

HEALTHSOUTH CORP
Form 10-Q
July 30, 2013

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, DC 20549

FORM 10-Q

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

For the quarterly period ended June 30, 2013

OR

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

Commission File Number 001-10315

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

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

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

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

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

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

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

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

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

The registrant had 87,298,703 shares of common stock outstanding, net of treasury shares, as of July 23, 2013.

TABLE OF CONTENTS

| | Page |
|---|-----------|
| <u>PART I</u> <u>Financial Information</u> | |
| <u>Item 1.</u> <u>Financial Statements (Unaudited)</u> | <u>1</u> |
| <u>Item 2.</u> <u>Management’s Discussion and Analysis of Financial Condition and Results of Operations</u> | <u>30</u> |
| <u>Item 3.</u> <u>Quantitative and Qualitative Disclosures about Market Risk</u> | <u>45</u> |
| <u>Item 4.</u> <u>Controls and Procedures</u> | <u>46</u> |
| | |
| <u>PART II</u> <u>Other Information</u> | |
| | |
| <u>Item 1.</u> <u>Legal Proceedings</u> | <u>47</u> |
| <u>Item 1A.</u> <u>Risk Factors</u> | <u>47</u> |
| <u>Item 2.</u> <u>Unregistered Sales of Equity Securities and Use of Proceeds</u> | <u>47</u> |
| <u>Item 5.</u> <u>Other Items</u> | <u>48</u> |
| <u>Item 6.</u> <u>Exhibits</u> | <u>49</u> |

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, regulatory investigations, our business strategy, our dividend and stock repurchase strategies, our financial plans, our growth plans, our future financial performance, our projected business results, our effective income tax rates, our leverage ratio, or our projected capital expenditures. In some cases, you can identify forward-looking statements by terminology such as “may,” “will,” “should,” “expects,” “plans,” “anticipates,” “believes,” “estimates,” “predicts,” “targets,” “potential,” or “continue” or the negative of these terms or other comparable terminology. Such forward-looking statements are necessarily estimates based upon current information and involve a number of risks and uncertainties, many of which are beyond our control. Any forward-looking statement is based on information current as of the date of this report and speaks only as of the date on which such statement is made. Actual events or results may differ materially from the results anticipated in these forward-looking statements as a result of a variety of factors. While it is impossible to identify all such factors, factors that could cause actual results to differ materially from those estimated by us include, but are not limited to, the following:

- each of the factors discussed in Item 1A, Risk Factors, of our Annual Report on Form 10-K for the year ended December 31, 2012;
- uncertainties and factors discussed elsewhere in this Form 10-Q, in our other filings from time to time with the SEC, or in materials incorporated therein by reference;
- changes in the regulations of the healthcare industry at either or both of the federal and state levels, including those contemplated now and in the future as part of national healthcare reform and deficit reduction, and related increases in the costs of complying with such changes;
- reductions or delays in, or suspension of, reimbursement for our services by governmental or private payors, including our ability to obtain and retain favorable arrangements with third-party payors;
- increased costs of regulatory compliance and compliance monitoring in the healthcare industry, including the costs of investigating and defending asserted claims, whether meritorious or not;
- our ability to attract and retain nurses, therapists, and other healthcare professionals in a highly competitive environment with often severe staffing shortages and the impact on our labor expenses from potential union activity and staffing recruitment and retention;
- competitive pressures in the healthcare industry and our response to those pressures;
- our ability to successfully complete and integrate de novo developments, acquisitions, investments, and joint ventures consistent with our growth strategy, including realization of anticipated revenues, cost savings, and productivity improvements arising from the related operations;
- any adverse outcome of various lawsuits, claims, and legal or regulatory proceedings involving us, including the ongoing investigations 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 disruptions or incidents affecting the proper operation, availability, or security of our information systems;
- the price of our common or preferred stock as it affects our willingness and ability to repurchase shares;
- our ability to attract and retain key management personnel; and
- general conditions in the economy and capital markets.

