

HEALTHSOUTH CORP  
Form 10-Q  
July 29, 2016  
UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, DC 20549

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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, 2016  
OR  
 TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d)  
OF THE SECURITIES EXCHANGE ACT OF 1934  
Commission File Number 001-10315

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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  
(Address of Principal Executive Offices) (Zip Code)

(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 89,770,417 shares of common stock outstanding, net of treasury shares, as of July 22, 2016.



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## NOTE TO READERS

As used in this report, the terms “HealthSouth,” “we,” “us,” “our,” and the “Company” refer to HealthSouth Corporation and its consolidated subsidiaries, unless otherwise stated or indicated by context. This drafting style is suggested by the Securities and Exchange Commission and is not meant to imply that HealthSouth Corporation, the publicly traded parent company, owns or operates any specific asset, business, or property. The hospitals, operations, and businesses described in this filing are primarily owned and operated by subsidiaries of the parent company. In addition, we use the term “HealthSouth Corporation” to refer to HealthSouth Corporation alone wherever a distinction between HealthSouth Corporation and its subsidiaries is required or aids in the understanding of this filing.

## 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 laws and regulations from time to time, our business strategy, our dividend and stock repurchase strategies, our financial plans, our growth plans, our future financial performance, our projected business results, or our projected capital expenditures. In some cases, the reader can identify forward-looking statements by terminology such as “may,” “will,” “should,” “could,” “expects,” “plans,” “anticipates,” “believes,” “estimates,” “predicts,” “targets,” “potential,” or “contingent,” 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, such as decreases in revenues or increases in costs or charges, 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, 2015, as well as uncertainties and factors discussed in Part II, Item 1A, Risk Factors, and 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 rules and 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 such as the reinstatement of the “75% Rule” or the introduction of site neutral payments with skilled nursing facilities for certain conditions, 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;



delays in the administrative appeals process associated with denied Medicare reimbursement claims, including from various Medicare audit programs, and our exposure to the related delay or reduction in the receipt of the reimbursement amounts for services previously provided;

the ongoing evolution of the healthcare delivery system, including alternative payment models and value-based purchasing initiatives;

our ability to comply with extensive and changing healthcare regulations as well as the 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;

changes in our payor mix or the acuity of our patients;

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, including the ongoing investigations initiated by the U.S. Department of Health and Human Services, Office of the Inspector General;

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 incidents affecting the proper operation, availability, or security of our information systems;

new or changing quality reporting requirements impacting operational costs or our Medicare reimbursement;

the price of our common stock as it affects our willingness and ability to repurchase shares and the financial and accounting effects of any repurchases;

our ability and willingness to continue to declare and pay dividends on our common stock;

our ability to successfully integrate Encompass Home Health and Hospice, the inpatient rehabilitation hospitals acquired from Reliant Hospital Partners, LLC, and the home health agency operations of CareSouth Health System, Inc., including the realization of anticipated benefits from those acquisitions and avoidance of unanticipated difficulties, costs, or liabilities that could arise from the acquisitions or integrations;

- our ability to maintain proper local, state and federal licensing where we and our subsidiaries do business;

our ability to attract and retain key management personnel, including as a part of executive management succession planning; and

general conditions in the economy and capital markets, including any instability or uncertainty related to governmental impasse over approval of the United States federal budget, an increase to the debt ceiling, or an international sovereign debt crisis.

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		Six Months Ended	
	Ended June 30,		June 30,	
	2016	2015	2016	2015
	(In Millions)			
Net operating revenues	\$920.7	\$764.4	\$1,830.5	\$1,505.0
Less: Provision for doubtful accounts	(15.4 )	(10.9 )	(31.9 )	(22.5 )
Net operating revenues less provision for doubtful accounts	905.3	753.5	1,798.6	1,482.5
Operating expenses:				
Salaries and benefits	486.1	401.8	972.2	786.9
Other operating expenses	121.5	104.2	240.7	207.4
Occupancy costs	17.9	12.5	35.9	24.6
Supplies	34.4	31.7	69.4	63.1
General and administrative expenses	34.4	32.1	66.3	66.7
Depreciation and amortization	42.9	32.7	85.3	64.6
Government, class action, and related settlements	—	—	—	8.0
Professional fees—accounting, tax, and legal	1.7	0.1	1.9	2.3
Total operating expenses	738.9	615.1	1,471.7	1,223.6
Loss on early extinguishment of debt	2.4	18.8	4.8	20.0
Interest expense and amortization of debt discounts and fees	43.4	30.9	88.0	62.7
Other income	(0.7 )	(3.0 )	(1.3 )	(3.5 )
Equity in net income of nonconsolidated affiliates	(2.4 )	(2.3 )	(4.8 )	(3.9 )
Income from continuing operations before income tax expense	123.7	94.0	240.2	183.6
Provision for income tax expense	42.4	32.2	82.1	62.5
Income from continuing operations	81.3	61.8	158.1	121.1
Loss from discontinued operations, net of tax	(0.1 )	(1.6 )	(0.2 )	(1.9 )
Net income	81.2	60.2	157.9	119.2
Less: Net income attributable to noncontrolling interests	(18.6 )	(17.3 )	(37.3 )	(33.8 )
Net income attributable to HealthSouth	62.6	42.9	120.6	85.4
Less: Convertible perpetual preferred stock dividends	—	—	—	(1.6 )
Net income attributable to HealthSouth common shareholders	\$62.6	\$42.9	\$120.6	\$83.8

(Continued)

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2016	2015	2016	2015
	(In Millions, Except Per Share Data)			
Weighted average common shares outstanding:				
Basic	89.3	89.8	89.4	88.4
Diluted	99.4	101.5	99.4	101.3
Earnings per common share:				
Basic earnings per share attributable to HealthSouth common shareholders:				
Continuing operations	\$0.70	\$0.49	\$1.34	\$0.96
Discontinued operations	—	(0.02 )	—	(0.02 )
Net income	\$0.70	\$0.47	\$1.34	\$0.94
Diluted earnings per share attributable to HealthSouth common shareholders:				
Continuing operations	\$0.65	\$0.47	\$1.26	\$0.91
Discontinued operations	—	(0.02 )	—	(0.02 )
Net income	\$0.65	\$0.45	\$1.26	\$0.89
Cash dividends per common share	\$0.23	\$0.21	\$0.46	\$0.42
Amounts attributable to HealthSouth common shareholders:				
Income from continuing operations	\$62.7	\$44.5	\$120.8	\$87.3
Loss from discontinued operations, net of tax	(0.1 )	(1.6 )	(0.2 )	(1.9 )
Net income attributable to HealthSouth	\$62.6	\$42.9	\$120.6	\$85.4

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

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2016	2015	2016	2015
	(In Millions)			
<b>COMPREHENSIVE INCOME</b>				
Net income	\$81.2	\$60.2	\$157.9	\$119.2
Other comprehensive income, net of tax:				
Net change in unrealized gain on available-for-sale securities:				
Unrealized net holding gain arising during the period	0.4	0.8	0.6	0.9
Reclassifications to net income	—	(0.6 )	—	(0.6 )
Other comprehensive income before income taxes	0.4	0.2	0.6	0.3
Provision for income tax expense related to other comprehensive income items	(0.2 )	(0.1 )	(0.3 )	(0.1 )
Other comprehensive income, net of tax	0.2	0.1	0.3	0.2
Comprehensive income	81.4	60.3	158.2	119.4
Comprehensive income attributable to noncontrolling interests	(18.6 )	(17.3 )	(37.3 )	(33.8 )
Comprehensive income attributable to HealthSouth	\$62.8	\$43.0	\$120.9	\$85.6

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, 2016	December 31, 2015
	(In Millions)	
Assets		
Current assets:		
Cash and cash equivalents	\$70.3	\$ 61.6
Accounts receivable, net of allowance for doubtful accounts of \$48.9 in 2016; \$39.3 in 2015	420.6	410.5
Other current assets	168.6	126.6
Total current assets	659.5	598.7
Property and equipment, net	1,336.9	1,310.1
Goodwill	1,899.7	1,890.1
Intangible assets, net	414.2	419.4
Deferred income tax assets	115.5	190.8
Other long-term assets	206.8	197.0
Total assets <sup>(1)</sup>	\$4,632.6	\$ 4,606.1
Liabilities and Shareholders' Equity		
Current liabilities:		
Current portion of long-term debt	\$36.5	\$ 36.8
Accounts payable	67.1	61.6
Accrued expenses and other current liabilities	355.5	328.0
Total current liabilities	459.1	426.4
Long-term debt, net of current portion	3,050.0	3,134.7
Other long-term liabilities	154.1	144.6
	3,663.2	3,705.7
Commitments and contingencies		
Redeemable noncontrolling interests	120.0	121.1
Shareholders' equity:		
HealthSouth shareholders' equity	672.7	611.4
Noncontrolling interests	176.7	167.9
Total shareholders' equity	849.4	779.3
Total liabilities <sup>(1)</sup> and shareholders' equity	\$4,632.6	\$ 4,606.1

Our consolidated assets as of June 30, 2016 include total assets of variable interest entities of \$255.3 million, <sup>(1)</sup> which cannot be used by us to settle the obligations of other entities. Our consolidated liabilities as of June 30, 2016 include total liabilities of the variable interest entities of \$54.6 million. See Note 3, Variable Interest Entities.

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 Shareholders' Equity  
(Unaudited)

Six Months Ended June 30, 2016 (In Millions)								
HealthSouth Common Shareholders								
	Number of Common Shares Outstanding	Common Stock	Capital in Excess of Par Value	Accumulated Deficit	Accumulated Other Comprehensive Loss	Treasury Stock	Noncontrolling Interests	Total
Balance at beginning of period	90.1	\$ 1.1	\$2,834.9	\$(1,696.0 )	\$ (1.2 )	\$(527.4)	\$ 167.9	\$779.3
Net income	—	—	—	120.6	—	—	29.8	150.4
Receipt of treasury stock	(0.4 )	—	—	—	—	(9.9 )	—	(9.9 )
Dividends declared on common stock	—	—	(41.7 )	—	—	—	—	(41.7 )
Stock-based compensation	—	—	11.5	—	—	—	—	11.5
Stock options exercised	0.2	—	5.4	—	—	(4.7 )	—	0.7
Distributions declared	—	—	—	—	—	—	(29.9 )	(29.9 )
Capital contributions from consolidated affiliates	—	—	—	—	—	—	7.6	7.6
Fair value adjustments to redeemable noncontrolling interests, net of tax	—	—	2.8	—	—	—	—	2.8
Repurchases of common stock in open market	(0.7 )	—	—	—	—	(24.1 )	—	(24.1 )
Other	0.6	—	1.7	—	0.3	(0.6 )	1.3	2.7
Balance at end of period	89.8	\$ 1.1	\$2,814.6	\$(1,575.4 )	\$ (0.9 )	\$(566.7)	\$ 176.7	\$849.4

Six Months Ended June 30, 2015 (In Millions)								
HealthSouth Common Shareholders								
	Number of Common Shares Outstanding	Common Stock	Capital in Excess of Par Value	Accumulated Deficit	Accumulated Other Comprehensive Loss	Treasury Stock	Noncontrolling Interests	Total
Balance at beginning of period	87.8	\$ 1.0	\$2,810.5	\$(1,879.1 )	\$ (0.5 )	\$(458.7)	\$ 146.3	\$619.5
Net income	—	—	—	85.4	—	—	27.4	112.8
Conversion of preferred stock	3.3	—	93.2	—	—	—	—	93.2
Receipt of treasury stock	(0.5 )	—	—	—	—	(16.6 )	—	(16.6 )
Dividends declared on common stock	—	—	(38.0 )	—	—	—	—	(38.0 )
Dividends declared on convertible perpetual preferred stock	—	—	(1.6 )	—	—	—	—	(1.6 )
Stock-based compensation	—	—	14.9	—	—	—	—	14.9
Stock options exercised	0.2	—	5.6	—	—	(3.6 )	—	2.0
Distributions declared	—	—	—	—	—	—	(23.4 )	(23.4 )

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Capital contributions from consolidated affiliates	—	—	—	—	—	—	8.6	8.6			
Fair value adjustments to redeemable noncontrolling interests, net of tax	—	—	(6.8	)	—	—	—	(6.8	)		
Other	0.7	0.1	0.6	(0.2	)	0.2	(0.5	)	(0.1	)	0.1
Balance at end of period	91.5	\$ 1.1	\$2,878.4	\$(1,793.9	)	\$ (0.3	)	\$(479.4)	\$ 158.8	\$764.7	

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 Cash Flows  
(Unaudited)

	Six Months Ended June 30, 2016    2015 (In Millions)	
Cash flows from operating activities:		
Net income	\$ 157.9	\$ 119.2
Loss from discontinued operations, net of tax	0.2	1.9
Adjustments to reconcile net income to net cash provided by operating activities—		
Provision for doubtful accounts	31.9	22.5
Depreciation and amortization	85.3	64.6
Loss on early extinguishment of debt	4.8	20.0
Equity in net income of nonconsolidated affiliates	(4.8 )	(3.9 )
Distributions from nonconsolidated affiliates	3.0	3.7
Stock-based compensation	13.1	15.6
Deferred tax expense	73.2	55.6
Other	6.9	11.0
Change in assets and liabilities, net of acquisitions—		
Accounts receivable	(59.5 )	(62.1 )
Other assets	(4.3 )	(6.5 )
Accounts payable	1.2	1.7
Accrued payroll	9.3	(23.6 )
Other liabilities	(1.9 )	(10.7 )
Premium received on bond issuance	—	8.0
Premium paid on redemption of bonds	(3.9 )	(11.8 )
Net cash used in operating activities of discontinued operations	(0.5 )	(0.3 )
Total adjustments	153.8	83.8
Net cash provided by operating activities	311.9	204.9

(Continued)

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

	Six Months Ended June 30, 2016 2015 (In Millions)	
Cash flows from investing activities:		
Purchases of property and equipment	(71.4 )	(46.3 )
Capitalized software costs	(15.2 )	(15.2 )
Acquisitions of businesses, net of cash acquired	(9.4 )	(77.7 )
Net change in restricted cash	(11.5 )	13.1
Other	2.0	(0.6 )
Net cash used in investing activities	(105.5)	(126.7)
Cash flows from financing activities:		
Proceeds from bond issuance	—	700.0
Principal payments on debt, including pre-payments	(112.8)	(546.1)
Borrowings on revolving credit facility	165.0	270.0
Payments on revolving credit facility	(145.0)	(442.0)
Debt amendment and issuance costs	—	(13.9 )
Repurchases of common stock, including fees and expenses	(24.1 )	—
Dividends paid on common stock	(41.9 )	(37.1 )
Dividends paid on convertible perpetual preferred stock	—	(3.1 )
Distributions paid to noncontrolling interests of consolidated affiliates	(33.6 )	(26.2 )
Other	(5.3 )	(1.0 )
Net cash used in financing activities	(197.7)	(99.4 )
Increase (decrease) in cash and cash equivalents	8.7	(21.2 )
Cash and cash equivalents at beginning of period	61.6	66.7
Cash and cash equivalents at end of period	\$70.3	\$45.5
Supplemental schedule of noncash financing activity:		
Conversion of preferred stock to common stock	\$—	\$93.2

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 one of the nation's largest providers of post-acute healthcare services, offering both facility-based and home-based post-acute services in 34 states and Puerto Rico through its network of inpatient rehabilitation hospitals, home health agencies, and hospice agencies.

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 24, 2016 (the "2015 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, 2015 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.

See also Note 12, Segment Reporting.

#### Variable Interest Entities—

Effective January 1, 2016, in connection with our adoption of ASU 2015-02, we updated our evaluation of all jointly held legal entities to determine whether they are now variable interest entities ("VIEs") under the new guidance. Any entity considered a VIE is evaluated to determine which party is the primary beneficiary and thus should consolidate the VIE. This analysis is complex, involves uncertainties, and requires significant judgment on various matters. In order to determine if we are the primary beneficiary of a VIE, we must determine what activities most significantly impact the economic performance of the entity, whether we have the power to direct those activities, and if our obligation to absorb losses or receive benefits from the VIE could potentially be significant to the VIE.

