiss certain claims against us. Instead, on March 9, 2012, the plaintiffs amended their complaint to include additional securities fraud claims against HealthSouth and add several former officers to the lawsuit. One of those named officers removed the case to federal court on March 14, 2012. We filed a motion to remand the case on April 10, 2012. We intend to vigorously defend ourselves in this case. Based on the stage of litigation, review of the current facts and circumstances as we understand them, the nature of the underlying claim, the results of the proceedings to date, and the nature and scope of the defense we continue to mount, we do not believe an adverse judgment or settlement is probable in this matter, and it is also not possible to estimate the amount of loss, if any, or range of possible loss that might result from an adverse judgment or settlement of this case.

We were named as a defendant in a lawsuit filed March 3, 2009 by an individual in the Court of Common Pleas, Richland County, South Carolina, captioned Sulton v. HealthSouth Corp, et al. The plaintiff alleged that certain treatment he received at a HealthSouth facility complicated a pre-existing infectious injury. The plaintiff sought recovery for pain and suffering, medical expenses, punitive damages, and other damages. On July 30, 2010, the jury in this case returned a verdict in favor of the plaintiff for \$12.3 million in damages. On May 2, 2011, we filed our brief in the appeal of this verdict with the South Carolina Court of Appeals. On May 29, 2012, the Supreme Court of South Carolina granted the parties' joint motion to submit the appeal directly to that court. The parties have completed their briefing for the appeal, but oral argument has not yet been scheduled. We intend to vigorously defend ourselves in this case. We believe the attending nurses acted both responsibly and professionally, and we will continue to support and defend them. Although we continue to believe in the merit of our defenses and counterarguments, we have recorded a liability of \$12.3 million in Other current liabilities in our condensed consolidated balance sheets as of June 30, 2012 and December 31, 2011 with a corresponding receivable of \$7.7 million in Other current assets for the portion of the claim we expect to be covered through our excess insurance coverages, resulting in a net charge of \$4.6 million to Other operating expenses in our consolidated statement of operations for the year ended December 31, 2010. The \$4.6 million portion of this claim would be a covered claim through our captive insurance subsidiary, HCS, Ltd. As a result of the verdict, we made a \$6.0 million payment through HCS, Ltd. to the Richland County Clerk as a deposit during the on-going appeal process. The deposit is a restricted asset included in Other current assets in our condensed consolidated balance sheets as of June 30, 2012 and December 31, 2011.

On May 31, 2012, we joined in a settlement of the previously disclosed dispute between Washington Regional Rehabilitation Services, LLC, our partner in a joint venture hospital in Fayetteville, Arkansas, and that hospital's

landlord, an affiliate of Medical Properties Trust, over whether Washington Regional properly exercised its right to purchase the property under the related lease. The related case was originally filed February 4, 2011 in the United States District Court for the Western District of Arkansas and captioned Washington Regional Outreach Services v. MPT of Fayetteville, LLC. With this litigation pending, the lease expired on June 30, 2011. Subsequent to that date, we were joined to the suit as a necessary party.

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Notes to Condensed Consolidated Financial Statements

Under the settlement agreement, the joint venture acquired the hospital from MPT on June 15, 2012. In exchange for the hospital and to settle all pending litigation, MPT received approximately \$16 million in cash as well as the lease payments held in escrow during the dispute. Accordingly, each party agreed to release all claims related to the litigation, and the court dismissed the litigation with prejudice on June 15, 2012 upon joint petition by the parties.

Other Matters—

The False Claims Act, 18 U.S.C. § 287, allows private citizens, called “relators,” to institute civil proceedings alleging violations of the False Claims Act. These qui tam cases are generally sealed by the court at the time of filing. The only parties privy to the information contained in the complaint are the relator, the federal government, and the presiding court. It is possible that qui tam lawsuits have been filed against us and that we are unaware of such filings or have been ordered by the presiding court not to discuss or disclose the filing of such lawsuits. We may be subject to liability under one or more undisclosed qui tam cases brought pursuant to the False Claims Act.

It is our obligation as a participant in Medicare and other federal healthcare programs to routinely conduct audits and reviews of the accuracy of our billing systems and other regulatory compliance matters. As a result of these reviews, we have made, and will continue to make, disclosures to the HHS-OIG and CMS relating to amounts we suspect represent over-payments from these programs, whether due to inaccurate billing or otherwise. Some of these disclosures have resulted in, or may result in, HealthSouth refunding amounts to Medicare or other federal healthcare programs.

On June 24, 2011, we received a document subpoena addressed to HealthSouth Hospital of Houston, a long-term acute care hospital ("LTCH") we closed in August 2011, from the Dallas, Texas office of the HHS-OIG. The subpoena is in connection with an investigation of possible false or otherwise improper claims submitted to Medicare and Medicaid and requests documents and materials relating to this closed LTCH's patient admissions, length of stay, and discharge matters. We are cooperating fully with the HHS-OIG in connection with this subpoena and are currently unable to predict the timing or outcome of this investigation.

We also face certain financial risks and challenges relating to our 2007 divestiture transactions (see Note 18, Assets and Liabilities in and Results of Discontinued Operations, to the consolidated financial statements accompanying the 2011 Form 10-K) following their closing. These include indemnification obligations or other claims and assessments, which in the aggregate could have a material adverse effect on our financial position, results of operations, and cash flows.