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

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements (Unaudited)

HealthSouth Corporation and Subsidiaries

Condensed Consolidated Statements of Operations

(Unaudited)

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|--------------------------------------|---------|---------------------------|-----------|
| | 2013 | 2012 | 2013 | 2012 |
| | (In Millions, Except Per Share Data) | | | |
| Net operating revenues | \$564.5 | \$533.4 | \$1,137.1 | \$1,072.0 |
| Less: Provision for doubtful accounts | (7.0 |) (6.5 |) (14.4 |) (12.8 |
| Net operating revenues less provision for doubtful accounts | 557.5 | 526.9 | 1,122.7 | 1,059.2 |
| Operating expenses: | | | | |
| Salaries and benefits | 273.6 | 257.4 | 548.2 | 518.4 |
| Other operating expenses | 81.0 | 75.0 | 159.1 | 148.8 |
| Occupancy costs | 11.9 | 12.3 | 24.1 | 24.8 |
| Supplies | 26.6 | 25.9 | 52.8 | 52.4 |
| General and administrative expenses | 29.5 | 28.0 | 59.7 | 58.0 |
| Depreciation and amortization | 23.1 | 20.0 | 45.2 | 39.5 |
| Government, class action, and related settlements | (2.0 |) — | (2.0 |) — |
| Professional fees—accounting, tax, and legal | 2.2 | 5.5 | 3.6 | 9.1 |
| Total operating expenses | 445.9 | 424.1 | 890.7 | 851.0 |
| Interest expense and amortization of debt discounts and fees | 24.4 | 23.0 | 48.6 | 46.3 |
| Other income | (1.9 |) (0.4 |) (2.6 |) (1.3 |
| Equity in net income of nonconsolidated affiliates | (3.3 |) (3.1 |) (6.2 |) (6.4 |
| Income from continuing operations before income tax expense | 92.4 | 83.3 | 192.2 | 169.6 |
| Provision for income tax (benefit) expense | (86.5 |) 26.9 | (53.0 |) 56.0 |
| Income from continuing operations | 178.9 | 56.4 | 245.2 | 113.6 |
| Income (loss) from discontinued operations, net of tax | 0.1 | 3.5 | (0.3 |) 3.1 |
| Net income | 179.0 | 59.9 | 244.9 | 116.7 |
| Less: Net income attributable to noncontrolling interests | (13.8 |) (13.2 |) (28.4 |) (25.8 |
| Net income attributable to HealthSouth | 165.2 | 46.7 | 216.5 | 90.9 |
| Less: Convertible perpetual preferred stock dividends | (5.8 |) (6.0 |) (11.5 |) (12.4 |
| Less: Repurchase of convertible perpetual preferred stock | — | (0.3 |) — | (0.8 |
| Net income attributable to HealthSouth common shareholders | \$159.4 | \$40.4 | \$205.0 | \$77.7 |
| Weighted average common shares outstanding: | | | | |
| Basic | 86.1 | 94.6 | 90.0 | 94.5 |
| Diluted | 99.8 | 108.0 | 103.4 | 108.3 |
| Earnings per common share: | | | | |
| Basic earnings per share attributable to HealthSouth common shareholders: | | | | |
| Continuing operations | \$1.85 | \$0.39 | \$2.28 | \$0.79 |
| Discontinued operations | — | 0.04 | — | 0.03 |
| Net income | \$1.85 | \$0.43 | \$2.28 | \$0.82 |

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Diluted earnings per share attributable to HealthSouth common shareholders:

| | | | | |
|-------------------------|---------|--------|--------|--------|
| Continuing operations | \$ 1.66 | \$0.39 | \$2.09 | \$0.79 |
| Discontinued operations | — | 0.04 | — | 0.03 |
| Net income | \$ 1.66 | \$0.43 | \$2.09 | \$0.82 |

Amounts attributable to HealthSouth common shareholders:

| | | | | |
|--|----------|--------|---------|--------|
| Income from continuing operations | \$ 165.1 | \$43.2 | \$216.8 | \$87.8 |
| Income (loss) from discontinued operations, net of tax | 0.1 | 3.5 | (0.3 |) 3.1 |
| Net income attributable to HealthSouth | \$ 165.2 | \$46.7 | \$216.5 | \$90.9 |