#### Net Operating Revenues—

We derived consolidated Net operating revenues from the following payor sources:

	Three Months		Six Months	
	Ended June 30,		Ended June 30,	
	2016	2015	2016	2015
Medicare	74.7 %	74.5 %	75.1 %	74.7 %
Medicare Advantage	8.1 %	7.7 %	7.9 %	8.0 %
Managed care	10.0 %	10.1 %	9.8 %	10.0 %
Medicaid	3.2 %	3.1 %	3.3 %	2.9 %
Other third-party payors	1.4 %	1.8 %	1.4 %	1.6 %
Workers' compensation	0.7 %	0.9 %	0.8 %	0.9 %
Patients	0.5 %	0.6 %	0.5 %	0.6 %
Other income	1.4 %	1.3 %	1.2 %	1.3 %
Total	100.0%	100.0%	100.0%	100.0%

HealthSouth Corporation and Subsidiaries  
Notes to Condensed Consolidated Financial Statements

Inpatient Rehabilitation Revenues

Our inpatient rehabilitation segment derived its Net operating revenues from the following payor sources:

	Three Months		Six Months	
	Ended June 30,		Ended June 30,	
	2016	2015	2016	2015
Medicare	73.1 %	72.7 %	73.3 %	73.1 %
Medicare Advantage	7.8 %	7.8 %	7.7 %	8.1 %
Managed care	11.5 %	11.4 %	11.2 %	11.3 %
Medicaid	2.9 %	2.6 %	3.0 %	2.3 %
Other third-party payors	1.7 %	2.1 %	1.7 %	1.9 %
Workers' compensation	0.8 %	1.1 %	1.0 %	1.1 %
Patients	0.6 %	0.7 %	0.6 %	0.7 %
Other income	1.6 %	1.6 %	1.5 %	1.5 %
Total	100.0%	100.0%	100.0%	100.0%

Home Health and Hospice Revenues

Our home health and hospice segment derived its Net operating revenues from the following payor sources:

	Three Months		Six Months	
	Ended June 30,		Ended June 30,	
	2016	2015	2016	2015
Medicare	82.3 %	83.9 %	82.9 %	83.8 %
Medicare Advantage	9.0 %	7.2 %	8.9 %	7.3 %
Managed care	3.7 %	2.9 %	3.2 %	3.0 %
Medicaid	4.8 %	5.8 %	4.8 %	5.7 %
Other third-party payors	— %	0.1 %	— %	0.1 %
Patients	0.1 %	0.1 %	0.1 %	0.1 %
Other income	0.1 %	— %	0.1 %	— %
Total	100.0%	100.0%	100.0%	100.0%

See Note 1, Summary of Significant Accounting Policies, to the consolidated financial statements accompanying the 2015 Form 10-K for our policies related to Net operating revenues, Accounts receivable, and our Allowance for doubtful accounts.

Recent Accounting Pronouncements—

In February 2015, the FASB issued ASU 2015-02, "Consolidations (Topic 810) - Amendments to the Consolidation Analysis," which provides guidance on evaluating whether a reporting entity should consolidate certain legal entities. Specifically, the amendments modify the evaluation of whether limited partnerships and similar legal entities are VIEs. Under this analysis, limited partnerships and other similar entities will be considered a VIE unless the limited partners hold substantive kick-out rights or participating rights. Further, the amendments eliminate the presumption that a general partner should consolidate a limited partnership under the voting interest model, as well as affect the consolidation analysis of reporting entities that are involved with VIEs, particularly those that have fee arrangements and related party relationships. This standard was effective for annual periods beginning after December 15, 2015 and interim periods within those annual periods. We elected to adopt this guidance using the modified retrospective approach. Our adoption of this guidance resulted in certain limited partnership-like entities that were previously consolidated as voting interest entities to now be consolidated as VIEs, for

HealthSouth Corporation and Subsidiaries  
Notes to Condensed Consolidated Financial Statements

which additional disclosures are required. Our adoption of ASU 2015-02 did not have a material impact on our financial position, results of operations, or cash flows. See Note 3, Variable Interest Entities.

In February 2016, the FASB issued ASU 2016-02, "Leases (Topic 842)," in order to increase transparency and comparability by recognizing lease assets and liabilities on the balance sheet and disclosing key information about leasing arrangements. Under the new standard, lessees will recognize a right-of-use asset and a corresponding lease liability for all leases other than leases that meet the definition of a short-term lease. The liability will be equal to the present value of lease payments. The asset will be based on the liability, subject to adjustment, such as for initial direct costs. For income statement purposes, the FASB retained a dual model, requiring leases to be classified as either operating or finance. Operating leases will result in straight-line expense while finance leases will result in an expense pattern similar to current capital leases. Classification will be based on criteria that are similar to those applied in current lease accounting. This standard will be effective for HealthSouth for the annual reporting period beginning after December 15, 2018. Early adoption is permitted. We continue to review the requirements of this standard and any potential impact it may have on our financial position, results of operations, or cash flows.

In March 2016, the FASB issued ASU 2016-09, "Improvements to Employee Share-Based Payment Accounting (Topic 718)," to simplify various aspects of share-based payment accounting and presentation. The new standard requires entities to record all of the tax effects related to share-based payments at settlement (or expiration) through the income statement. This will require us to reclassify tax benefits in excess of compensation cost ("windfalls") and tax deficiencies ("shortfalls") to the extent of previous windfalls from Capital in excess of par value to Provision for income tax expense. This change is required to be applied prospectively to all excess tax benefits and tax deficiencies resulting from settlements after the date of adoption of the ASU. The standard eliminates the requirement to delay recognition of a windfall tax benefit until it reduces current taxes payable. This change is required to be applied on a modified retrospective basis, with a cumulative-effect adjustment to opening retained earnings. In addition, all income tax-related cash flows resulting from share-based payments are required to be reported as operating activities on the statement of cash flows as opposed to the current presentation as an inflow from financing activities and an outflow from operating activities. Either prospective or retrospective transition of this provision is permitted. Finally, the standard clarifies that all cash payments made to taxing authorities on the employees' behalf for withheld shares should be presented as financing activities on the statement of cash flows. This change will be applied retrospectively. For HealthSouth, this guidance is effective for annual reporting periods beginning after December 15, 2016 and interim periods within that reporting period. Early adoption is permitted, with any adjustments reflected as of the beginning of the fiscal year of adoption. We continue to review the requirements of this standard and any potential impact it may have on our financial position, results of operations, or cash flows.

## 2. Business Combinations

### Inpatient Rehabilitation

In February 2016, we acquired 50% of the inpatient rehabilitation hospital at CHI St. Vincent Hot Springs ("Hot Springs"), a 20-bed inpatient rehabilitation hospital in Hot Springs, Arkansas, through a joint venture with St. Vincent Community Health Services, Inc. The acquisition, which was funded through a contribution to the consolidated joint venture, was not material to our financial position, results of operations, or cash flows. The Hot Springs transaction was made to enhance our position and ability to provide inpatient rehabilitative services to patients in Hot Springs and its surrounding areas. As a result of this transaction, Goodwill increased by \$1.8 million, none of which is deductible for federal income tax purposes. The goodwill reflects our expectations of our ability to gain access to and penetrate the acquired hospital's historical patient base and the benefits of being able to leverage operational efficiencies with favorable growth opportunities based on positive demographic trends in this market.

We accounted for this transaction under the acquisition method of accounting and reported the results of operations of the acquired hospital from its respective date of acquisition. Assets acquired and liabilities assumed, if any, were recorded at their estimated fair values as of the respective acquisition date. The fair value of the identifiable intangible asset was based on valuations using the income approach. The income approach is based on management's estimates of future operating results and cash flows discounted using a weighted-average cost of capital that reflects market participant assumptions. The excess of the fair value of the consideration conveyed over the fair value of the net assets



acquired was recorded as goodwill.

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The fair value of the assets acquired at the acquisition date were as follows (in millions):

Property and equipment	\$5.1
Identifiable intangible asset:	
Trade name (useful life of 20 years)	0.2
Goodwill	1.8
Total assets acquired	\$7.1

Information regarding the net cash paid for all inpatient rehabilitation acquisitions during each period presented is as follows (in millions):

	Three Months Ended June 30, 2015	Six Months Ended June 30, 2016	2015
Fair value of assets acquired	\$62.8	\$5.3	\$62.8
Goodwill	—0.7	1.8	0.7
Fair value of liabilities assumed	—(2.7 )	—	(2.7 )
Fair value of noncontrolling interest owned by joint venture partner	—(4.2 )	(7.1 )	(4.2 )
Net cash paid for acquisition	\$56.6	\$—	\$56.6

Home Health and Hospice

On May 1, 2016, we acquired Home Health Agency of Georgia, LLC (“Camellia”), a home health and hospice provider with two home health locations and two hospice locations in the Greater Atlanta area. The acquisition, which was funded using cash on hand, was not material to our financial position, results of operations, or cash flows. As a result of this transaction, Goodwill increased by \$8.1 million, all of which is deductible for federal income tax purposes. The Camellia acquisition was made to enhance our position and ability to provide post-acute healthcare services to patients in the applicable geographic area. The goodwill reflects our expectations of our ability to utilize Camellia’s mobile workforce and established relationships within the community and the benefits of being able to leverage operational efficiencies with favorable growth opportunities based on positive demographic trends in this market.

We accounted for this transaction under the acquisition method of accounting and reported the results of operations of Camellia from the date of acquisition. Assets acquired and liabilities assumed were recorded at their estimated fair values as of the acquisition date. The fair values of identifiable intangible assets were based on valuations using the cost and income approaches. The cost approach is based on amounts that would be required to replace the asset (i.e., replacement cost). The income approach is based on management’s estimates of future operating results and cash flows discounted using a weighted-average cost of capital that reflects market participant assumptions. The excess of the fair value of the consideration conveyed over the fair value of the net assets acquired was recorded as goodwill.

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The fair value of the assets acquired and liabilities assumed at the acquisition date were as follows (in millions):  
Identifiable intangible asset:

Noncompete agreements (useful lives of 5 years)	\$0.1
Certificate of need (useful life of 10 years)	1.0
Licenses (useful lives of 10 years)	0.3
Goodwill	8.1
Total assets acquired	9.5
Total liabilities assumed	(0.1 )
Net assets acquired	\$9.4

Information regarding the net cash paid for home health and hospice acquisitions during each period presented is as follows (in millions):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2016	2015	2016	2015
Fair value of assets acquired	\$1.4	\$7.1	\$1.4	\$8.4
Goodwill	8.1	6.8	8.1	12.8
Fair value of liabilities assumed	(0.1 )	(0.1 )	(0.1 )	(0.1 )
Net cash paid for acquisitions	\$9.4	\$13.8	\$9.4	\$21.1

### Pro Forma Results of Operations

The following table summarizes the results of operations of Hot Springs and Camellia from their respective dates of acquisition included in our consolidated results of operations and the unaudited pro forma results of operations of the combined entity had the date of the acquisitions been January 1, 2015 (in millions):

	Net Operating Revenues	Net Income Attributable to HealthSouth
Acquired entities only: Actual from acquisition date to June 30, 2016	\$ 3.0	\$ (0.8 )
Combined entity: Supplemental pro forma from 04/01/2016-06/30/2016	921.2	62.6
Combined entity: Supplemental pro forma from 04/01/2015-06/30/2015	766.9	43.0
Combined entity: Supplemental pro forma from 01/01/2016-06/30/2016	1,833.0	120.7
Combined entity: Supplemental pro forma from 01/01/2015-06/30/2015	1,510.1	85.8

See Note 2, Business Combinations, to the consolidated financial statements accompanying the 2015 Form 10-K for information regarding acquisitions completed in 2015.

### 3. Variable Interest Entities

As of June 30, 2016, we consolidated ten limited partnership-like entities that are VIEs and of which we are the primary beneficiary. All ten of these entities were also consolidated as of December 31, 2015. Our ownership percentages in these entities range from 6.8% to 99.5%. Through partnership and management agreements with or governing each of these entities, we manage all of these entities and handle all day-to-day operating decisions. Accordingly, we have the decision making power over the activities that most significantly impact the economic performance of our VIEs and an obligation to absorb losses or receive benefits from the VIE that could potentially be significant to the VIE. These decisions and significant

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activities include, but are not limited to, marketing efforts, oversight of patient admissions, medical training, nurse and therapist scheduling, provision of healthcare services, billing, collections and creation and maintenance of medical records. The terms of the agreements governing each of our VIEs prohibit us from using the assets of each VIE to satisfy the obligations of other entities.

The carrying amounts and classifications of the consolidated VIEs' assets and liabilities, which are included in our consolidated balance sheet, are as follows (in millions):

	June 30, 2016
Assets	
Current assets:	
Cash and cash equivalents	\$1.5
Accounts receivable, net of allowance for doubtful accounts	31.4
Other current assets	6.7
Total current assets	39.6
Property and equipment, net	132.6
Goodwill	73.5
Intangible assets, net	8.6
Other long-term assets	1.0
Total assets	\$255.3
Liabilities	
Current liabilities:	
Current portion of long-term debt	\$1.4
Accounts payable	8.5
Accrued expenses and other current liabilities	14.1
Total current liabilities	24.0
Long-term debt, net of current portion	30.6
Total liabilities	\$54.6

#### 4. Investments in and Advances to Nonconsolidated Affiliates

As of June 30, 2016 and December 31, 2015, we had \$13.6 million and \$11.7 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 seven partially owned subsidiaries, of which six 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 60%. We account for these investments using the cost and equity methods of accounting.

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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,	
	2016	2015	2016	2015
Net operating revenues	\$10.9	\$8.9	\$22.1	\$17.1
Operating expenses	(5.8 )	(3.8 )	(12.1 )	(7.7 )
Income from continuing operations, net of tax	5.0	4.8	10.0	8.7
Net income	5.0	4.8	10.0	8.7

#### 5. Long-term Debt

Our long-term debt outstanding consists of the following (in millions):

	June 30, 2016	December 31, 2015
Credit Agreement—		
Advances under revolving credit facility	\$150.0	\$130.0
Term loan facilities	432.3	443.3
Bonds payable—		
7.75% Senior Notes due 2022	75.3	174.3
5.125% Senior Notes due 2023	294.9	294.6
5.75% Senior Notes due 2024	1,192.9	1,192.6
5.75% Senior Notes due 2025	343.6	343.4
2.00% Convertible Senior Subordinated Notes due 2043	270.7	265.9
Other notes payable	43.3	39.2
Capital lease obligations	283.5	288.2
	3,086.5	3,171.5
Less: Current portion	(36.5 )	(36.8 )
Long-term debt, net of current portion	\$3,050.0	\$3,134.7

The following chart shows scheduled principal payments due on long-term debt for the next five years and thereafter (in millions):

	Face Amount	Net Amount
July 1 through December 31, 2016	\$18.2	\$18.2
2017	36.8	36.8
2018	37.2	37.2
2019	40.1	40.0
2020	834.2	783.5
2021	10.7	10.7
Thereafter	2,179.4	2,160.1
Total	\$3,156.6	\$3,086.5

On February 23, 2016, we gave notice of, and made an irrevocable commitment for, the redemption of \$50 million of the outstanding principal amount of our existing 7.75% Senior Notes due 2022 (the “2022 Notes”). On March 24, 2016, we

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completed this redemption using cash on hand and capacity under our revolving credit facility. Pursuant to the terms of the 2022 Notes, this optional redemption was made at a price of 103.875%, which resulted in a total cash outlay of approximately \$52 million. As a result of this redemption, we recorded a \$2.4 million Loss on early extinguishment of debt in the first quarter of 2016.

On April 6, 2016, we gave notice of, and made an irrevocable commitment for, the redemption of an additional \$50 million of the outstanding principal amount of the 2022 Notes. On May 6, 2016, we completed this redemption using cash on hand and capacity under our revolving credit facility. Pursuant to the terms of the 2022 Notes, this optional redemption was also made at a price of 103.875%, which resulted in a total cash outlay of approximately \$52 million. As a result of this redemption, we recorded a \$2.4 million Loss on early extinguishment of debt in the second quarter of 2016.

On July 28, 2016, we gave notice of, and made an irrevocable commitment for, the redemption of the remaining outstanding principal balance of \$76.0 million of the 2022 Notes. Pursuant to the terms of the 2022 Notes, this optional redemption will be made at a price of 102.583%, which will result in a total cash outlay of approximately \$78 million when the transaction closes on September 15, 2016. We plan to use cash on hand and capacity under our revolving credit facility to fund the redemption. As a result of this redemption, we expect to record an approximate \$3 million Loss on early extinguishment of debt in the third quarter of 2016.

In February 2016, we entered into a development/lease agreement with CR HQ, LLC (the “Developer”) to construct our new corporate headquarters in Birmingham, Alabama. Under the terms of this agreement, the Developer is responsible for all costs of constructing the new facility ‘shell’ which will then be leased to us for an initial term of 15 years with four, five-year renewal options. The lease is expected to commence in the first half of 2018. We are responsible for the costs associated with improvements to the interior of the building. Due to the nature and extent of the tenant improvements we will be making to the new corporate headquarters and certain provisions of the development/lease agreement, we are deemed to be the accounting owner of the new corporate headquarters during the construction period. Construction commenced in the second quarter of 2016. Accordingly, we increased Property and equipment, net by \$5.8 million, based on the construction costs incurred to date by the Developer, and recorded a corresponding noncurrent financing obligation liability of \$5.8 million in Long-term debt, net of current portion within our condensed consolidated balance sheet as of June 30, 2016. The total financing obligation associated with the Developer’s costs to construct the new corporate headquarters is estimated at \$56 million. The amounts recorded for construction costs and the corresponding liability are non-cash activities for purposes of our condensed consolidated statement of cash flows.

For additional information regarding our indebtedness, see Note 8, Long-term Debt, to the consolidated financial statements accompanying the 2015 Form 10-K.