9. Condensed Consolidating Financial Information

The accompanying condensed consolidating financial information has been prepared and presented pursuant to SEC Regulation S-X, Rule 3-10, “Financial Statements of Guarantors and Issuers of Guaranteed Securities Registered or Being Registered.” Each of the subsidiary guarantors is 100% owned by HealthSouth, and all guarantees are full and unconditional and joint and several, subject to certain customary conditions for release. HealthSouth’s investments in its consolidated subsidiaries, as well as guarantor subsidiaries’ investments in non-guarantor subsidiaries and non-guarantor subsidiaries’ investments in guarantor subsidiaries, are presented under the equity method of accounting. As described in Note 8, Long-term Debt, to the consolidated financial statements accompanying the 2011 Form 10-K, the terms of our credit agreement restrict us from declaring or paying cash dividends on our common stock unless: (1) we are not in default under our credit agreement and (2) the amount of the dividend, when added to the aggregate amount of certain other defined payments made during the same fiscal year, does not exceed certain maximum thresholds. However, as described in Note 11, Convertible Perpetual Preferred Stock, to the consolidated financial statements accompanying the 2011 Form 10-K, our preferred stock generally provides for the payment of cash dividends, subject to certain limitations.

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HealthSouth Corporation and Subsidiaries
Notes to Condensed Consolidated Financial Statements
Condensed Consolidating Statement of Operations

	Three Months Ended June 30, 2012				
	HealthSouth Corporation (In Millions)	Guarantor Subsidiaries	Non Guarantor Subsidiaries	Eliminating Entries	HealthSouth Consolidated
Net operating revenues	\$6.2	\$381.4	\$159.9	\$(14.1)	) \$533.4
Less: Provision for doubtful accounts	0.2	(5.0)	) (1.7)	) —	(6.5)
Net operating revenues less provision for doubtful accounts	6.4	376.4	158.2	(14.1)	) 526.9
Operating expenses:					
Salaries and benefits	6.8	179.4	74.6	(3.4)	) 257.4
Other operating expenses	4.3	53.2	23.5	(6.6)	) 74.4
General and administrative expenses	28.0	—	—	—	28.0
Supplies	0.2	18.5	7.2	—	25.9
Depreciation and amortization	2.1	14.1	3.8	—	20.0
Occupancy costs	1.2	10.9	4.3	(4.1)	) 12.3
Loss on disposal of assets	—	0.6	—	—	0.6
Professional fees—accounting, tax, and legal	5.5	—	—	—	5.5
Total operating expenses	48.1	276.7	113.4	(14.1)	) 424.1
Interest expense and amortization of debt discounts and fees	20.8	1.9	0.6	(0.3)	) 23.0
Other income	—	(0.1)	) (0.6)	) 0.3	(0.4)
Equity in net income of nonconsolidated affiliates	(0.8)	) (2.3)	) —	—	(3.1)
Equity in net income of consolidated affiliates	(68.5)	) (5.1)	) —	73.6	—
Management fees	(24.0)	) 18.5	5.5	—	—
Income from continuing operations before income tax (benefit) expense	30.8	86.8	39.3	(73.6)	) 83.3
Provision for income tax (benefit) expense	(15.2)	) 32.5	9.6	—	26.9
Income from continuing operations	46.0	54.3	29.7	(73.6)	) 56.4
Income from discontinued operations, net of tax	0.7	0.8	2.0	—	3.5
Net Income	46.7	55.1	31.7	(73.6)	) 59.9
Less: Net income attributable to noncontrolling interests	—	—	(13.2)	) —	(13.2)
Net income attributable to HealthSouth	\$46.7	\$55.1	\$18.5	\$(73.6)	) \$46.7
Comprehensive income	\$46.9	\$55.1	\$31.7	\$(73.6)	) \$60.1
Comprehensive income attributable to HealthSouth	\$46.9	\$55.1	\$18.5	\$(73.6)	) \$46.9

HealthSouth Corporation and Subsidiaries
Notes to Condensed Consolidated Financial Statements
Condensed Consolidating Statement of Operations

	Three Months Ended June 30, 2011				HealthSouth Consolidated
	HealthSouth Corporation (In Millions)	Guarantor Subsidiaries	Non Guarantor Subsidiaries	Eliminating Entries	
Net operating revenues	\$4.4	\$362.0	\$149.8	\$(11.1)	) \$505.1
Less: Provision for doubtful accounts	(0.1	) (3.5	) (1.4	) —	(5.0)
Net operating revenues less provision for doubtful accounts	4.3	358.5	148.4	(11.1)	) 500.1
Operating expenses:					
Salaries and benefits	4.6	169.8	70.6	(3.4)	) 241.6
Other operating expenses	10.1	49.1	21.5	(5.3)	) 75.4
General and administrative expenses	27.4	—	—	—	27.4
Supplies	0.3	18.5	7.4	—	26.2
Depreciation and amortization	2.4	13.0	4.2	—	19.6
Occupancy costs	1.2	9.0	4.4	(2.5)	) 12.1
Loss on disposal of assets	—	0.1	0.9	—	1.0
Government, class action, and related settlements	(10.6	) —	—	—	(10.6)
Professional fees—accounting, tax, and legal	8.4				