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

1

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

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|-----------------------------|---------|---------------------------|---------|
| | 2013 | 2012 | 2013 | 2012 |
| | (In Millions) | | | |
| COMPREHENSIVE INCOME | | | | |
| Net income | \$179.0 | \$59.9 | \$244.9 | \$116.7 |
| Other comprehensive (loss) income, net of tax: | | | | |
| Net change in unrealized (loss) gain on available-for-sale securities: | | | | |
| Unrealized net holding (loss) gain arising during the period | (0.9 |) 0.2 | (0.8 |) 1.0 |
| Reclassifications to net income | (1.0 |) — | (1.0 |) — |
| Other comprehensive (loss) income before income taxes | (1.9 |) 0.2 | (1.8 |) 1.0 |
| Provision for income tax benefit related to other comprehensive (loss) income items | 0.1 | — | 0.1 | — |
| Other comprehensive (loss) income, net of tax | (1.8 |) 0.2 | (1.7 |) 1.0 |
| Comprehensive income | 177.2 | 60.1 | 243.2 | 117.7 |
| Comprehensive income attributable to noncontrolling interests | (13.8 |) (13.2 |) (28.4 |) (25.8 |
| Comprehensive income attributable to HealthSouth | \$163.4 | \$46.9 | \$214.8 | \$91.9 |

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, 2013 | December 31, 2012 |
|---|------------------|----------------------|
| | (In Millions) | |
| Assets | | |
| Current assets: | | |
| Cash and cash equivalents | \$68.7 | \$132.8 |
| Accounts receivable, net of allowance for doubtful accounts of \$32.0 in 2013; \$28.7 in 2012 | 273.7 | 249.3 |
| Deferred income tax assets | 137.5 | 137.5 |
| Other current assets | 111.6 | 117.2 |
| Total current assets | 591.5 | 636.8 |
| Property and equipment, net | 793.3 | 748.0 |
| Goodwill | 457.2 | 437.3 |
| Intangible assets, net | 86.8 | 73.2 |
| Deferred income tax assets | 444.8 | 393.5 |
| Other long-term assets | 138.1 | 135.4 |
| Total assets | \$2,511.7 | \$2,424.2 |
| Liabilities and Shareholders' Equity | | |
| Current liabilities: | | |
| Accounts payable | \$57.3 | \$45.3 |
| Accrued expenses and other current liabilities | 254.3 | 255.6 |
| Total current liabilities | 311.6 | 300.9 |
| Long-term debt, net of current portion | 1,319.7 | 1,239.9 |
| Other long-term liabilities | 131.4 | 130.5 |
| | 1,762.7 | 1,671.3 |
| Commitments and contingencies | | |
| Convertible perpetual preferred stock | 342.2 | 342.2 |
| Redeemable noncontrolling interests | 14.1 | 7.2 |
| Shareholders' equity: | | |
| HealthSouth shareholders' equity | | |
| Common stock, \$.01 par value; 200,000,000 shares authorized; issued: 101,934,201 in 2013; 100,919,297 in 2012 | 1.0 | 1.0 |
| Capital in excess of par value | 2,886.3 | 2,876.6 |
| Accumulated deficit | (2,208.2 |) (2,424.7 |
| Accumulated other comprehensive (loss) income | (0.3 |) 1.4 |
| Treasury stock, at cost (14,639,430 shares in 2013 and 5,233,521 shares in 2012) | (404.0 |) (163.3 |
| Total HealthSouth shareholders' equity | 274.8 | 291.0 |
| Noncontrolling interests | 117.9 | 112.5 |
| Total shareholders' equity | 392.7 | 403.5 |
| Total liabilities and shareholders' equity | \$2,511.7 | \$2,424.2 |

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, 2013 | | | | | | | | |
|---|---|-----------------|--------------------------------------|------------------------|---|-------------------|-----------------------------|----------|
| (In Millions) | | | | | | | | |
| HealthSouth Common Shareholders | | | | | | | | |
| | Number of Common Shares Outstanding | Common Stock | Capital in Excess of Par Value | Accumulated Deficit | Accumulated Other Comprehensive Income (Loss) | Treasury Stock | Noncontrolling Interests | Total |
| Balance at beginning of period | 95.7 | \$ 1.0 | \$2,876.6 | \$ (2,424.7) | \$ 1.4 | \$(163.3) | \$ 112.5 | \$403.5 |
| Net income | — | — | — | 216.5 | — | — | 25.8 | 242.3 |
| Receipt of treasury stock | (0.3) | — | — | — | — | (5.8) | — | (5.8) |
| Dividends declared on convertible perpetual preferred stock | — | — | (11.5) | — | — | — | — | (11.5) |
| Stock-based compensation | — | — | 12.8 | — | — | — | — | 12.8 |
| Stock options exercised | 0.2 | — | 4.0 | — | — | — | — | 4.0 |
| Distributions declared | — | — | — | — | — | — | (20.4) | (20.4) |
| Repurchases of common stock through tender offer | (9.1) | — | — | — | — | (234.1) | — | (234.1) |
| Other | 0.8 | — | 4.4 | — | (1.7) | (0.8) | — | 1.9 |
| Balance at end of period | 87.3 | \$ 1.0 | \$2,886.3 | \$ (2,208.2) | \$ (0.3) | \$(404.0) | \$ 117.9 | \$392.7 |