#### 6. Redeemable Noncontrolling Interests

The following is a summary of the activity related to our Redeemable noncontrolling interests during the six months ended June 30, 2016 and 2015 (in millions):

	Six Months	
	Ended June 30,	
	2016	2015
Balance at beginning of period	\$121.1	\$84.7
Net income attributable to noncontrolling interests	7.5	6.4
Distributions declared	(4.3 )	(4.0 )
Change in fair value	(4.3 )	11.4
Balance at end of period	\$120.0	\$98.5

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The following table reconciles the net income attributable to nonredeemable Noncontrolling interests, as recorded in the shareholders' equity section of the condensed consolidated balance sheets, and the net income attributable to Redeemable noncontrolling interests, as recorded in the mezzanine section of the condensed consolidated balance sheets, to the Net income attributable to noncontrolling interests presented in the condensed consolidated statements of operations for the three and six months ended June 30, 2016 and 2015 (in millions):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2016	2015	2016	2015
Net income attributable to nonredeemable noncontrolling interests	\$ 15.0	\$ 13.8	\$ 29.8	\$ 27.4
Net income attributable to redeemable noncontrolling interests	3.6	3.5	7.5	6.4
Net income attributable to noncontrolling interests	\$ 18.6	\$ 17.3	\$ 37.3	\$ 33.8

7. 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, 2016	Fair Value Measurements at Reporting Date Using				Valuation Technique <sup>(1)</sup>
	Fair Value	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	
Other current assets:					
Current portion of restricted marketable securities	\$ 27.4	\$ 27.4	\$	\$	—M
Other long-term assets:					
Restricted marketable securities	29.9	29.9	—	—	M
Redeemable noncontrolling interests	120.0	—	120.0	—	I
As of December 31, 2015					
Other current assets:					
Current portion of restricted marketable securities	\$ 16.1	\$ 16.1	\$	\$	—M
Other long-term assets:					
Restricted marketable securities	40.1	40.1	—	—	M
Redeemable noncontrolling interests	121.1	—	121.1	—	I

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

The fair values of our financial assets and liabilities are determined as follows:

Restricted marketable securities - The fair values of our available-for-sale restricted marketable securities are determined based on quoted market prices in active markets or quoted prices, dealer quotations, or alternative pricing sources supported by observable inputs in markets that are not considered to be active.

Redeemable noncontrolling interests - The fair value of the Redeemable noncontrolling interest related to our home health segment is determined using the product of a twelve-month specified performance measure and a specified median market price multiple based on a basket of public health companies. To determine the fair value of the Redeemable noncontrolling interests in our joint venture hospitals, we use the applicable hospitals'





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projected operating results and cash flows discounted using a rate that reflects market participant assumptions for the applicable facilities. The projected operating results use management's best estimates of economic and market conditions over the forecasted periods including assumptions for pricing and volume, operating expenses, and capital expenditures. See also Note 6, Redeemable Noncontrolling Interests.

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, 2016 and June 30, 2015, 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.

As discussed in Note 1, Summary of Significant Accounting Policies, "Fair Value Measurements," to the consolidated financial statements accompanying the 2015 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, 2016		As of December 31, 2015	
	Carrying Amount	Estimated Fair Value	Carrying Amount	Estimated Fair Value
Long-term debt:				
Advances under revolving credit facility	\$ 150.0	\$ 150.0	\$ 130.0	\$ 130.0
Term loan facilities	432.3	433.8	443.3	445.0
7.75% Senior Notes due 2022	75.3	79.3	174.3	183.7
5.125% Senior Notes due 2023	294.9	297.8	294.6	288.0
5.75% Senior Notes due 2024	1,192.9	1,215.8	1,192.6	1,146.0
5.75% Senior Notes due 2025	343.6	350.0	343.4	332.5
2.00% Convertible Senior Subordinated Notes due 2043	270.7	372.4	265.9	345.0
Other notes payable	43.3	43.3	39.2	39.2
Financial commitments:				
Letters of credit	—	35.0	—	34.2

Fair values for our long-term debt and financial commitments are determined using inputs, including quoted prices in nonactive 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 2015 Form 10-K.

#### 8. Share-Based Payments

In February and May 2016, we issued a total of 0.8 million restricted stock awards to members of our management team and our board of directors. Approximately 0.2 million of these awards contain only a service condition, while the remainder contain both a service and a performance or market condition. For the awards that include a performance or market 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 2016, we granted 0.1 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 13, Share-Based Payments, to the consolidated financial statements accompanying the 2015 Form 10-K.

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### 9. Income Taxes

Our Provision for income tax expense of \$42.4 million and \$82.1 million for the three and six months ended June 30, 2016, respectively, primarily resulted from the application of our estimated effective blended federal and state income tax rate. Our Provision for income tax expense of \$32.2 million and \$62.5 million for the three and six months ended June 30, 2015, respectively, primarily resulted from the application of our estimated effective blended federal and state income tax rate.

The \$115.5 million of net deferred tax assets included in the accompanying condensed consolidated balance sheet as of June 30, 2016 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, 2016, we maintained a valuation allowance of \$27.6 million due to uncertainties regarding our ability to utilize a portion of our state net operating losses ("NOLs") and other credits 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. We have significant federal and state NOLs that expire in various amounts at varying times through 2031. Our reported federal NOL of \$25.1 million (approximately \$72 million on a gross basis) as of June 30, 2016 excludes \$15.5 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 when they reduce taxes payable. At June 30, 2016, we had unused federal tax credit carryforwards of \$15.8 million. These credit carryforwards expire in various amounts at various times through 2036.

Total remaining gross unrecognized tax benefits were \$2.8 million and \$2.9 million as of June 30, 2016 and December 31, 2015, respectively, all of which would affect our effective tax rate if recognized. A reconciliation of the beginning and ending liability for unrecognized tax benefits is as follows (in millions):

	Gross Unrecognized Income Tax Benefits
Balance at December 31, 2015	\$ 2.9
Gross amount of increases in unrecognized tax benefits related to prior periods	0.3
Gross amount of decreases in unrecognized tax benefits related to prior periods	(0.4 )
Gross amount of increases in unrecognized tax benefits related to current periods	0.1
Gross amount of decreases in unrecognized tax benefits related to current periods	(0.1 )
Balance at June 30, 2016	\$ 2.8

Our continuing practice is to recognize interest and penalties related to income tax matters in income tax expense. Interest recorded as part of our income tax provision during the three and six months ended June 30, 2016 and 2015 was not material. Accrued interest income related to income taxes as of June 30, 2016 and December 31, 2015 was not material.

In December 2014, we signed an agreement with the IRS to begin participating in their Compliance Assurance Process, a program in which we and the IRS endeavor to agree on the treatment of significant tax positions prior to the filing of our federal income tax return. We signed a new agreement in December 2015 for the 2016 tax year. As a result of these agreements, the IRS surveyed our 2013, 2012, and 2011 federal income tax returns and will examine our 2015 and 2016 returns when filed. Our 2014 federal income tax return has been filed, and the IRS has not indicated its intent to examine or survey this return. We have settled federal income tax examinations with the IRS for all tax years through 2012. Our state income tax



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returns are also periodically examined by various regulatory taxing authorities. We are currently under audit by six states for tax years ranging from 2007 through 2014.

For the tax years that remain open under the applicable statutes of limitation, amounts related to unrecognized tax benefits have been considered by management in its estimate of our potential net recovery of prior years' income taxes. Based on discussions with taxing authorities, we anticipate \$0.4 million to \$2.6 million of our unrecognized tax benefits may be released within the next 12 months.

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## 10. Earnings per Common Share

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,	
	2016	2015	2016	2015
<b>Basic:</b>				
<b>Numerator:</b>				
Income from continuing operations	\$81.3	\$61.8	\$158.1	\$121.1
Less: Net income attributable to noncontrolling interests included in continuing operations	(18.6 )	(17.3 )	(37.3 )	(33.8 )
Less: Income allocated to participating securities	(0.2 )	(0.3 )	(0.4 )	(0.6 )
Less: Convertible perpetual preferred stock dividends	—	—	—	(1.6 )
Income from continuing operations attributable to HealthSouth common shareholders	62.5	44.2	120.4	85.1
Loss from discontinued operations, net of tax, attributable to HealthSouth common shareholders	(0.1 )	(1.6 )	(0.2 )	(1.9 )
Net income attributable to HealthSouth common shareholders	\$62.4	\$42.6	\$120.2	\$83.2
<b>Denominator:</b>				
Basic weighted average common shares outstanding	89.3	89.8	89.4	88.4
Basic earnings per share attributable to HealthSouth common shareholders:				
Continuing operations	\$0.70	\$0.49	\$1.34	\$0.96
Discontinued operations	—	(0.02 )	—	(0.02 )
Net income	\$0.70	\$0.47	\$1.34	\$0.94
<b>Diluted:</b>				
<b>Numerator:</b>				
Income from continuing operations	\$81.3	\$61.8	\$158.1	\$121.1
Less: Net income attributable to noncontrolling interests included in continuing operations	(18.6 )	(17.3 )	(37.3 )	(33.8 )
Add: Interest on convertible debt, net of tax	2.4	2.3	4.8	4.6
Income from continuing operations attributable to HealthSouth common shareholders	65.1	46.8	125.6	91.9
Loss from discontinued operations, net of tax, attributable to HealthSouth common shareholders	(0.1 )	(1.6 )	(0.2 )	(1.9 )
Net income attributable to HealthSouth common shareholders	\$65.0	\$45.2	\$125.4	\$90.0
<b>Denominator:</b>				
Diluted weighted average common shares outstanding	99.4	101.5	99.4	101.3
Diluted earnings per share attributable to HealthSouth common shareholders:				
Continuing operations	\$0.65	\$0.47	\$1.26	\$0.91
Discontinued operations	—	(0.02 )	—	(0.02 )
Net income	\$0.65	\$0.45	\$1.26	\$0.89

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The following table sets forth the reconciliation between basic weighted average common shares outstanding and diluted weighted average common shares outstanding (in millions):

	Three Months Ended June 30, 2016		Six Months Ended June 30, 2015	
Basic weighted average common shares outstanding	89.3	89.8	89.4	88.4
Convertible perpetual preferred stock	—	0.8	—	2.0
Convertible senior subordinated notes	8.5	8.2	8.5	8.2
Restricted stock awards, dilutive stock options, restricted stock units, and common stock warrants	1.6	2.7	1.5	2.7
Diluted weighted average common shares outstanding	99.4	101.5	99.4	101.3

In October 2015, February 2016, and May 2016, our board of directors declared cash dividends of \$0.23 per share that were paid in January 2016, April 2016, and July 2016, respectively. On July 21, 2016, our board of directors approved an increase in our quarterly dividend and declared a cash dividend of \$0.24 per share, payable on October 17, 2016 to stockholders of record on October 3, 2016. As of June 30, 2016 and December 31, 2015, accrued common stock dividends of \$21.3 million were included in Accrued expenses and other current liabilities in our condensed consolidated balance sheets. Future dividend payments are subject to declaration by our board of directors.

On April 22, 2015, we delivered notice of the exercise of our rights to force conversion of all outstanding shares of our Convertible perpetual preferred stock (par value of \$0.10 per share and liquidation preference of \$1,000 per share) pursuant to the underlying certificate of designations. The effective date of the conversion was April 23, 2015. On that date, each share of preferred stock automatically converted into 33.9905 shares of our common stock (par value of \$0.01 per share). We completed the forced conversion by issuing and delivering in the aggregate 3,271,415 shares of our common stock to the registered holders of the 96,245 shares of the preferred stock outstanding and paying cash in lieu of fractional shares due to those holders.

The indenture underlying our convertible notes includes antidilutive protection that requires adjustments to the number of shares of common stock issuable upon conversion and the exercise price for common stock upon the occurrence of certain events, including payment of cash dividends on our common stock after a de minimis threshold. At issuance, the convertible notes had a conversion price of \$39.65 per share, which was equal to an initial conversion rate of 25.2194 shares per \$1,000 principal amount of the convertible notes. The payment of dividends on our common stock has triggered and will continue to trigger, from time to time, the antidilutive adjustment provisions of the convertible notes. The current conversion price of the convertible notes is \$37.59 per share, and the conversion rate is 26.6011 for each \$1,000 principal amount of the convertible notes.

See Note 8, Long-term Debt, Note 10, Convertible Perpetual Preferred Stock, and Note 16, Earnings per Common Share, to the consolidated financial statements accompanying the 2015 Form 10-K for additional information related to our convertible notes, common stock, common stock warrants, and convertible perpetual preferred stock.

#### 11. Contingencies and Other Commitments

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.

##### Nichols 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 stayed in the Circuit Court on August 8, 2005.



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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. On September 12, 2012, the plaintiffs further amended their complaint to request certification as a class action. One of those named officers has repeatedly attempted to remove the case to federal district court, most recently on December 11, 2012. We filed our latest motion to remand the case back to state court on January 10, 2013. On September 27, 2013, the federal court remanded the case back to state court. On November 25, 2014, the plaintiffs filed another amended complaint to assert new allegations relating to the time period of 1997 to 2002. On December 10, 2014, we filed a motion to dismiss on the grounds the plaintiffs lack standing because their claims are derivative in nature, and the claims are time-barred by the statute of limitations. On May 26, 2016, the court granted our motion to dismiss. The plaintiffs appealed the dismissal of the case to the Supreme Court of Alabama on June 28, 2016. The supreme court has not yet scheduled a hearing on the appeal.

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.

Other Litigation—

One of our hospital subsidiaries was named as a defendant in a lawsuit filed August 12, 2013 by an individual in the Circuit Court of Etowah County, Alabama, captioned Honts v. HealthSouth Rehabilitation Hospital of Gadsden, LLC. The plaintiff alleged that her mother, who died more than three months after being discharged from our hospital, received an unprescribed opiate medication at the hospital. We deny the patient received any such medication, accounted for all the opiates at the hospital and argued the plaintiff established no causal liability between the actions of our staff and her mother's death. The plaintiff sought recovery for punitive damages. On May 18, 2016, the jury in this case returned a verdict in favor of the plaintiff for \$20.0 million. On June 17, 2016, we filed a renewed motion for judgment as a matter of law or, in the alternative, a motion for new trial or, in the further alternative, a motion seeking reduction of the damages awarded (collectively, the "post-judgment motions"). Those post-judgment motions remain pending before the trial court. We intend to vigorously defend ourselves in this case through those motions and by appeal, if necessary. Although we continue to believe in the merit of our defenses and counterarguments, we have recorded a liability of \$21.0 million (including \$1.0 million in fees and expenses) in Accrued expenses and other liabilities in our condensed consolidated balance sheet as of June 30, 2016 with a corresponding receivable of \$15.0 million in Other current assets for the portion of the liability we would expect to be covered through our excess insurance coverages, resulting in a net charge of an additional \$5.7 million to Other operating expenses in our condensed consolidated statements of operations for the three and six months ended June 30, 2016. The \$6.0 million portion of this liability would be a covered claim through our captive insurance subsidiary, HCS, Ltd. As a result of the verdict, we posted a bond in the amount of the judgment pending resolution of our post-judgment motions, and if necessary, any appeals.

Governmental Inquiries and Investigations—

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, and issued from the Dallas, Texas office of the HHS-OIG. The subpoena stated it was in connection with an investigation of possible false or otherwise improper claims submitted to Medicare and Medicaid and requested documents and materials relating to patient admissions, length of stay, and discharge matters at this closed LTCH. We furnished the documents requested and have heard nothing from the HHS-OIG since December 2012.

On March 4, 2013, we received document subpoenas from an office of the HHS-OIG addressed to four of our hospitals. Those subpoenas also requested complete copies of medical records for 100 patients treated at each of those



hospitals between September 2008 and June 2012. The investigation is being conducted by the United States Department of Justice (the “DOJ”). On April 24, 2014, we received document subpoenas relating to an additional seven of our hospitals. The new subpoenas reference substantially similar investigation subject matter as the original subpoenas and request materials from the period January 2008 through December 2013. Two of the four hospitals addressed in the original set of subpoenas have received supplemental subpoenas to cover this new time period. The most recent subpoenas do not include requests for specific

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patient files. However, in February 2015, the DOJ requested the voluntary production of the medical records of an additional 70 patients, some of whom were treated in hospitals not subject to the subpoenas, and we provided these records.

All of the subpoenas are in connection with an investigation of alleged improper or fraudulent claims submitted to Medicare and Medicaid and request documents and materials relating to practices, procedures, protocols and policies, of certain pre- and post-admissions activities at these hospitals including, among other things, marketing functions, pre-admission screening, post-admission physician evaluations, patient assessment instruments, individualized patient plans of care, and compliance with the Medicare 60% rule. Under the Medicare rule commonly referred to as the “60% rule,” an inpatient rehabilitation hospital must treat 60% or more of its patients from at least one of a specified list of medical conditions in order to be reimbursed at the inpatient rehabilitation hospital payment rates, rather than at the lower acute care hospital payment rates.

We are cooperating fully with the DOJ in connection with these subpoenas and are currently unable to predict the timing or outcome of the related investigations.

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 typically 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 those suits remain under seal or that we are unaware of such filings or prevented by existing law, court order, or agreement with the government from discussing or disclosing the filing of such suits. 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 the United States Centers for Medicare and Medicaid Services 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.