| Six Months Ended June 30, 2012 | | | | | | | | |
|---|---|-----------------|--------------------------------------|------------------------|---|-------------------|-----------------------------|---------|
| (In Millions) | | | | | | | | |
| HealthSouth Common Shareholders | | | | | | | | |
| | Number of Common Shares Outstanding | Common Stock | Capital in Excess of Par Value | Accumulated Deficit | Accumulated Other Comprehensive Income (Loss) | Treasury Stock | Noncontrolling Interests | Total |
| Balance at beginning of period | 95.2 | \$ 1.0 | \$2,874.1 | \$ (2,609.7) | \$ (0.2) | \$(148.8) | \$ 84.6 | \$201.0 |
| Net income | — | — | — | 90.9 | — | — | 23.9 | 114.8 |
| Receipt of treasury stock | (0.7) | — | — | — | — | (11.9) | — | (11.9) |
| Dividends declared on convertible perpetual preferred stock | — | — | (12.4) | — | — | — | — | (12.4) |
| Stock-based compensation | — | — | 12.0 | — | — | — | — | 12.0 |
| Distributions declared | — | — | — | — | — | — | (20.5) | (20.5) |
| Capital contributions from consolidated affiliates | — | — | — | — | — | — | 9.8 | 9.8 |
| Other | 1.2 | — | 0.9 | — | 1.0 | (1.7) | 0.1 | 0.3 |
| Balance at end of period | 95.7 | \$ 1.0 | \$2,874.6 | \$ (2,518.8) | \$ 0.8 | \$(162.4) | \$ 97.9 | \$293.1 |

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

4

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

| | Six Months Ended June 30, | |
|---|---------------------------|---------|
| | 2013 | 2012 |
| | (In Millions) | |
| Cash flows from operating activities: | | |
| Net income | \$244.9 | \$116.7 |
| Loss (income) from discontinued operations | 0.3 | (3.1) |
| Adjustments to reconcile net income to net cash provided by operating activities— | | |
| Provision for doubtful accounts | 14.4 | 12.8 |
| Depreciation and amortization | 45.2 | 39.5 |
| Equity in net income of nonconsolidated affiliates | (6.2) | (6.4) |
| Distributions from nonconsolidated affiliates | 5.0 | 5.5 |
| Stock-based compensation | 12.8 | 12.0 |
| Deferred tax (benefit) expense | (53.5) | 51.7 |
| Other | 0.3 | 3.0 |
| Increase in assets— | | |
| Accounts receivable | (38.8) | (35.7) |
| Other assets | (0.7) | (7.0) |
| Increase (decrease) in liabilities— | | |
| Accounts payable | 9.5 | 10.3 |
| Other liabilities | (6.2) | (6.0) |
| Net cash (used in) provided by operating activities of discontinued operations | (0.2) | 1.7 |
| Total adjustments | (18.4) | 81.4 |
| Net cash provided by operating activities | 226.8 | 195.0 |

(Continued)

5

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

| | Six Months Ended June 30, | | |
|---|---------------------------|---------|---|
| | 2013 | 2012 | |
| | (In Millions) | | |
| Cash flows from investing activities: | | | |
| Purchases of property and equipment | (69.0 |) (82.8 |) |
| Capitalized software costs | (11.9 |) (11.6 |) |
| Acquisition of business, net of cash acquired | (28.9 |) (2.1 |) |
| Proceeds from sale of restricted investments | 10.3 | 0.2 | |
| Purchase of restricted investments | (5.4 |) (4.4 |) |
| Net change in restricted cash | 4.7 | 4.6 | |
| Other | (1.2 |) 0.1 | |
| Net cash provided by investing activities of discontinued operations | — | 7.7 | |
| Net cash used in investing activities | (101.4 |) (88.3 |) |
| Cash flows from financing activities: | | | |
| Principal payments on debt, including pre-payments | (0.7 |) (4.7 |) |
| Principal borrowings on notes | 11.4 | — | |
| Borrowings on revolving credit facility | 132.0 | 40.0 | |
| Payments on revolving credit facility | (59.0 |) (50.0 |) |
| Principal payments under capital lease obligations | (6.7 |) (5.7 |) |
| Repurchase of common stock, including fees and expenses | (234.1 |) — | |
| Repurchase of convertible perpetual preferred stock | — | (46.0 |) |
| Dividends paid on convertible perpetual preferred stock | (11.5 |) (13.1 |) |
| Distributions paid to noncontrolling interests of consolidated affiliates | (23.9 |) (24.0 |) |
| Contributions from consolidated affiliates | — | 7.9 | |
| Other | 3.0 | (0.1 |) |
| Net cash used in financing activities | (189.5 |) (95.7 |) |
| (Decrease) increase in cash and cash equivalents | (64.1 |) 11.0 | |
| Cash and cash equivalents at beginning of period | 132.8 | 30.1 | |
| Cash and cash equivalents at end of period | \$68.7 | \$41.1 | |

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

HealthSouth Corporation and Subsidiaries
Notes to Condensed Consolidated Financial Statements

1. Basis of Presentation

HealthSouth Corporation, incorporated in Delaware in 1984, including its subsidiaries, is the largest owner and operator of inpatient rehabilitation hospitals in the United States. We operate inpatient rehabilitation hospitals and provide specialized rehabilitative treatment on both an inpatient and outpatient basis.

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 19, 2013 (the "2012 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, 2012 has been derived from audited financial statements, but it does not include all disclosures required by GAAP. However, we believe the disclosures are adequate to make the information presented not misleading.

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

Reclassifications—

Certain immaterial amounts have been revised to conform to the current year presentation. In our condensed consolidated balance sheet as of December 31, 2012, we reclassified amounts previously reported as Other long-term liabilities to a combination of Capital in excess of par value, noncurrent Deferred income tax assets, and Redeemable noncontrolling interests. These amounts relate to a joint venture entity where the partner's noncontrolling interest includes redemption features that are not solely within our control. This adjustment decreased liabilities by \$6.2 million, decreased shareholders' equity by \$0.6 million, increased assets by \$0.4 million, and increased amounts in the mezzanine section of our condensed consolidated balance sheet by \$7.2 million. See Note 5, Redeemable Noncontrolling Interests.

Net Operating Revenues—

During the three and six months ended June 30, 2013 and 2012, we derived consolidated Net operating revenues from the following payor sources:

| | Three Months Ended June 30, | | Six Months Ended June 30, | | |
|---------------------------------------|-----------------------------|---------|---------------------------|---------|---|
| | 2013 | 2012 | 2013 | 2012 | |
| Medicare | 74.6 | % 72.9 | % 74.6 | % 73.3 | % |
| Medicaid | 1.0 | % 1.3 | % 1.1 | % 1.2 | % |
| Workers' compensation | 1.2 | % 1.5 | % 1.3 | % 1.5 | % |
| Managed care and other discount plans | 18.4 | % 19.6 | % 18.4 | % 19.5 | % |
| Other third-party payors | 1.7 | % 1.8 | % 1.7 | % 1.7 | % |
| Patients | 1.2 | % 1.3 | % 1.2 | % 1.3 | % |
| Other income | 1.9 | % 1.6 | % 1.7 | % 1.5 | % |
| Total | 100.0 | % 100.0 | % 100.0 | % 100.0 | % |

See Note 1, Summary of Significant Accounting Policies, to the consolidated financial statements accompanying the 2012 Form 10-K for our policies related to Net operating revenues, Accounts receivable, and our Allowance for doubtful accounts.