12. Segment Reporting

Our internal financial reporting and management structure is focused on the major types of services provided by HealthSouth. We manage our operations using two operating segments which are also our reportable segments: (1) inpatient rehabilitation and (2) home health and hospice. These reportable operating segments are consistent with information used by our chief executive officer, who is our chief operating decision maker, to assess performance and allocate resources. The following is a brief description of our reportable segments:

**Inpatient Rehabilitation** - Our national network of inpatient rehabilitation hospitals stretches across 29 states and Puerto Rico, with a concentration of hospitals in the eastern half of the United States and Texas. As of June 30, 2016, we operate 121 inpatient rehabilitation hospitals, including one hospital that operates as a joint venture which we account for using the equity method of accounting. In addition, we manage four inpatient rehabilitation units through management contracts. We provide specialized rehabilitative treatment on both an inpatient and outpatient basis. Our inpatient rehabilitation hospitals provide a higher level of rehabilitative care to patients who are recovering from conditions such as stroke and other neurological disorders, cardiac and pulmonary conditions, brain and spinal cord injuries, complex orthopedic conditions, and amputations.

**Home Health and Hospice** - As of June 30, 2016, we provide home health and hospice services in 218 locations across 24 states. Two of these agencies operate as joint ventures which we account for using the equity method of accounting. Our home health services include a comprehensive range of Medicare-certified home nursing services to adult patients in need of care. These services include, among others, skilled nursing, physical, occupational, and speech therapy, medical social work, and home health aide services. We also provide specialized home care services in Texas and Kansas for pediatric patients with severe medical conditions. Our hospice services primarily



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include in-home services to terminally ill patients and their families to address patients' physical needs, including pain control and symptom management, and to provide emotional and spiritual support.

The accounting policies of our reportable segments are the same as those described in Note 1, Basis of Presentation, "Variable Interest Entities," to these condensed consolidated financial statements and Note 1, Summary of Significant Accounting Policies, to the consolidated financial statements accompanying the 2015 Form 10-K. All revenues for our services are generated through external customers. See Note 1, Basis of Presentation, "Net Operating Revenues," for the payor composition of our revenues. No corporate overhead is allocated to either of our reportable segments. Our chief operating decision maker evaluates the performance of our segments and allocates resources to them based on adjusted earnings before interest, taxes, depreciation, and amortization ("Segment Adjusted EBITDA").

Selected financial information for our reportable segments is as follows (in millions):

	Inpatient Rehabilitation				Home Health and Hospice			
	Three Months Ended June 30,		Six Months Ended June 30,		Three Months Ended June 30,		Six Months Ended June 30,	
	2016	2015	2016	2015	2016	2015	2016	2015
Net operating revenues	\$752.6	\$645.3	\$1,501.8	\$1,275.6	\$168.1	\$119.1	\$328.7	\$229.4
Less: Provision for doubtful accounts	(14.5 )	(10.2 )	(30.1 )	(21.2 )	(0.9 )	(0.7 )	(1.8 )	(1.3 )
Net operating revenues less provision for doubtful accounts	738.1	635.1	1,471.7	1,254.4	167.2	118.4	326.9	228.1
Operating expenses:								
Inpatient rehabilitation:								
Salaries and benefits	366.1	317.6	736.0	624.0	—	—	—	—
Other operating expenses	106.8	93.5	211.6	188.7	—	—	—	—
Supplies	31.8	29.9	64.2	59.7	—	—	—	—
Occupancy costs	15.4	10.7	31.0	21.1	—	—	—	—
Home health and hospice:								
Cost of services sold (excluding depreciation and amortization)	—	—	—	—	81.6	56.7	160.0	110.1
Support and overhead costs	—	—	—	—	58.0	41.0	115.0	79.1
	520.1	451.7	1,042.8	893.5	139.6	97.7	275.0	189.2
Other income	(0.7 )	(0.4 )	(1.3 )	(0.9 )	—	—	—	—
Equity in net income of nonconsolidated affiliates	(2.2 )	(2.3 )	(4.4 )	(3.9 )	(0.2 )	—	(0.4 )	—
Noncontrolling interests	16.8	15.6	33.6	30.8	1.8	1.7	3.7	3.0
Segment Adjusted EBITDA	\$204.1	\$170.5	\$401.0	\$334.9	\$26.0	\$19.0	\$48.6	\$35.9
Capital expenditures	\$47.4	\$33.1	\$86.1	\$59.4	\$1.9	\$1.9	\$2.4	\$2.2

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	Inpatient Rehabilitation	Home Health and Hospice	HealthSouth Consolidated	
As of June 30, 2016				
Total assets	\$ 3,612.4	\$ 1,091.5	\$ 4,632.6	
Investments in and advances to nonconsolidated affiliates	10.8	2.8	13.6	
As of December 31, 2015				
Total assets	\$ 3,589.0	\$ 1,088.4	\$ 4,606.1	
Investments in and advances to nonconsolidated affiliates	9.3	2.4	11.7	
Segment reconciliations (in millions):				
	Three Months Ended June 30,		Six Months Ended June 30,	
	2016	2015	2016	2015
Total segment Adjusted EBITDA	\$230.1	\$189.5	\$449.6	\$370.8
General and administrative expenses	(34.4 )	(32.1 )	(66.3 )	(66.7 )
Depreciation and amortization	(42.9 )	(32.7 )	(85.3 )	(64.6 )
(Loss) gain on disposal or impairment of assets	(0.2 )	(0.8 )	(0.4 )	0.7
Government, class action, and related settlements	—	—	—	(8.0 )
Professional fees - accounting, tax, and legal	(1.7 )	(0.1 )	(1.9 )	(2.3 )
Loss on early extinguishment of debt	(2.4 )	(18.8 )	(4.8 )	(20.0 )
Interest expense and amortization of debt discounts and fees	(43.4 )	(30.9 )	(88.0 )	(62.7 )
Net income attributable to noncontrolling interests	18.6	17.3	37.3	33.8
Gain related to SCA equity interest	—	2.6	—	2.6
Income from continuing operations before income tax expense	\$123.7	\$94.0	\$240.2	\$183.6
			June 30,	December 31,
			2016	2015
Total assets for reportable segments			\$4,703.9	\$ 4,677.4
Reclassification of deferred income tax liabilities to net deferred income tax assets			(71.3 )	(71.3 )
Total consolidated assets			\$4,632.6	\$ 4,606.1
Additional detail regarding the revenues of our operating segments by service line follows (in millions):				
	Three Months Ended June 30,		Six Months Ended June 30,	
	2016	2015	2016	2015
Inpatient rehabilitation:				
Inpatient	\$721.2	\$618.7	\$1,440.5	\$1,225.3
Outpatient and other	31.4	26.6	61.3	50.3
Total inpatient rehabilitation	752.6	645.3	1,501.8	1,275.6
Home health and hospice:				
Home health	157.1	111.5	308.0	215.4
Hospice	11.0	7.6	20.7	14.0
Total home health and hospice	168.1	119.1	328.7	229.4
Total net operating revenues	\$920.7	\$764.4	\$1,830.5	\$1,505.0

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13. 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 nonguarantor subsidiaries and nonguarantor subsidiaries' investments in guarantor subsidiaries, are presented under the equity method of accounting with the related investment presented within the line items Intercompany receivable and investments in consolidated affiliates and Intercompany payable in the accompanying condensed consolidating balance sheets.

The terms of our credit agreement allow us to declare and pay cash dividends on our common stock so long as: (1) we are not in default under our credit agreement and (2) our senior secured leverage ratio (as defined in our credit agreement) remains less than or equal to 1.75x. The terms of our senior note indenture allow us to declare and pay cash dividends on our common stock so long as (1) we are not in default, (2) the consolidated coverage ratio (as defined in the indenture) exceeds 2x or we are otherwise allowed under the indenture to incur debt, and (3) we have capacity under the indenture's restricted payments covenant to declare and pay dividends. See Note 8, Long-term Debt, to the consolidated financial statements accompanying the 2015 Form 10-K.

Periodically, certain wholly owned subsidiaries of HealthSouth make dividends or distributions of available cash and/or intercompany receivable balances to their parents. In addition, HealthSouth makes contributions to certain wholly owned subsidiaries. When made, these dividends, distributions, and contributions impact the Intercompany receivable, Intercompany payable, and HealthSouth shareholders' equity line items in the accompanying condensed consolidating balance sheet but have no impact on the consolidated financial statements of HealthSouth Corporation.

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	Three Months Ended June 30, 2016				HealthSouth Consolidated
	HealthSouth Corporation	Subsidiaries	Non-guarantor Subsidiaries	Eliminating Entries	
	(In Millions)				
Net operating revenues	\$5.1	\$ 546.1	\$ 398.9	\$ (29.4 )	\$ 920.7
Less: Provision for doubtful accounts	—	(10.6 )	(4.8 )	—	(15.4 )
Net operating revenues less provision for doubtful accounts	5.1	535.5	394.1	(29.4 )	905.3
Operating expenses:					
Salaries and benefits	11.0	248.7	231.0	(4.6 )	486.1
Other operating expenses	6.9	76.7	49.4	(11.5 )	121.5
Occupancy costs	0.9	22.4	7.9	(13.3 )	17.9
Supplies	—	22.4	12.0	—	34.4
General and administrative expenses	31.2	—	3.2	—	34.4
Depreciation and amortization	2.4	25.9	14.6	—	42.9
Professional fees—accounting, tax, and legal	1.7	—	—	—	1.7
Total operating expenses	54.1	396.1	318.1	(29.4 )	738.9
Loss on early extinguishment of debt	2.4	—	—	—	2.4
Interest expense and amortization of debt discounts and fees	36.6	5.7	6.0	(4.9 )	43.4
Other income	(4.9 )	(0.1 )	(0.6 )	4.9	(0.7 )
Equity in net income of nonconsolidated affiliates	—	(2.2 )	(0.2 )	—	(2.4 )
Equity in net income of consolidated affiliates	(88.7 )	(10.4 )	—	99.1	—
Management fees	(33.8 )	25.9	7.9	—	—
Income from continuing operations before income tax (benefit) expense	39.4	120.5	62.9	(99.1 )	123.7
Provision for income tax (benefit) expense	(23.3 )	48.1	17.6	—	42.4
Income from continuing operations	62.7	72.4	45.3	(99.1 )	81.3
Loss from discontinued operations, net of tax	(0.1 )	—	—	—	(0.1 )
Net income	62.6	72.4	45.3	(99.1 )	81.2
Less: Net income attributable to noncontrolling interests	—	—	(18.6 )	—	(18.6 )
Net income attributable to HealthSouth	\$62.6	\$ 72.4	\$ 26.7	\$ (99.1 )	\$ 62.6
Comprehensive income	\$62.8	\$ 72.4	\$ 45.3	\$ (99.1 )	\$ 81.4
Comprehensive income attributable to HealthSouth	\$62.8	\$ 72.4	\$ 26.7	\$ (99.1 )	\$ 62.8

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	Three Months Ended June 30, 2015					
	HealthSouth Corporation	Subsidiaries	Grantor Subsidiaries	Nonguarantor Subsidiaries	Eliminating Entries	HealthSouth Consolidated
	(In Millions)					
Net operating revenues	\$5.1	\$ 460.0		\$ 325.0	\$ (25.7 )	\$ 764.4
Less: Provision for doubtful accounts	—	(8.1 )		(2.8 )	—	(10.9 )
Net operating revenues less provision for doubtful accounts	5.1	451.9		322.2	(25.7 )	753.5
Operating expenses:						
Salaries and benefits	12.2	212.1		181.7	(4.2 )	401.8
Other operating expenses	6.7	67.0		40.7	(10.2 )	104.2
Occupancy costs	1.0	15.8		7.0	(11.3 )	12.5
Supplies	—	20.7		11.0	—	31.7
General and administrative expenses	31.5	—		0.6	—	32.1
Depreciation and amortization	2.4	19.4		10.9	—	32.7
Professional fees—accounting, tax, and legal	0.1	—		—	—	0.1
Total operating expenses	53.9	335.0		251.9	(25.7 )	615.1
Loss on early extinguishment of debt	18.8	—		—	—	18.8
Interest expense and amortization of debt discounts and fees	28.4	2.1		2.9	(2.5 )	30.9
Other income	(4.8 )	(0.1 )		(0.6 )	2.5	(3.0 )
Equity in net income of nonconsolidated affiliates	—	(2.3 )		—	—	(2.3 )
Equity in net income of consolidated affiliates	(81.7 )	(8.8 )		—	90.5	—
Management fees	(29.3 )	21.8		7.5	—	—
Income from continuing operations before income tax (benefit) expense	19.8	104.2		60.5	(90.5 )	94.0
Provision for income tax (benefit) expense	(24.7 )	39.7		17.2	—	32.2
Income from continuing operations	44.5	64.5		43.3	(90.5 )	61.8
Loss from discontinued operations, net of tax	(1.6 )	—		—	—	(1.6 )
Net income	42.9	64.5		43.3	(90.5 )	60.2
Less: Net income attributable to noncontrolling interests	—	—		(17.3 )	—	(17.3 )
Net income attributable to HealthSouth	\$42.9	\$ 64.5		\$ 26.0	\$ (90.5 )	\$ 42.9
Comprehensive income	\$43.0	\$ 64.5		\$ 43.3	\$ (90.5 )	\$ 60.3
Comprehensive income attributable to HealthSouth	\$43.0	\$ 64.5		\$ 26.0	\$ (90.5 )	\$ 43.0



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	Six Months Ended June 30, 2016				
	HealthSouth Corporation	Guarantor Subsidiaries	Nonguarantor Subsidiaries	Eliminating Entries	HealthSouth Consolidated
	(In Millions)				
Net operating revenues	\$ 10.0	\$ 1,088.5	\$ 790.3	\$ (58.3 )	\$ 1,830.5
Less: Provision for doubtful accounts	—	(22.4 )	(9.5 )	—	(31.9 )
Net operating revenues less provision for doubtful accounts	10.0	1,066.1	780.8	(58.3 )	1,798.6
Operating expenses:					
Salaries and benefits	22.3	500.0	459.1	(9.2 )	972.2
Other operating expenses	12.5	152.6	98.1	(22.5 )	240.7
Occupancy costs	1.8	44.8	15.9	(26.6 )	35.9
Supplies	—	45.2	24.2	—	69.4
General and administrative expenses	64.3	—	2.0	—	66.3
Depreciation and amortization	4.8	51.8	28.7	—	85.3
Professional fees—accounting, tax, and legal	1.9	—	—	—	1.9
Total operating expenses	107.6	794.4	628.0	(58.3 )	1,471.7
Loss on early extinguishment of debt	4.8	—	—	—	4.8
Interest expense and amortization of debt discounts and fees	75.4	10.9	11.4	(9.7 )	88.0
Other income	(9.6 )	(0.2 )	(1.2 )	9.7	(1.3 )
Equity in net income of nonconsolidated affiliates	—	(4.4 )	(0.4 )	—	(4.8 )
Equity in net income of consolidated affiliates	(174.4 )	(19.9 )	—	194.3	—
Management fees	(68.0 )	51.7	16.3	—	—
Income from continuing operations before income tax (benefit) expense	74.2	233.6	126.7	(194.3 )	240.2
Provision for income tax (benefit) expense	(46.6 )	93.2	35.5	—	82.1
Income from continuing operations	120.8	140.4	91.2	(194.3 )	158.1
Loss from discontinued operations, net of tax	(0.2 )	—	—	—	(0.2 )
Net income	120.6	140.4	91.2	(194.3 )	157.9
Less: Net income attributable to noncontrolling interests	—	—	(37.3 )	—	(37.3 )
Net income attributable to HealthSouth	\$ 120.6	\$ 140.4	\$ 53.9	\$ (194.3 )	\$ 120.6
Comprehensive income	\$ 120.9	\$ 140.4	\$ 91.2	\$ (194.3 )	\$ 158.2
Comprehensive income attributable to HealthSouth	\$ 120.9	\$ 140.4	\$ 53.9	\$ (194.3 )	\$ 120.9

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	Six Months Ended June 30, 2015				
	HealthSouth Corporation	Guarantor Subsidiaries	Nonguarantor Subsidiaries	Eliminating Entries	HealthSouth Consolidated
	(In Millions)				
Net operating revenues	\$10.4	\$ 907.7	\$ 637.3	\$ (50.4 )	\$ 1,505.0
Less: Provision for doubtful accounts	—	(17.0 )	(5.5 )	—	(22.5 )
Net operating revenues less provision for doubtful accounts	10.4	890.7	631.8	(50.4 )	1,482.5
Operating expenses:					
Salaries and benefits	20.3	418.2	356.7	(8.3 )	786.9
Other operating expenses	16.2	128.7	83.1	(20.6 )	207.4
Occupancy costs	2.1	30.4	13.6	(21.5 )	24.6
Supplies	—	41.1	22.0	—	63.1
General and administrative expenses	65.8	—	0.9	—	66.7
Depreciation and amortization	4.7	38.3	21.6	—	64.6
Government, class action, and related settlements	8.0	—	—	—	8.0
Professional fees—accounting, tax, and legal	2.3	—	—	—	2.3
Total operating expenses	119.4	656.7	497.9	(50.4 )	1,223.6
Loss on early extinguishment of debt	20.0	—	—	—	20.0
Interest expense and amortization of debt discounts and fees	57.6	4.4	5.6	(4.9 )	62.7
Other income	(7.1 )	(0.1 )	(1.2 )	4.9	(3.5 )
Equity in net income of nonconsolidated affiliates	—	(3.9 )	—	—	(3.9 )
Equity in net income of consolidated affiliates	(160.1)	(17.4 )	—	177.5	—
Management fees	(57.8 )	43.1	14.7	—	—
Income from continuing operations before income tax (benefit) expense	38.4	207.9	114.8	(177.5 )	183.6
Provision for income tax (benefit) expense	(48.9 )	79.1	32.3	—	62.5
Income from continuing operations	87.3	128.8	82.5	(177.5 )	121.1
Loss from discontinued operations, net of tax	(1.9 )	—	—	—	(1.9 )
Net income	85.4	128.8	82.5	(177.5 )	119.2
Less: Net income attributable to noncontrolling interests	—	—	(33.8 )	—	(33.8 )
Net income attributable to HealthSouth	\$85.4	\$ 128.8	\$ 48.7	\$ (177.5 )	\$ 85.4
Comprehensive income	\$85.6	\$ 128.8	\$ 82.5	\$ (177.5 )	\$ 119.4
Comprehensive income attributable to HealthSouth	\$85.6	\$ 128.8	\$ 48.7	\$ (177.5 )	\$ 85.6