HealthSouth Corporation and Subsidiaries
Notes to Condensed Consolidated Financial Statements

2. Business Combinations

In April 2013, we closed the transaction to acquire Walton Rehabilitation Hospital, a 58-bed inpatient rehabilitation hospital in Augusta, Georgia. The acquisition was not material to our financial position, results of operations, or cash flows. As a result of this transaction, Goodwill increased by \$13.7 million. The acquisition was funded using availability under our revolving credit facility.

This acquisition was made to enhance our position and ability to provide inpatient rehabilitative services to patients in Georgia. All of the goodwill resulting from this transaction 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 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.

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

| | | |
|---|--------|---|
| Property and equipment, net | \$11.3 | |
| Identifiable intangible assets: | | |
| Noncompete agreement (useful life of 5 years) | 0.1 | |
| Tradename (useful life of 20 years) | 0.9 | |
| Certificate of need (useful life of 20 years) | 3.3 | |
| Goodwill | 13.7 | |
| Total assets acquired | 29.3 | |
| Total current liabilities assumed | (0.4 |) |
| Net assets acquired | \$28.9 | |

HealthSouth Corporation and Subsidiaries
Notes to Condensed Consolidated Financial Statements

The Company's reported Net operating revenues and Net income for the three and six months ended June 30, 2013 include operating results for Walton Rehabilitation Hospital from April 1, 2013 through June 30, 2013. The following table summarizes the results of operations of the above mentioned transaction from the date of acquisition included in our consolidated results of operations and the results of operations of the combined entity had the date of the acquisition been January 1, 2012 (in millions):

| | Net Operating Revenues | Net (Loss) Income Attributable to HealthSouth |
|---|------------------------|---|
| Acquired entity only: Actual from acquisition date to June 30, 2013 | \$2.7 | \$(1.2) |
| Combined entity: Supplemental pro forma from 04/01/2013-06/30/2013* | 564.5 | 165.2 |
| Combined entity: Supplemental pro forma from 04/01/2012-06/30/2012 | 539.4 | 46.5 |
| Combined entity: Supplemental pro forma from 01/01/2013-06/30/2013 | 1,142.0 | 216.1 |
| Combined entity: Supplemental pro forma from 01/01/2012-06/30/2012 | 1,083.5 | 90.9 |

*Pro forma amounts equal reported operating results due to the acquisition of Walton Rehabilitation Hospital effective April 1, 2013.

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

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|-----------------------------------|-----------------------------|-------|---------------------------|-------|
| | 2013 | 2012 | 2013 | 2012 |
| Fair value of assets acquired | \$15.6 | \$2.1 | \$15.6 | \$2.1 |
| Goodwill | 13.7 | — | 13.7 | — |
| Fair value of liabilities assumed | (0.4) | — | (0.4) | — |
| Net cash paid for acquisitions | \$28.9 | \$2.1 | \$28.9 | \$2.1 |

3. Investments in and Advances to Nonconsolidated Affiliates

As of June 30, 2013 and December 31, 2012, we had \$21.9 million and \$20.8 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 12 partially owned subsidiaries, of which 9 are general or limited partnerships, limited liability companies, or joint ventures in which HealthSouth or one of its subsidiaries is a general or limited partner, managing member, member, or venturer, as applicable. We do not control these affiliates but have the ability to exercise significant influence over the operating and financial policies of certain of these affiliates. Our ownership percentages in these affiliates range from approximately 1% to 51%. We account for these investments using the cost and equity methods of accounting.

HealthSouth Corporation and Subsidiaries
Notes to Condensed Consolidated Financial Statements

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

| | Three Months Ended | | Six Months Ended June | |
|---|--------------------|---------|-----------------------|---------|
| | June 30, | | 30, | |
| | 2013 | 2012 | 2013 | 2012 |
| Net operating revenues | \$19.7 | \$22.6 | \$39.2 | \$45.6 |
| Operating expenses | (11.0 |) (13.8 |) (22.2 |) (27.9 |
| Income from continuing operations, net of tax | 7.3 | 6.9 | 14.0 | 14.4 |
| Net income | 7.3 | 6.9 | 14.0 | 14.4 |