HealthSouth Corporation and Subsidiaries  
Notes to Condensed Consolidated Financial Statements  
Condensed Consolidating Balance Sheet

	As of June 30, 2016				
	HealthSouth Corporation	Guarantor Subsidiaries	Nonguarantor Subsidiaries	Eliminating Entries	HealthSouth Consolidated
	(In Millions)				
<b>Assets</b>					
<b>Current assets:</b>					
Cash and cash equivalents	\$56.5	\$ 2.4	\$ 11.4	\$—	\$ 70.3
Accounts receivable, net	—	262.0	158.6	—	420.6
Other current assets	67.3	23.1	138.2	(60.0 )	168.6
Total current assets	123.8	287.5	308.2	(60.0 )	659.5
Property and equipment, net	21.1	987.8	328.0	—	1,336.9
Goodwill	—	860.6	1,039.1	—	1,899.7
Intangible assets, net	15.2	119.0	280.0	—	414.2
Deferred income tax assets	99.5	64.1	—	(48.1 )	115.5
Other long-term assets	49.2	88.6	69.0	—	206.8
Intercompany notes receivable	537.3	—	—	(537.3 )	—
Intercompany receivable and investments in consolidated affiliates	2,809.9	13.8	—	(2,823.7 )	—
Total assets	\$3,656.0	\$ 2,421.4	\$ 2,024.3	\$(3,469.1 )	\$ 4,632.6
<b>Liabilities and Shareholders' Equity</b>					
<b>Current liabilities:</b>					
Current portion of long-term debt	\$40.0	\$ 6.3	\$ 7.7	\$(17.5 )	\$ 36.5
Accounts payable	5.6	39.7	21.8	—	67.1
Accrued expenses and other current liabilities	153.7	92.7	151.6	(42.5 )	355.5
Total current liabilities	199.3	138.7	181.1	(60.0 )	459.1
Long-term debt, net of current portion	2,743.2	252.4	54.4	—	3,050.0
Intercompany notes payable	—	—	537.3	(537.3 )	—
Other long-term liabilities	40.8	14.6	146.5	(47.8 )	154.1
Intercompany payable	—	—	176.3	(176.3 )	—
	2,983.3	405.7	1,095.6	(821.4 )	3,663.2
<b>Commitments and contingencies</b>					
Redeemable noncontrolling interests	—	—	120.0	—	120.0
<b>Shareholders' equity:</b>					
HealthSouth shareholders' equity	672.7	2,015.7	632.0	(2,647.7 )	672.7
Noncontrolling interests	—	—	176.7	—	176.7
Total shareholders' equity	672.7	2,015.7	808.7	(2,647.7 )	849.4
Total liabilities and shareholders' equity	\$3,656.0	\$ 2,421.4	\$ 2,024.3	\$(3,469.1 )	\$ 4,632.6

HealthSouth Corporation and Subsidiaries  
Notes to Condensed Consolidated Financial Statements  
Condensed Consolidating Balance Sheet

	As of December 31, 2015				
	HealthSouth Corporation	Guarantor Subsidiaries	Nonguarantor Subsidiaries	Eliminating Entries	HealthSouth Consolidated
	(In Millions)				
<b>Assets</b>					
<b>Current assets:</b>					
Cash and cash equivalents	\$41.2	\$ 1.2	\$ 19.2	\$—	\$ 61.6
Accounts receivable, net	—	261.5	149.0	—	410.5
Other current assets	29.3	22.2	93.9	(18.8 )	126.6
Total current assets	70.5	284.9	262.1	(18.8 )	598.7
Property and equipment, net	14.5	988.4	307.2	—	1,310.1
Goodwill	—	860.7	1,029.4	—	1,890.1
Intangible assets, net	8.8	122.4	288.2	—	419.4
Deferred income tax assets	176.2	64.1	—	(49.5 )	190.8
Other long-term assets	48.6	75.3	73.1	—	197.0
Intercompany notes receivable	546.6	—	—	(546.6 )	—
Intercompany receivable and investments in consolidated affiliates	2,779.7	—	—	(2,779.7 )	—
Total assets	\$3,644.9	\$ 2,395.8	\$ 1,960.0	\$(3,394.6 )	\$ 4,606.1
<b>Liabilities and Shareholders' Equity</b>					
<b>Current liabilities:</b>					
Current portion of long-term debt	\$40.0	\$ 6.8	\$ 7.5	\$(17.5 )	\$ 36.8
Accounts payable	5.8	35.4	20.4	—	61.6
Accrued expenses and other current liabilities	122.2	71.8	135.3	(1.3 )	328.0
Total current liabilities	168.0	114.0	163.2	(18.8 )	426.4
Long-term debt, net of current portion	2,821.9	255.6	57.2	—	3,134.7
Intercompany notes payable	—	—	546.6	(546.6 )	—
Other long-term liabilities	43.6	12.3	137.8	(49.1 )	144.6
Intercompany payable	—	156.7	157.5	(314.2 )	—
	3,033.5	538.6	1,062.3	(928.7 )	3,705.7
<b>Commitments and contingencies</b>					
Redeemable noncontrolling interests	—	—	121.1	—	121.1
<b>Shareholders' equity:</b>					
HealthSouth shareholders' equity	611.4	1,857.2	608.7	(2,465.9 )	611.4
Noncontrolling interests	—	—	167.9	—	167.9
Total shareholders' equity	611.4	1,857.2	776.6	(2,465.9 )	779.3
Total liabilities and shareholders' equity	\$3,644.9	\$ 2,395.8	\$ 1,960.0	\$(3,394.6 )	\$ 4,606.1

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

	Six Months Ended June 30, 2016				
	HealthSouth Corporation	Guarantor Subsidiaries	Nonguarantor Subsidiaries	Eliminating Entries	HealthSouth Consolidated
	(In Millions)				
Net cash provided by operating activities	\$31.5	\$ 182.5	\$ 97.9	\$ —	\$ 311.9
Cash flows from investing activities:					
Purchases of property and equipment	(5.4 )	(35.3 )	(30.7 )	—	(71.4 )
Capitalized software costs	(7.6 )	(6.0 )	(1.6 )	—	(15.2 )
Acquisitions of businesses, net of cash acquired	—	—	(9.4 )	—	(9.4 )
Net change in restricted cash	—	—	(11.5 )	—	(11.5 )
Funding of intercompany note receivable	(6.5 )	—	—	6.5	—
Proceeds from repayment of intercompany note receivable	22.0	—	—	(22.0 )	—
Other	(2.8 )	(0.1 )	4.9	—	2.0
Net cash used in investing activities	(0.3 )	(41.4 )	(48.3 )	(15.5 )	(105.5 )
Cash flows from financing activities:					
Principal payments on debt, including pre-payments	(111.2)	(0.8 )	(0.8 )	—	(112.8 )
Principal borrowings on intercompany note payable	—	—	6.5	(6.5 )	—
Principal payments on intercompany note payable	—	—	(22.0 )	22.0	—
Borrowings on revolving credit facility	165.0	—	—	—	165.0
Payments on revolving credit facility	(145.0)	—	—	—	(145.0 )
Repurchases of common stock, including fees and expenses	(24.1 )	—	—	—	(24.1 )
Dividends paid on common stock	(41.9 )	—	—	—	(41.9 )
Distributions paid to noncontrolling interests of consolidated affiliates	—	—	(33.6 )	—	(33.6 )
Other	2.2	(2.9 )	(4.6 )	—	(5.3 )
Change in intercompany advances	139.1	(136.2 )	(2.9 )	—	—
Net cash used in financing activities	(15.9 )	(139.9 )	(57.4 )	15.5	(197.7 )
Increase (decrease) in cash and cash equivalents	15.3	1.2	(7.8 )	—	8.7
Cash and cash equivalents at beginning of period	41.2	1.2	19.2	—	61.6
Cash and cash equivalents at end of period	\$56.5	\$ 2.4	\$ 11.4	\$ —	\$ 70.3

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

	Six Months Ended June 30, 2015				
	HealthSouth Corporation	Guarantor Subsidiaries	Nonguarantor Subsidiaries	Eliminating Entries	HealthSouth Consolidated
	(In Millions)				
Net cash (used in) provided by operating activities	\$(13.5)	\$ 120.9	\$ 97.5	\$ —	\$ 204.9
Cash flows from investing activities:					
Purchases of property and equipment	(5.1 )	(24.2 )	(17.0 )	—	(46.3 )
Capitalized software costs	(13.9 )	—	(1.3 )	—	(15.2 )
Acquisitions of businesses, net of cash acquired	(56.5 )	—	(21.2 )	—	(77.7 )
Net change in restricted cash	—	—	13.1	—	13.1
Other	7.7	3.3	(5.6 )	(6.0 )	(0.6 )
Net cash used in investing activities	(67.8 )	(20.9 )	(32.0 )	(6.0 )	(126.7 )
Cash flows from financing activities:					
Proceeds from bond issuance	700.0	—	—	—	700.0
Principal payments on debt, including pre-payments	(545.0)	(0.8 )	(0.3 )	—	(546.1 )
Borrowings on revolving credit facility	270.0	—	—	—	270.0
Payments on revolving credit facility	(442.0)	—	—	—	(442.0 )
Debt amendment and issuance costs	(13.9 )	—	—	—	(13.9 )
Dividends paid on common stock	(37.1 )	—	—	—	(37.1 )
Dividends paid on convertible perpetual preferred stock	(3.1 )	—	—	—	(3.1 )
Distributions paid to noncontrolling interests of consolidated affiliates	—	—	(26.2 )	—	(26.2 )
Other	1.7	(0.8 )	(7.9 )	6.0	(1.0 )
Change in intercompany advances	138.6	(98.6 )	(40.0 )	—	—
Net cash provided by (used in) financing activities	69.2	(100.2 )	(74.4 )	6.0	(99.4 )
Decrease in cash and cash equivalents	(12.1 )	(0.2 )	(8.9 )	—	(21.2 )
Cash and cash equivalents at beginning of period	41.9	1.4	23.4	—	66.7
Cash and cash equivalents at end of period	\$29.8	\$ 1.2	\$ 14.5	\$ —	\$ 45.5

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

The following Management's Discussion and Analysis of Financial Condition and Results of Operations ("MD&A") relates to HealthSouth Corporation and its subsidiaries and should be read in conjunction with our condensed consolidated financial statements included under Part I, Item 1, Financial Statements (Unaudited), of this report and our audited consolidated financial statements for the year ended December 31, 2015 and Management's Discussion and Analysis of Financial Condition and Results of Operations which are included in our Annual Report on Form 10-K for the year ended December 31, 2015 (the "2015 Form 10-K").

This MD&A is designed to provide the reader with information that will assist in understanding our condensed consolidated financial statements, the changes in certain key items in those financial statements from period to period, and the primary factors that accounted for those changes, as well as how certain accounting principles affect our condensed consolidated financial statements. See "Cautionary Statements Regarding Forward-Looking Statements" on page i of this report for a description of important factors that could cause actual results to differ from expected results. See also Item 1A, Risk Factors, of this report and to the 2015 Form 10-K.

### Executive Overview

#### Our Business

We are one of the nation's largest providers of post-acute healthcare services, offering both facility-based and home-based post-acute services in 34 states and Puerto Rico through our network of inpatient rehabilitation hospitals, home health agencies, and hospice agencies. As discussed in this Item, "Segment Results of Operations," we manage our operations using two operating segments which are also our reportable segments: (1) inpatient rehabilitation and (2) home health and hospice. For additional information about our business, see Item 1, Business, of the 2015 Form 10-K.

#### Inpatient Rehabilitation

We are the nation's largest owner and operator of inpatient rehabilitation hospitals in terms of patients treated and discharged, revenues, and number of hospitals. We provide specialized rehabilitative treatment on both an inpatient and outpatient basis. While our national network of inpatient hospitals stretches across 29 states and Puerto Rico, we are concentrated in the eastern half of the United States and Texas. As of June 30, 2016, we operate 121 inpatient rehabilitation hospitals, including one hospital that operates as a joint venture which we account for using the equity method of accounting. In addition to HealthSouth hospitals, we manage four inpatient rehabilitation units through management contracts. Our inpatient rehabilitation segment represented approximately 82% of our Net operating revenues for the three and six months ended June 30, 2016.

#### Home Health and Hospice

We are the nation's fourth largest provider of Medicare-certified skilled home health services. As of June 30, 2016, we provide home health and hospice services in 218 locations across 24 states. Two of these home health locations operate as joint ventures which we account for using the equity method of accounting. Our home health services include a comprehensive range of Medicare-certified home nursing services to adult patients in need of care. These services include, among others, skilled nursing, physical, occupational, and speech therapy, medical social work, and home health aide services. We also provide specialized home care services in Texas and Kansas for pediatric patients with severe medical conditions. Our hospice services primarily include in-home services to terminally ill patients and their families to address patients' physical needs, including pain control and symptom management, and to provide emotional and spiritual support. Our home health and hospice segment represented approximately 18% of our Net operating revenues for the three and six months ended June 30, 2016.

As of March 31, 2016, all of HealthSouth's 25 legacy agencies, with the exception of one closing, had been integrated into Encompass Home Health and Hospice ("Encompass"), which we acquired on December 31, 2014, with 12 of those locations relocated or merged into existing Encompass locations. In addition, Encompass operates one of HealthSouth's integrated agencies as two locations.

#### 2016 Overview

Our 2016 strategy focuses on the following priorities:

- continuing to provide high-quality, cost-effective care to patients in our existing markets;
- achieving organic growth at our existing hospitals, home health agencies, and hospice agencies;





expanding our services to more patients who require post-acute healthcare services by constructing and acquiring new hospitals in new markets and acquiring home health and hospice agencies in new markets;  
continuing our shareholder value-enhancing strategies such as common stock dividends and repurchases of our common stock; and

positioning the Company for continued success in the evolving healthcare delivery system. This preparation includes continuing the installation of our electronic clinical information system in our hospitals which allows for interfaces with all major acute care electronic medical record systems and health information exchanges and participating in bundling projects and Accountable Care Organizations (“ACOs”).

During the three and six months ended June 30, 2016, Net operating revenues increased by 20.4% and 21.6% over the same periods of 2015 due primarily to our acquisitions of the operations of Reliant Hospital Partners, LLC and affiliated entities (“Reliant”) on October 1, 2015 and CareSouth Health System, Inc. (“CareSouth”) on November 2, 2015 (see Note 2, Business Combinations, to the consolidated financial statements accompanying the 2015 Form 10-K).

Within our inpatient rehabilitation segment, discharge growth of 13.6% coupled with a 2.6% increase in net patient revenue per discharge in the second quarter of 2016 generated 16.6% growth in net patient revenue from our hospitals compared to the second quarter of 2015. Discharge growth included a 1.9% increase in same-store discharges. During the six months ended June 30, 2016, discharge growth of 15.3% coupled with a 2.0% increase in net patient revenue per discharge generated 17.7% growth in net patient revenue from our hospitals compared to the six months ended June 30, 2015. Discharge growth for the six-month period included a 2.3% increase in same-store discharges. Our inpatient rehabilitation quality and outcome measures, as reported through the Uniform Data System for Medical Rehabilitation (the “UDS”), remained well above the average for hospitals included in the UDS database.

Within our home health and hospice segment, admission growth of 52.7% coupled with the impact of a 1.6% decrease in revenue per episode in the second quarter of 2016 generated 41.1% growth in home health and hospice revenue compared to the second quarter of 2015. Admission growth included a 11.1% increase in same-store admissions.

During the six months ended June 30, 2016, admission growth of 54.4% coupled with the impact of a 1.9% decrease in revenue per episode generated 43.3% growth in home health and hospice revenue compared to the six months ended June 30, 2015. Admission growth for the six-month period included a 11.7% increase in same-store admissions.

The quality of patient care star rating for our home health agencies continued to be well above the national average, as reported by the United States Centers for Medicare and Medicaid Services (“CMS”). In addition, 30-day readmission rates at our home health agencies continued to be well below the national average, as reported by Avalere Health and the Alliance for Home Health Quality and Innovation.

Our growth efforts thus far in 2016 have included the following:

began operating the 27-bed inpatient rehabilitation hospital at CHI St. Vincent Hot Springs, a Catholic Health Initiatives’ hospital, in Hot Springs, Arkansas with our joint venture partner, St. Vincent Community Health Services, Inc, in February 2016. The joint venture completed construction of a new 40-bed hospital and began accepting patients on July 1, 2016;

acquired, in May 2016, Home Health Agency of Georgia, LLC., a home health and hospice provider with two home health locations and two hospice locations in the Greater Atlanta area;

began accepting patients at our new home health locations in Lee’s Summit, Missouri in February 2016 and New Port Richey, Florida in May 2016;

continued our capacity expansions by adding 60 new beds to existing hospitals; and

continued development of the following de novo hospitals:

Location	# of Beds	Actual / Expected Construction Start Date	Expected Operational Date
Modesto, California	50	Q1 2015	Q4 2016
Pearland, Texas <sup>(1)</sup>	40	Q4 2016	Q4 2017
Shelby County, Alabama <sup>(2)</sup>	34	First half of 2017	First half of 2018
Murrieta, California <sup>(3)</sup>	50	First half of 2017	Second half of 2018

<sup>(1)</sup> In March 2016, we acquired land and began the design and permitting process to build an inpatient rehabilitation hospital.

<sup>(2)</sup> In June 2016, we were awarded a certificate of need, acquired land, and began the design and permitting process to build an inpatient rehabilitation hospital.

<sup>(3)</sup> In August 2014, we acquired land and began the design and permitting process to build an inpatient rehabilitation hospital.

In addition to our growth efforts, we took the following steps to further increase the strength and flexibility of our balance sheet.

In March 2016, we redeemed \$50.0 million of the outstanding principal amount of our existing 7.75% Senior Notes due 2022 (the “2022 Notes”) using cash on hand and capacity under our revolving credit facility. Pursuant to the terms of these notes, this optional redemption was made at a price of 103.875%, which resulted in a total cash outlay of approximately \$52 million.

In May 2016, we redeemed an additional \$50.0 million of the outstanding principal amount of the 2022 Notes using cash on hand and capacity under our revolving credit facility. Pursuant to the terms of these notes, this optional redemption was also made at a price of 103.875%, which resulted in a total cash outlay of approximately \$52 million. For additional information regarding these actions, see Note 5, Long-term Debt, to the condensed consolidated financial statements included in Part I, Item 1, Financial Statements (Unaudited), of this report and the “Liquidity and Capital Resources” section of this Item.

We also continued our shareholder value-enhancing strategies by repurchasing 0.6 million shares of our common stock in the open market for approximately \$22 million during the first and second quarters of 2016. In addition, we continued paying a quarterly cash dividend of \$0.23 per share on our common stock in the first and second quarters of 2016. See the “Liquidity and Capital Resources” section of this Item.

#### Business Outlook

We believe our business outlook remains positive for two primary reasons. First, demographic trends, such as population aging, should increase long-term demand for facility-based and home-based post-acute services. While we treat patients of all ages, most of our patients are 65 and older, and the number of Medicare enrollees is expected to grow approximately 3% per year for the foreseeable future. We believe the demand for facility-based and home-based post-acute services will continue to increase as the U.S. population ages and life expectancies increase.

Second, we are an industry leader in the growing post-acute sector. As the nation’s largest owner and operator of inpatient rehabilitation hospitals, we believe we differentiate ourselves from our competitors based on our broad platform of clinical expertise, the quality of our clinical outcomes, the sustainability of best practices, and the application of rehabilitative technology. As the fourth largest provider of Medicare-certified skilled home health services, we believe we differentiate ourselves from our competitors by virtue of our scale and density in the markets we serve, the application of a highly integrated technology platform, our ability to manage a variety of care pathways, and a proven track record of consummating and integrating acquisitions.

We have invested considerable resources into clinical and management systems and protocols that have allowed us to consistently produce high-quality outcomes for our patients while continuing to contain cost growth. Our proprietary hospital



management reporting system aggregates data from each of our key business systems into a comprehensive reporting package used by the management teams in our hospitals, as well as executive management, and allows them to analyze data and trends and create custom reports on a timely basis. Our commitment to technology also includes the on-going implementation of our rehabilitation-specific electronic clinical information system. As of June 30, 2016, we had installed this system in 92 of our 121 hospitals. We believe this system will improve patient care and safety, enhance staff recruitment and retention, and set the stage for connectivity with other providers and health information exchanges. Our home health and hospice segment also uses information technology to enhance patient care and manage the business by utilizing Homecare Homebase<sup>SM</sup>, a comprehensive information platform that allows home health providers to process clinical, compliance, and marketing information as well as analyze data and trends for management purposes using custom reports on a timely basis. This allows our home health segment to manage the entire patient work flow and provide valuable data for health systems, payors, and ACO partners. We are currently the preferred home health provider to one ACO serving approximately 20,000 patients and are exploring several other participation opportunities.

We believe these factors align with our strengths in, and focus on, post-acute services. In addition, we believe we can address the demand for facility-based and home-based post-acute services in markets where we currently do not have a presence by constructing or acquiring new hospitals and by acquiring home health and hospice agencies in that highly fragmented industry.

Longer-term, the nature and timing of the transformation of the current healthcare system to coordinated care delivery and payment models is uncertain and will likely remain so for some time, as the development of new delivery and payment systems will almost certainly require significant time and resources. Furthermore, many of the alternative approaches being explored may not work as intended. However, as outlined in the 2015 Form 10-K (see Item 7, Management's Discussion and Analysis of Financial Condition and Results of Operations, "Executive Overview—Key Challenges—Changes to Our Operating Environment Resulting from Healthcare Reform"), our goal is to position the Company in a prudent manner to be responsive to industry shifts. We have invested in our core business and created an infrastructure that enables us to provide high-quality care on a cost-effective basis. We have been disciplined in creating a capital structure that is flexible with no significant debt maturities prior to 2020. Our balance sheet remains strong and includes a substantial portfolio of owned real estate. We have significant availability under our revolving credit facility, and we continue to generate strong cash flows from operations. Importantly, we have flexibility with how we choose to deploy our cash and create value for shareholders, including repayments of long-term debt, repurchases of our common stock, bed additions, de novos, acquisitions of inpatient rehabilitation hospitals, home health agencies, and hospice agencies, and common stock dividends. While our financial leverage increased as a result of the acquisitions discussed in Note 2, Business Combinations, to the consolidated financial statements accompanying the 2015 Form 10-K, we anticipate in the longer term reducing our financial leverage based on growth of Adjusted EBITDA and an allocation of a portion of our free cash flow to debt reduction.

For these and other reasons, we believe we will be able to adapt to changes in reimbursement, sustain our business model, and grow through acquisition and consolidation opportunities as they arise.

#### Key Challenges

The healthcare industry is facing many well-publicized regulatory and reimbursement challenges. The industry is also facing uncertainty associated with the efforts, primarily arising from initiatives included in the 2010 Healthcare Reform Laws (as defined in Item 1, Business, "Regulatory and Reimbursement Challenges" of the 2015 Form 10 K) to identify and implement workable coordinated care delivery models. Successful healthcare providers are those who provide high-quality, cost-effective care and have the ability to adjust to changes in the regulatory and operating environments. We believe we have the necessary capabilities — scale, infrastructure, balance sheet, and management — to adapt to changes and continue to succeed in a highly regulated industry, and we have a proven track record of doing so.

As we continue to execute our business plan, the following are some of the challenges we face.

**Operating in a Highly Regulated Industry.** We are required to comply with extensive and complex laws and regulations at the federal, state, and local government levels. These rules and regulations have affected, or could in the future affect, our business activities by having an impact on the reimbursement we receive for services provided or the

costs of compliance, mandating new documentation standards, requiring additional licensure or certification, regulating our relationships with physicians and other referral sources, regulating the use of our properties, and limiting our ability to enter new markets or add new capacity to existing hospitals and agencies. Ensuring continuous compliance with extensive laws and regulations is an operating requirement for all healthcare providers.

We have invested, and will continue to invest, substantial time, effort, and expense in implementing and maintaining training programs as well as internal controls and procedures designed to ensure regulatory compliance, and we are committed to continued adherence to these guidelines. More specifically, because Medicare comprises a significant portion of our Net operating revenues, it is particularly important for us to remain compliant with the laws and regulations governing the Medicare program and related matters including anti-kickback and anti-fraud requirements. If we were unable to remain compliant with these regulations, our financial position, results of operations, and cash flows could be materially, adversely impacted.

Concerns held by federal policymakers about the federal deficit and national debt levels could result in enactment of further federal spending reductions, further entitlement reform legislation affecting the Medicare program, or both, in 2016 and beyond. Additionally, many legislators in the United States House of Representatives and the United States Senate continue to express the policy objective of modifying or repealing the Patient Protection and Affordable Care Act (as subsequently amended, the “2010 Healthcare Reform Laws”). At this time, it is unclear what, if any, of the Medicare-related changes may ultimately be enacted and signed into law by the President, but it is possible that any reductions in Medicare spending will have a material impact on reimbursements for healthcare providers generally and post-acute providers specifically. We cannot predict what, if any, changes in Medicare spending or modifications to the healthcare laws and regulations will result from future budget and other legislative initiatives.

The Medicare Payment Advisory Commission (“MedPAC”) is an independent agency that advises Congress on issues affecting Medicare and makes payment policy recommendations to Congress and CMS for a variety of Medicare payment systems including, among others, the inpatient rehabilitation facility prospective payment system (the “IRF-PPS”), the home health prospective payment system (the “HH-PPS”) and the hospice prospective payment system (the “Hospice-PPS”). Congress and CMS are not obligated to adopt MedPAC recommendations, and, based on outcomes in previous years, there can be no assurance those recommendations will be adopted. However, MedPAC’s recommendations have, and may in the future, become the basis for subsequent legislative or regulatory action.

In March 2016, MedPAC released recommendations to eliminate the market basket update for each of the IRF-PPS, the HH-PPS, and the Hospice-PPS for 2017. In another recommendation affecting IRFs, MedPAC suggested increasing the IRF-PPS outlier payment pool. Under the IRF-PPS, CMS effectively withholds 3% of payments due to providers to fund an outlier pool used to pay for patient treatments that are extraordinarily costly. MedPAC recommended the outlier pool be increased above its current 3% level. Any change in the outlier payment pool up to 5% could be done by CMS without legislative action. If implemented, this change would reduce the base Medicare payment to all IRF providers and redistribute payment to IRFs receiving a higher proportion of outlier payments. The latest proposed rule for the IRF-PPS discussed below did not follow MedPAC’s recommendations to eliminate the market basket update or to increase the outlier pool.

On April 21, 2016, CMS released its notice of proposed rulemaking for fiscal year 2017 (the “2017 Rule”) for IRFs under the IRF-PPS. The proposed rule would implement a net 1.45% market basket increase effective for discharges between October 1, 2016 and September 30, 2017, calculated as follows:

Market basket update	2.7%
Healthcare reform reduction	75 basis points
Productivity adjustment	50 basis points

The proposed rule also includes other changes that impact our hospital-by-hospital base rate for Medicare reimbursement. Such changes include, but are not limited to, revisions to the wage index values, changes to designations between rural and urban facilities, and updates to the outlier fixed loss threshold. The proposed rule also continues the freeze to the update to the IRF-PPS facility-level rural adjustment factor, low-income patient factor, and teaching status adjustment factors. Based on our analysis which utilizes, among other things, the acuity of our patients over the 12-month period prior to the proposed rule’s release and incorporates other adjustments included in the proposed rule, we believe the 2017 Rule will result in a net increase to our Medicare payment rates of approximately 1.7% effective October 1, 2016, prior to the impact of sequestration.

Additionally, the proposed rule contains changes that could affect us in future years. For example, CMS proposed five additional quality reporting measures, the reporting of which may require additional time and expense and could affect

reimbursement beginning October 1, 2017.

Reimbursement claims made by healthcare providers, including inpatient rehabilitation hospitals as well as home health and hospice agencies, are subject to audit from time to time by governmental payors and their agents, such as the Medicare Administrative Contractors (“MACs”), fiscal intermediaries and carriers, as well as the Office of Inspector General, CMS, and state Medicaid programs. Under programs designated as “widespread probes,” certain of our MACs have conducted pre-payment claim reviews of our billings and denied payment for certain diagnosis codes. The majority of the denials we have encountered in these probes derive from one MAC. In connection with recent probes, this MAC has made determinations regarding medical necessity which represent its uniquely restrictive interpretations of the CMS coverage rules. We have discussed our objections to those interpretations with both the MAC and CMS. We cannot predict what, if any, changes will result from those discussions. If the MAC continues to deny a significant number of claims for certain diagnosis codes, we may experience increases in the Provision for doubtful accounts, decreases in cash flow as a result of increasing accounts receivable, and/or a shift in the patients and conditions we treat, any of which could have an adverse effect on our financial position, results of operations, and liquidity.

On November 16, 2015, CMS issued its final rule establishing the Comprehensive Care for Joint Replacement (“CJR”) payment model. This mandatory model holds acute care hospitals accountable for the quality of care they deliver to Medicare fee-for-service beneficiaries for lower extremity joint replacements (i.e., knees and hips) from surgery through recovery. Through the five-year payment model, which began on April 1, 2016, healthcare providers in 67 geographic areas (“MSAs”) would continue to be paid under existing Medicare payment systems. However, the hospital where the joint replacement takes place would be held accountable for the quality and costs of care for the entire episode of care — from the time of the surgery through 90 days after discharge. Depending on the quality and cost performance during the entire episode, the hospital may receive an additional payment or be required to repay Medicare for a portion of the episode costs. As a result, the acute care hospitals would be incented to work with physicians and post-acute care providers to ensure beneficiaries receive the coordinated care they need in an efficient manner. We believe its impact would be positive for HealthSouth as it should favor high-quality, low-cost providers like us who have made significant commitments to information systems that enable and enhance connectivity. We also believe the rule further validates our movement into home health via the acquisition of Encompass. Currently, lower extremity joint replacement patients represent less than 8% of our total annual discharges due to our required compliance with the 60% rule. Given the 67 MSAs included in the CJR model, our patients potentially subject to this model represent approximately 2.1% of our annual Medicare discharges. The lower extremity joint replacement patients we do treat are generally higher acuity and bilateral or possess significant comorbidities. In these cases and in any risk-bearing bundling initiative, quality of outcomes is critical to achieving targeted financial results.

On July 25, 2016, CMS issued a proposed rule to establish a new mandatory payment bundling model for cardiac care and extend the existing bundled payment model for hip replacement to other hip surgeries. The program as proposed is generally similar to the CJR program described above, in that acute care hospitals would be at risk for patients’ quality of care and Medicare expenditures incurred during their hospital stay and 90 days thereafter. CMS proposes to establish additional hip fracture bundles in the 67 MSAs (HealthSouth is located in 27 of these MSAs) where the CJR program is being implemented, and CMS proposes 294 potential MSAs for the cardiac bundle, of which 98 would be applied as part of the final rule. CMS proposes to begin the program in July 2017, and hospitals will have a gradual phasing-in of risk beginning in April 2018. Of the 294 potential MSAs included in the proposed model for cardiac cases, our hospitals are included in approximately 60 MSAs. If all of these 60 MSAs are selected as part of the final 98 MSAs for mandatory cardiac bundle, our patients potentially subject to this model represent approximately 1.0% of our annual Medicare discharges. Our patients potentially subject to the expanded portion of the hip replacement model represent approximately 1.2% of our annual Medicare discharges incremental to the above CJR program. Our analysis of this proposed rule and its potential impact on HealthSouth is ongoing.

On June 27, 2016, CMS released its notice of proposed rulemaking for calendar year 2017 for home health agencies under the HH-PPS. CMS estimates the rule will reduce Medicare payments to home health agencies by approximately 1.0% in 2017. Specifically, while the proposed rule provides for a market basket update of 2.8%, that update is offset by a 2.3% rebasing adjustment reduction (the last year of a four-year phase-in), a productivity adjustment reduction of 50 basis points, an outlier fixed dollar loss adjustment of 0.1%, and a coding intensity reduction of 0.9% (the second year of a three-year phase-in). We believe the proposed 2017 rule will result in a net decrease to Encompass’ Medicare



payment rates within a range of 3.0% to 4.0% effective for episodes ending in calendar year 2017. The net decrease to Encompass' Medicare payment rates is primarily impacted by an approximate 1.0% case mix re-weighting and approximately 1.0% to 2.0% for the change in the outlier calculation methodology. Additionally, we believe the proposed 2017 rule could have an approximate \$1.5 million

negative impact on revenues in the fourth quarter of 2016 applicable to episodes that begin in 2016 and end in 2017. On June 8, 2016, CMS implemented a new pre-claim review demonstration of home health services in five states for a period of three years. Encompass operates in three of these states (Florida, Texas, and Massachusetts), which represents approximately 50% of their Medicare claims. The pre-claim demonstration will begin in Florida no earlier than October 1, 2016, in Texas no earlier than December 1, 2016, and in Massachusetts no earlier than January 1, 2017. As a result of the pre-claim review demonstration, we expect an increase in Encompass' administrative costs beginning in the second half of 2016. Additionally, we may experience increases in the Provision for doubtful accounts and decreases in cash flow as a result of increasing accounts receivable, each of which could have an adverse effect on our financial position, results of operations, and liquidity.

See also Item 1, Business, "Sources of Revenues" and "Regulation," and Item 1A, Risk Factors, to the 2015 Form 10-K and Note 11, Contingencies and Other Commitments, "Governmental Inquiries and Investigations," to the condensed consolidated financial statements included in Part I, Item 1, Financial Statements (Unaudited), of this report.

**Changes to Our Operating Environment Resulting from Healthcare Reform.** Our challenges related to healthcare reform are discussed in Item 1, Business, "Sources of Revenues," Item 1A, Risk Factors, and Item 7, Management's Discussion and Analysis of Financial Condition and Results of Operations, "Executive Overview—Key Challenges," to the 2015 Form 10-K. Many provisions within the 2010 Healthcare Reform Laws have impacted, or could in the future impact, our business. Most notably for us are the reductions to our hospitals' annual market basket updates, including productivity adjustments, mandated reductions to home health and hospice Medicare reimbursements, and future payment reforms such as ACOs and bundled payments.

The healthcare industry in general is facing uncertainty associated with the efforts, primarily arising from initiatives included in the 2010 Healthcare Reform Laws, to identify and implement workable coordinated care delivery models. In a coordinated care delivery model, hospitals, physicians, and other care providers work together to provide coordinated healthcare on a more efficient, patient-centered basis. These providers are then paid based on the overall value of the services they provide to a patient rather than the number of services they provide. While this is consistent with our goal and proven track record of being a high-quality, cost-effective provider, broad-based implementation of a new delivery model would represent a significant transformation for the healthcare industry. As the industry and its regulators explore this transformation, we are positioning the Company in preparation for whatever changes are ultimately made to the delivery system. We are currently participating in several coordinated care delivery model initiatives and are exploring ACO participation in several others. Eight of our IRFs began participating in Phase 2, the "at-risk" phase, of Model 3 of CMS' Bundled Payments for Care Improvement ("BPCI") initiative in 2015. We also have several IRFs that have signed participation agreements with acute care providers participating in Model 2 of the BPCI initiative. Ten of our home health agencies began participating in Phase 2 of Model 3 of the BPCI initiative in April 2014. In July 2015, 42 additional home health agencies began participating in Phase 2 of Model 3 of this initiative. In addition, we have partnered as the home health provider with Premier PHC™, an ACO serving approximately 20,000 Medicare patients.

Given the complexity and the number of changes in the 2010 Healthcare Reform Laws and other pending regulatory initiatives, we cannot predict their ultimate impact. In addition, the ultimate nature and timing of the transformation of the healthcare delivery system is uncertain, and will likely remain so for some time. We will continue to evaluate these laws and regulations and position the Company for this industry shift. Based on our track record, we believe we can adapt to these regulatory and industry changes. Further, we have engaged, and will continue to engage, actively in discussions with key legislators and regulators to attempt to ensure any healthcare laws or regulations adopted or amended promote our goal of high-quality, cost-effective care.

**Maintaining Strong Volume Growth.** Various factors, including competition, increasing regulatory and administrative burdens, and changes in the healthcare delivery system, may impact our ability to maintain and grow our hospital, home health, and hospice volumes. In any particular market, we may encounter competition from local or national entities with longer operating histories or other competitive advantages, such as acute care hospitals who provide post-acute services similar to ours or other post-acute providers with relationships with referring acute care hospitals or physicians. Aggressive payment review practices by Medicare contractors, aggressive enforcement of regulatory policies by government agencies, and restrictive or burdensome rules, regulations or statutes governing admissions

practices may lead us to not accept patients who would be appropriate for and would benefit from the services we provide. In addition, from time to time, we must get

regulatory approval to expand our services and locations in states with certificate of need laws. This approval may be withheld or take longer than expected. In the case of new-store volume growth, the addition of hospitals, home health agencies, and hospice agencies to our portfolio also may be difficult and take longer than expected.

Recruiting and Retaining High-Quality Personnel. See Item 1A, Risk Factors, to the 2015 Form 10-K for a discussion of competition for staffing, shortages of qualified personnel, and other factors that may increase our labor costs.

Recruiting and retaining qualified personnel for our inpatient hospitals and home health and hospice agencies remain a high priority for us. We attempt to maintain a comprehensive compensation and benefits package that allows us to remain competitive in this challenging staffing environment while remaining consistent with our goal of being a high-quality, cost-effective provider of post-acute services.

See also Item 1, Business, Item 1A, Risk Factors, and Item 7, Management’s Discussion and Analysis of Financial Condition and Results of Operations, “Executive Overview—Key Challenges,” to the 2015 Form 10 K.

These key challenges notwithstanding, we believe we have a strong business model, a strong balance sheet, and a proven track record of achieving strong financial and operational results. We are attempting to position the Company to respond to changes in the healthcare delivery system, and believe we will be in a position to take advantage of any opportunities that arise as the industry moves to this new stage. We believe we are positioned to continue to grow, adapt to external events, and create value for our shareholders in 2016 and beyond.

#### Results of Operations

##### Payor Mix

We derived consolidated Net operating revenues from the following payor sources:

	Three Months		Six Months	
	Ended June 30,		Ended June 30,	
	2016	2015	2016	2015
Medicare	74.7 %	74.5 %	75.1 %	74.7 %
Medicare Advantage	8.1 %	7.7 %	7.9 %	8.0 %
Managed care	10.0 %	10.1 %	9.8 %	10.0 %
Medicaid	3.2 %	3.1 %	3.3 %	2.9 %
Other third-party payors	1.4 %	1.8 %	1.4 %	1.6 %
Workers’ compensation	0.7 %	0.9 %	0.8 %	0.9 %
Patients	0.5 %	0.6 %	0.5 %	0.6 %
Other income	1.4 %	1.3 %	1.2 %	1.3 %
Total	100.0%	100.0%	100.0%	100.0%

For additional information regarding our payors, see the “Sources of Revenues” section of Item 1, Business, of the 2015 Form 10-K.

## Our Results

For the three and six months ended June 30, 2016 and 2015, our consolidated results of operations were as follows:

	Three Months Ended June 30,		Percentage Change 2016 vs. 2015	Six Months Ended June 30,		Percentage Change 2016 vs. 2015		
	2016	2015		2016	2015			
(In Millions, Except Percentage Change)								
Net operating revenues	\$920.7	\$764.4	20.4	%	\$1,830.5	\$1,505.0	21.6	%
Less: Provision for doubtful accounts	(15.4 )	(10.9 )	41.3	%	(31.9 )	(22.5 )	41.8	%
Net operating revenues less provision for doubtful accounts	905.3	753.5	20.1	%	1,798.6	1,482.5	21.3	%
Operating expenses:								
Salaries and benefits	486.1	401.8	21.0	%	972.2	786.9	23.5	%
Other operating expenses	121.5	104.2	16.6	%	240.7	207.4	16.1	%
Occupancy costs	17.9	12.5	43.2	%	35.9	24.6	45.9	%
Supplies	34.4	31.7	8.5	%	69.4	63.1	10.0	%
General and administrative expenses	34.4	32.1	7.2	%	66.3	66.7	(0.6 )	%
Depreciation and amortization	42.9	32.7	31.2	%	85.3	64.6	32.0	%
Government, class action, and related settlements	—	—	N/A		—	8.0	(100.0 )	%
Professional fees—accounting, tax, and legal	1.7	0.1	1,600.0	%	1.9	2.3	(17.4 )	%
Total operating expenses	738.9	615.1	20.1	%	1,471.7	1,223.6	20.3	%
Loss on early extinguishment of debt	2.4	18.8	(87.2 )	%	4.8	20.0	(76.0 )	%
Interest expense and amortization of debt discounts and fees	43.4	30.9	40.5	%	88.0	62.7	40.4	%
Other income	(0.7 )	(3.0 )	(76.7 )	%	(1.3 )	(3.5 )	(62.9 )	%
Equity in net income of nonconsolidated affiliates	(2.4 )	(2.3 )	4.3	%	(4.8 )	(3.9 )	23.1	%
Income from continuing operations before income tax expense	123.7	94.0	31.6	%	240.2	183.6	30.8	%
Provision for income tax expense	42.4	32.2	31.7	%	82.1	62.5	31.4	%
Income from continuing operations	81.3	61.8	31.6	%	158.1	121.1	30.6	%
Loss from discontinued operations, net of tax	(0.1 )	(1.6 )	(93.8 )	%	(0.2 )	(1.9 )	(89.5 )	%
Net income	81.2	60.2	34.9	%	157.9	119.2	32.5	%
Less: Net income attributable to noncontrolling interests	(18.6 )	(17.3 )	7.5	%	(37.3 )	(33.8 )	10.4	%
Net income attributable to HealthSouth	\$62.6	\$42.9	45.9	%	\$120.6	\$85.4	41.2	%

## Provision for Doubtful Accounts and Operating Expenses as a % of Net Operating Revenues

	Three Months		Six Months	
	Ended June		Ended June	
	30,	30,	30,	30,
	2016	2015	2016	2015
Provision for doubtful accounts	1.7 %	1.4 %	1.7 %	1.5 %
Operating expenses:				
Salaries and benefits	52.8 %	52.6 %	53.1 %	52.3 %
Other operating expenses	13.2 %	13.6 %	13.1 %	13.8 %
Occupancy costs	1.9 %	1.6 %	2.0 %	1.6 %
Supplies	3.7 %	4.1 %	3.8 %	4.2 %
General and administrative expenses	3.7 %	4.2 %	3.6 %	4.4 %
Depreciation and amortization	4.7 %	4.3 %	4.7 %	4.3 %
Government, class action, and related settlements	— %	— %	— %	0.5 %
Professional fees—accounting, tax, and legal	0.2 %	— %	0.1 %	0.2 %
Total operating expenses	80.3 %	80.5 %	80.4 %	81.3 %

In the discussion that follows, we use “same-store” comparisons to explain the changes in certain performance metrics and line items within our financial statements. We calculate same-store comparisons based on hospitals and agencies open throughout both the full current periods and prior periods presented. These comparisons include the financial results of market consolidation transactions in existing markets, as it is difficult to determine, with precision, the incremental impact of these transactions on our results of operations.

## Net Operating Revenues

Our consolidated Net operating revenues increased by \$156.3 million, or 20.4%, in the second quarter of 2016 compared to the second quarter of 2015. This increase primarily resulted from strong volume growth in both of our operating segments and included the effect of our acquisitions of Reliant on October 1, 2015 and CareSouth on November 2, 2015. See additional discussion in the “Segment Results of Operations” section of this Item.

## Provision for Doubtful Accounts

The change in our Provision for doubtful accounts in any given period primarily results from the fluctuations in pre-payment claims denials by MACs and continued substantial delays (exceeding four years) in the adjudication process at the administrative law judge hearing level. For additional information, see Item 1, Business, “Sources of Revenues—Medicare Reimbursement,” and Item 7, Management’s Discussion and Analysis of Financial Condition and Results of Operations, “Results of Operations—Our Results—Provision for Doubtful Accounts,” to the 2015 Form 10-K.

## Salaries and Benefits

Salaries and benefits increased in the three and six months ended June 30, 2016 compared to the same periods of 2015 primarily due to increased patient volumes, including an increase in the number of full-time equivalents as a result of our 2015 development activities, the acquisitions of Reliant and CareSouth, and increases in merit and benefit costs. Salaries and benefits as a percent of Net operating revenues increased by 20 basis points and 80 basis points during the three and six months ended June 30, 2016 compared to the same periods of 2015, respectively, primarily as a result of merit and benefit cost increases, Medicare home health reimbursement rate cuts, and the ramping up of new hospitals in Franklin, Tennessee and Hot Springs, Arkansas. Salaries and benefits as a percent of Net operating revenues during the three and six months ended June 30, 2015 included an approximate \$5 million Supplemental Security Income (“SSI”) adjustment that negatively impacted revenue in the second quarter of 2015 (as discussed in this Item, “Segment Results of Operations—Inpatient Rehabilitation—Net Operating Revenues”).

## Other Operating Expenses

Other operating expenses increased in the three and six months ended June 30, 2016 compared to the same periods of 2015 primarily due to the acquisitions of Reliant and CareSouth and increased patient volumes at our hospitals. Other operating



expenses for the six months ended June 30, 2015 included the settlement of an employee sexual harassment matter that was not covered by insurance.

As a percent of Net operating revenues, Other operating expenses decreased during the three and six months ended June 30, 2016 compared to the same periods of 2015 primarily due to our increasing revenues, primarily as a result of the acquisitions of Reliant and CareSouth. As a percent of Net operating revenues, Other operating expenses also decreased during the six months ended June 30, 2016 compared to the same period of 2015 due to the aforementioned settlement.

#### Occupancy Costs

Occupancy costs increased during the three and six months ended June 30, 2016 compared to the same periods of 2015 in terms of dollars and as a percent of Net operating revenues due to the acquisition of Reliant, which leased all of its hospitals.

#### Supplies

Supplies increased during the three and six months ended June 30, 2016 compared to the same periods of 2015 due primarily to increased patient volumes. Supplies decreased as a percent of Net operating revenues during the three and six months ended June 30, 2016 compared to the same periods of 2015 primarily due to continued supply chain initiatives.

#### General and Administrative Expenses

General and administrative expenses decreased during the six months ended June 30, 2016 compared to the same period of 2015 due primarily to activity associated with stock-based compensation discussed in Note 14, Employee Benefit Plans, to the consolidated financial statements accompanying the 2015 Form 10-K, and transaction costs related to the acquisition of Reliant. General and administrative expenses decreased as a percent of Net operating revenues during the three and six months ended June 30, 2016 compared to the same periods of 2015 primarily due to our increasing revenue, primarily as a result of the acquisitions of Reliant and CareSouth.

#### Depreciation and Amortization

Depreciation and amortization increased during the three and six months ended June 30, 2016 compared to the same periods of 2015 due to our capital expenditures and development activities throughout 2015 and 2016.

#### Government, Class Action, and Related Settlements

The loss included in Government, Class Action, and Related Settlements during the six months ended June 30, 2015 resulted from a settlement discussed in Note 17, Contingencies and Other Commitments, to the consolidated financial statements accompanying the 2015 Form 10-K.

#### Professional Fees—Accounting, Tax, and Legal

Professional Fees—Accounting, Tax, and Legal in each period presented related primarily to legal and consulting fees for continued litigation and support matters discussed in Note 17, Contingencies and Other Commitments, to the consolidated financial statements accompanying the 2015 Form 10-K.

#### Loss on Early Extinguishment of Debt

The Loss on early extinguishment of debt during the three and six months ended June 30, 2016 resulted from the redemptions of our 2022 Notes in March 2016 and May 2016.

In January 2015, we issued an additional \$400 million of our 5.75% Senior Notes due 2024 at a price of 102% of the principal amount and used \$250 million of the net proceeds to repay borrowings under our term loan facilities, with the remaining net proceeds used to repay borrowings under our revolving credit facility. As a result of the term loan prepayment, we recorded a \$1.2 million Loss on early extinguishment of debt in the first quarter of 2015.

In April 2015, we used the net proceeds from the offering of 5.125% Senior Notes due 2023 along with cash on hand to execute the redemption of our 8.125% Senior Notes due 2020. As a result of this redemption, we recorded an \$18.8 million Loss on early extinguishment of debt in the second quarter of 2015.

See Note 5, Long-term Debt, to the condensed consolidated financial statements included in Part I, Item 1, Financial Statements (Unaudited) and Note 8, Long-term Debt, to the consolidated financial statements accompanying the 2015 Form 10 K for additional information regarding these transactions.





#### Interest Expense and Amortization of Debt Discounts and Fees

The increase in Interest expense and amortization of debt discounts and fees during the three and six months ended June 30, 2016 compared to the same periods of 2015 resulted from an increase in average borrowings due to our use of debt to fund the acquisitions of Reliant and CareSouth. Our average cash interest rate remained relatively flat during the three and six months ended June 30, 2016 compared to the same periods of 2015. See Note 5, Long-term Debt, to the condensed consolidated financial statements included in Part I, Item 1, Financial Statements (Unaudited), of this report and Note 8, Long-term Debt, to the consolidated financial statements accompanying the 2015 Form 10-K.

#### Other Income

Other income for the three and six months ended June 30, 2015 included a \$2.0 million gain related to the increase in fair value of our option to purchase up to a 5% equity interest in Surgical Care Affiliates (“SCA”), our former surgery centers division, from April 1, 2015 (the date it became exercisable) to April 13, 2015 (the date we exercised the option). Other income for the three and six months ended June 30, 2015 also included a \$0.6 million realized gain from the sale of a portion of SCA common stock during the second quarter of 2015. See Note 12, Fair Value Measurements, to the consolidated financial statements accompanying the 2015 Form 10-K.

#### Income from Continuing Operations Before Income Tax Expense

Our pre-tax income from continuing operations increased during the three and six months ended June 30, 2016 compared to the same periods of 2015 due to increased Net operating revenues as a result of our acquisitions of Reliant and CareSouth.

#### Provision for Income Tax Expense

Due to our federal and state net operating loss carryforwards (“NOLs”), we currently estimate our cash income tax expense to be approximately \$15 million to \$30 million, net of refunds, for 2016. These payments are expected to result from state income tax expense of subsidiaries which have separate state filing requirements, alternative minimum taxes, and federal income taxes based upon tax planning opportunities, the extent of the remaining federal NOL balance and the availability of other federal tax credits. For the three months ended June 30, 2016 and 2015, current income tax expense was \$4.0 million and \$3.4 million, respectively. For the six months ended June 30, 2016 and 2015, current income tax expense was \$9.0 million and \$6.9 million, respectively.

Our Provision for income tax expense in each period presented, primarily resulted from the application of our estimated effective blended federal and state income tax rate.

In certain state jurisdictions, we do not expect to generate sufficient income to use all of the available NOLs prior to their expiration. This determination is based on our evaluation of all available evidence in these jurisdictions including results of operations during the preceding three years, our forecast of future earnings, and prudent tax planning strategies. 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 jurisdiction, or if the timing of future tax deductions differs from our expectations.

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 unrecognized tax benefits were \$2.8 million and \$2.9 million as of June 30, 2016 and December 31, 2015, respectively.

See Note 9, Income Taxes, to the condensed consolidated financial statements included in Part I, Item 1, Financial Statements (Unaudited), of this report and Note 15, Income Taxes, to the consolidated financial statements accompanying the 2015 Form 10-K.

#### Net Income Attributable to Noncontrolling Interests

The increase in Net Income Attributable to Noncontrolling Interests during the three and six months ended June 30, 2016 compared to the same period of 2015 primarily resulted from increased profitability of our joint ventures.

#### Segment Results of Operations

Our internal financial reporting and management structure is focused on the major types of services provided by HealthSouth. We manage our operations using two operating segments which are also our reportable segments:

(1) inpatient



rehabilitation and (2) home health and hospice. For additional information regarding our business segments, including a detailed description of the services we provide, financial data for each segment, and a reconciliation of total segment Adjusted EBITDA to income from continuing operations before income tax expense, see Note 12, Segment Reporting, to the condensed consolidated financial statements included in Part I, Item 1, Financial Statements (Unaudited), of this report.

Inpatient Rehabilitation

Our inpatient rehabilitation segment derived its Net operating revenues from the following payor sources:

	Three Months		Six Months	
	Ended June 30,		Ended June 30,	
	2016	2015	2016	2015
Medicare	73.1 %	72.7 %	73.3 %	73.1 %
Medicare Advantage	7.8 %	7.8 %	7.7 %	8.1 %
Managed care	11.5 %	11.4 %	11.2 %	11.3 %
Medicaid	2.9 %	2.6 %	3.0 %	2.3 %
Other third-party payors	1.7 %	2.1 %	1.7 %	1.9 %
Workers' compensation	0.8 %	1.1 %	1.0 %	1.1 %
Patients	0.6 %	0.7 %	0.6 %	0.7 %
Other income	1.6 %	1.6 %	1.5 %	1.5 %
Total	100.0%	100.0%	100.0%	100.0%

Additional information regarding our inpatient rehabilitation segment's operating results for the three and six months ended June 30, 2016 and 2015 is as follows:

	Three Months Ended June 30,		Percentage Change	Six Months Ended June		Percentage Change	
	2016	2015	2016 vs. 2015	2016	2015	2016 vs. 2015	
(In Millions, Except Percentage Change)							
Net operating revenues:							
Inpatient	\$721.2	\$618.7	16.6 %	\$1,440.5	\$1,225.3	17.6 %	
Outpatient and other	31.4	26.6	18.0 %	61.3	50.3	21.9 %	
Inpatient rehabilitation segment revenues	752.6	645.3	16.6 %	1,501.8	1,275.6	17.7 %	
Less: Provision for doubtful accounts	(14.5 )	(10.2 )	42.2 %	(30.1 )	(21.2 )	42.0 %	
Net operating revenues less provision for doubtful accounts	738.1	635.1	16.2 %	1,471.7	1,254.4	17.3 %	
Operating expenses:							
Salaries and benefits	366.1	317.6	15.3 %	736.0	624.0	17.9 %	
Other operating expenses	106.8	93.5	14.2 %	211.6	188.7	12.1 %	
Supplies	31.8	29.9	6.4 %	64.2	59.7	7.5 %	
Occupancy costs	15.4	10.7	43.9 %	31.0	21.1	46.9 %	
Other income	(0.7 )	(0.4 )	75.0 %	(1.3 )	(0.9 )	44.4 %	
Equity in net income of nonconsolidated affiliates	(2.2 )	(2.3 )	(4.3 )%	(4.4 )	(3.9 )	12.8 %	
Noncontrolling interests	16.8	15.6	7.7 %	33.6	30.8	9.1 %	
Segment Adjusted EBITDA	\$204.1	\$170.5	19.7 %	\$401.0	\$334.9	19.7 %	
(Actual Amounts)							
Discharges	41,365	36,408	13.6 %	82,463	71,524	15.3 %	
Net patient revenue per discharge	\$17,435	\$16,994	2.6 %	\$17,468	\$17,131	2.0 %	
Outpatient visits	164,761	144,914	13.7 %	327,410	276,267	18.5 %	
Average length of stay (days)	12.6	13.0	(3.1 )%	12.8	13.1	(2.3 )%	
Occupancy %	68.2 %	70.4 %	(3.1 )%	68.8 %	70.2 %	(2.0 )%	
# of licensed beds	8,430	7,374	14.3 %	8,430	7,374	14.3 %	
Full-time equivalents*	19,708	17,601	12.0 %	19,627	17,302	13.4 %	
Employees per occupied bed	3.43	3.41	0.6 %	3.39	3.36	0.9 %	

Excludes approximately 420 full-time equivalents for the three and six months ended June 30, 2016 and approximately 400 full-time equivalents for the three and six months ended June 30, 2015 who are

\* considered part of corporate overhead with their salaries and benefits included in General and administrative expenses in our consolidated statements of operations. Full-time equivalents included in the above table represent HealthSouth employees who participate in or support the operations of our hospitals and exclude an estimate of full-time equivalents related to contract labor.

We actively manage the productive portion of our Salaries and benefits utilizing certain metrics, including employees per occupied bed, or "EPOB." This metric is determined by dividing the number of full-time equivalents, including an estimate of full-time equivalents from the utilization of contract labor, by the number of occupied beds during each period. The number of occupied beds is determined by multiplying the number of licensed beds by our occupancy percentage.

#### Net Operating Revenues

Net operating revenues were 16.6% higher during the second quarter of 2016 compared to the same quarter of 2015. This increase included a 13.6% increase in patient discharges and a 2.6% increase in net patient revenue per discharge.



Discharge growth included a 1.9% increase in same-store discharges. Discharge growth from new stores resulted from our acquisitions of Reliant (October 2015) and Cardinal Hill Rehabilitation Hospital (May 2015), our joint venture with St. Vincent Community Health Services, Inc. in Hot Springs, Arkansas (February 2016), and one de novo hospital that opened in Franklin, Tennessee (December 2015). Growth in net patient revenue per discharge benefited by approximately 90 basis points from an approximate \$5 million SSI adjustment that negatively impacted revenue in the second quarter of 2015. CMS periodically retroactively updates SSI ratios that are used to determine adjustments to Medicare payment rates for low-income patients. In June 2015, CMS updated the ratios for fiscal year 2013, and we retroactively recorded adjustments to full-year 2013, full-year 2014, and year-to-date 2015.

Net operating revenues were 17.7% higher during the six months ended June 30, 2016 compared to the same period of 2015. This increase included a 15.3% increase in patient discharges and a 2.0% increase in net patient revenue per discharge. Discharge growth included a 2.3% increase in same-store discharges. Discharge growth and net patient revenue per discharge for the year-to-date period of 2016 were impacted by the same factors as discussed above for the second quarter of 2016. In addition, during the six months ended June 30, 2016, net patient revenue per discharge was impacted by the ramping up of new hospitals (Franklin, TN and Hot Springs, AR) which are required to treat a minimum of 30 patients for zero revenue as part of the Medicare certification process.

Outpatient revenues increased during the three and six months ended June 30, 2016 compared to the same periods of 2015 due to the acquisitions of Reliant and Cardinal Hill.

See Note 2, Business Combinations, to the condensed consolidated financial statements included in Part I, Item 1, Financial Statements (Unaudited), of this report for information regarding our joint venture with St. Vincent Community Health Services, Inc. See Note 2, Business Combinations, to the consolidated financial statements accompanying the 2015 Form 10-K for information regarding Reliant and Cardinal Hill.

#### Adjusted EBITDA

The increase in Adjusted EBITDA during the second quarter of 2016 compared to the same quarter of 2015 primarily resulted from revenue growth, as discussed above. All operating expenses as a percent of net operating revenues were impacted in the second quarter of 2015 by the aforementioned SSI adjustment. Salaries and benefits in the second quarter of 2016 included the positive impact of \$2.4 million in rebates associated with a contractual periodic pharmacy benefit reconciliation for 2014 and 2015. Hospital operating expenses (Other operating expenses, Supplies, and Occupancy costs) as a percent of Net operating revenues improved in the second quarter of 2016 compared to the second quarter of 2015 primarily due to continued supply chain initiatives. This improvement in hospital operating expenses occurred in spite of an increase in Occupancy costs as a percent of Net operating revenues due to the acquisition of Reliant. Bad debt expense as a percent of Net operating revenues increased from 1.6% in the second quarter of 2015 to 1.9% in the second quarter of 2016 due to administrative payment delays at our largest MAC. The increase in Adjusted EBITDA during the six months ended June 30, 2016 resulted from the same factors as discussed above for the second quarter of 2016. Adjusted EBITDA for the six months ended June 30, 2015 was negatively impacted by a settlement of an employee sexual harassment matter that was not covered by insurance.

#### Home Health and Hospice

Our home health and hospice segment derived its Net operating revenues from the following payor sources:

	Three Months		Six Months	
	Ended June 30, 2016	2015	Ended June 30, 2016	2015
Medicare	82.3 %	83.9 %	82.9 %	83.8 %
Medicare Advantage	9.0 %	7.2 %	8.9 %	7.3 %
Managed care	3.7 %	2.9 %	3.2 %	3.0 %
Medicaid	4.8 %	5.8 %	4.8 %	5.7 %
Other third-party payors	— %	0.1 %	— %	0.1 %
Patients	0.1 %	0.1 %	0.1 %	0.1 %
Other income	0.1 %	— %	0.1 %	— %
Total	100.0%	100.0%	100.0%	100.0%





Additional information regarding our home health and hospice segment's operating results for the three and six months ended June 30, 2016 and 2015 is as follows:

	Three Months Ended June 30,		Percentage Change 2016 vs. 2015	Six Months Ended June 30,		Percentage Change 2016 vs. 2015
	2016	2015		2016	2015	
(In Millions, Except Percentage Change)						
Net operating revenues:						
Home health	\$157.1	\$111.5	40.9 %	\$308.0	\$215.4	43.0 %
Hospice	11.0	7.6	44.7 %	20.7	14.0	47.9 %
Home health and hospice segment revenues	168.1	119.1	41.1 %	328.7	229.4	43.3 %
Less: Provision for doubtful accounts	(0.9 )	(0.7 )	28.6 %	(1.8 )	(1.3 )	38.5 %
Net operating revenues less provision for doubtful accounts	167.2	118.4	41.2 %	326.9	228.1	43.3 %
Operating expenses:						
Cost of services sold (excluding depreciation and amortization)	81.6	56.7	43.9 %	160.0	110.1	45.3 %
Support and overhead costs	58.0	41.0	41.5 %	115.0	79.1	45.4 %
Equity in net income of nonconsolidated affiliates	(0.2 )	—	N/A	(0.4 )	—	N/A
Noncontrolling interests	1.8	1.7	5.9 %	3.7	3.0	23.3 %
Segment Adjusted EBITDA	\$26.0	\$19.0	36.8 %	\$48.6	\$35.9	35.4 %

(Actual Amounts)

Home health:						
Admissions	25,753	16,862	52.7 %	51,516	33,361	54.4 %
Recertifications	20,432	15,103	35.3 %	39,885	29,588	34.8 %
Episodes	45,774	31,817	43.9 %	89,618	61,329	46.1 %
Average revenue per episode	\$3,033	\$3,082	(1.6 )%	\$3,034	\$3,092	(1.9 )%
Episodic visits per episode	18.9	19.4	(2.6 )%	19.0	19.5	(2.6 )%
Total visits	967,968	675,095	43.4 %	1,905,772	1,306,094	45.9 %
Cost per visit	\$73	\$71	2.8 %	\$73	\$71	2.8 %
Hospice:						
Admissions	785	594	32.2 %	1,509	1,218	23.9 %
Patient days	71,277	49,272	44.7 %	134,709	90,170	49.4 %
Revenue per day	\$154	\$154	— %	\$154	\$155	(0.6 )%

#### Net Operating Revenues

Home health and hospice revenue was 41.1% higher during the second quarter of 2016 compared to the same quarter of 2015. This increase included a 52.7% increase in admissions and was impacted by a 1.6% decrease in average revenue per episode. Admission growth included a 11.1% increase in same-store admissions. Admission growth from new stores resulted from the acquisition of CareSouth and Encompass' other acquisitions throughout 2015. Average revenue per episode was impacted by the Medicare home health reimbursement rate cuts that became effective January 1, 2016, a higher percentage of patients requiring therapy visits, and lower revenue per episode at CareSouth due to patient mix.

Home health and hospice revenue was 43.3% higher during the six months ended June 30, 2016 compared to the same period of 2015. This increase included a 54.4% increase in admissions and was impacted by a 1.9% decrease in average revenue per episode. Admission growth included a 11.7% increase in same-store admissions. Admission growth from new stores and average revenue per episode resulted from the same factors discussed above for the second quarter of 2016.



See Note 2, Business Combinations, to the consolidated financial statements accompanying the 2015 Form 10-K for information regarding CareSouth and Encompass' other acquisitions throughout 2015.

#### Adjusted EBITDA

The increase in Adjusted EBITDA during the three and six months ended June 30, 2016 compared to the same periods of 2015 primarily resulted from revenue growth. Adjusted EBITDA for the segment during the three and six months ended June 30, 2016 was impacted by lower average revenue per episode, higher cost per visit driven by an increased percentage of therapy patients, merit and benefit costs increases, and expenses related to the integration of CareSouth.

#### Liquidity and Capital Resources

Our primary sources of liquidity are cash on hand, cash flows from operations, and borrowings under our revolving credit facility.

The objectives of our capital structure strategy are to ensure we maintain adequate liquidity and flexibility. Pursuing and achieving those objectives allows us to support the execution of our operating and strategic plans and weather temporary disruptions in the capital markets and general business environment. Maintaining adequate liquidity is a function of our unrestricted Cash and cash equivalents and our available borrowing capacity. Maintaining flexibility in our capital structure is a function of, among other things, the amount of debt maturities in any given year, the options for debt prepayments without onerous penalties, and limiting restrictive terms and maintenance covenants in our debt agreements.

Consistent with these objectives, in March 2016, we redeemed \$50.0 million of the outstanding principal amount of our existing 2022 Notes using cash on hand and capacity under our revolving credit facility. Pursuant to the terms of the 2022 Notes, this optional redemption was made at a price of 103.875%, which resulted in a total cash outlay of approximately \$52 million. As a result of this redemption, we recorded a \$2.4 million Loss on early extinguishment of debt in the first quarter of 2016.

On April 6, 2016, we gave notice of, and made an irrevocable commitment for, the redemption of an additional \$50 million of the outstanding principal amount of our 2022 Notes. On May 6, 2016, we completed this redemption using cash on hand and capacity under our revolving credit facility. Pursuant to the terms of the 2022 Notes, this optional redemption was also made at a price of 103.875%, which resulted in a total cash outlay of approximately \$52 million. As a result of this redemption, we recorded a \$2.4 million Loss on early extinguishment of debt in the second quarter of 2016.

On July 28, 2016, we gave notice of, and made an irrevocable commitment for, the redemption of the remaining outstanding principal balance of \$76.0 million of the 2022 Notes. Pursuant to the terms of the 2022 Notes, this optional redemption will be made at a price of 102.583%, which will result in a total cash outlay of approximately \$78 million when the transaction closes on September 15, 2016. We plan to use cash on hand and capacity under our revolving credit facility to fund the redemption. As a result of this redemption, we expect to record an approximate \$3 million Loss on early extinguishment of debt in the third quarter of 2016.

We have been disciplined in creating a capital structure that is flexible with no significant debt maturities prior to 2020. Our balance sheet remains strong, and we have significant availability under our credit agreement. We continue to generate strong cash flows from operations, and we have significant flexibility with how we choose to invest our cash and return capital to shareholders. While our financial leverage increased as a result of the Reliant and CareSouth transactions, we anticipate in the longer term reducing our financial leverage based on growth of Adjusted EBITDA and an allocation of a portion of our free cash flow to debt reduction.

For additional information regarding our indebtedness, see Note 5, Long-term Debt, to the condensed consolidated financial statements included in Part I, Item 1, Financial Statements (Unaudited), of this report and Note 8, Long-term Debt, to the consolidated financial statements accompanying the 2015 Form 10-K.

#### Current Liquidity

As of June 30, 2016, we had \$70.3 million in Cash and cash equivalents. Cash and cash equivalents as of June 30, 2016 excluded \$57.4 million in restricted cash (included in Other current assets) and \$57.3 million of restricted marketable securities (\$27.4 million included in Other current assets and \$29.9 million included in Other long-term assets). Our restricted assets pertain primarily to obligations associated with our captive insurance company, as well as obligations we have under agreements with joint venture partners. See Note 3, Cash and Marketable Securities, to the

consolidated financial statements accompanying the 2015 Form 10-K.