4. Long-term Debt

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

| | June 30, 2013 | December 31, 2012 |
|--|---------------|-------------------|
| Credit Agreement— | | |
| Advances under revolving credit facility | \$73.0 | \$— |
| Bonds payable— | | |
| 7.25% Senior Notes due 2018 | 302.8 | 302.9 |
| 8.125% Senior Notes due 2020 | 286.4 | 286.2 |
| 7.75% Senior Notes due 2022 | 280.6 | 280.7 |
| 5.75% Senior Notes due 2024 | 275.0 | 275.0 |
| Other notes payable | 47.7 | 36.8 |
| Capital lease obligations | 65.2 | 71.9 |
| | 1,330.7 | 1,253.5 |
| Less: Current portion | (11.0 |) (13.6 |
| Long-term debt, net of current portion | \$1,319.7 | \$1,239.9 |

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, 2013 | \$6.3 | \$6.3 |
| 2014 | 10.7 | 10.7 |
| 2015 | 10.0 | 10.0 |
| 2016 | 9.0 | 9.0 |
| 2017 | 8.1 | 8.1 |
| 2018 | 383.1 | 384.4 |
| Thereafter | 904.2 | 902.2 |
| Total | \$1,331.4 | \$1,330.7 |

The amounts drawn on our revolving credit facility during the first six months of 2013 were primarily used for the repurchase of our common stock, as discussed in Note 9, Earnings per Common Share.

HealthSouth Corporation and Subsidiaries
Notes to Condensed Consolidated Financial Statements

In June 2013, we amended our existing credit agreement to, among other things, permit unlimited restricted payments (as defined in the credit agreement) so long as the senior secured leverage ratio remains less than or equal to 1.5x and to extend the maturity date of the revolving credit facility from August 2017 to June 2018. All other material terms of the existing credit agreement remained the same and are described in more detail in Note 8, Long-term Debt, to the consolidated financial statements accompanying the 2012 Form 10 K.

On July 25, 2013, our board of directors authorized the optional redemption of 10% of the outstanding principal amount of our existing 7.25% Senior Notes due 2018 and 7.75% Senior Notes due 2022 pursuant to the terms of these senior notes. Our right to call these bonds at 103% of the principal amount and the discretion provided by this authorization are not synonymous with an exercise of the call option.

Our bonds payable were issued pursuant to an indenture (the "Base Indenture") between us and The Bank of Nova Scotia Trust Company of New York, as trustee (the "Original Trustee"), as supplemented by subsequent supplemental indentures relating to each respective series of senior notes (collectively with the Base Indenture, the "Indenture"). The Original Trustee notified us of its intention to discontinue its corporate trust operations and, accordingly, to resign upon the appointment of a successor trustee. Effective July 29, 2013, Wells Fargo Bank, National Association, was appointed as successor trustee under the Indenture.

For additional information regarding our indebtedness, see Note 8, Long-term Debt, to the consolidated financial statements accompanying the 2012 Form 10-K.

5. Redeemable Noncontrolling Interests

Redeemable noncontrolling interests relate to two joint venture entities:

In the first quarter of 2013, we entered into an agreement to convert our 100% owned hospital in Jonesboro, Arkansas into a joint venture with St. Bernards Healthcare. Following the formation of the joint venture, our ownership percentage was reduced to approximately 56%. As a result of this transaction, Goodwill increased by \$6.2 million.

In 2009, we entered into an agreement to convert our 100% owned hospital in Altoona, Pennsylvania into a joint venture with Altoona Regional Health System. Following the formation of the joint venture, our ownership percentage was reduced to 55%. Historically, the noncontrolling interest related to this joint venture was included in Other long-term liabilities in our condensed consolidated balance sheets. See Note 1, Basis of Presentation, "Reclassifications."

The joint venture agreements for these two entities contain provisions that allow our partners to require us to purchase their interests in the joint venture at fair value at certain points in the future. Because these noncontrolling interests provide for redemption features that are not solely within our control, we classify them as Redeemable noncontrolling interests outside of permanent equity in our condensed consolidated balance sheets. At the end of each reporting period, we compare the carrying value of the Redeemable noncontrolling interests to their estimated redemption value. If the estimated redemption value is greater than the current carrying value, the carrying value is adjusted to the estimated redemption value, with the adjustments recorded through equity in the line item Capital in excess of par value.

We determine the fair value of our Redeemable noncontrolling interests with these redemption options primarily using the income approach. The income approach includes the use of the hospital's projected operating results and cash flows discounted using a rate that reflects market participant assumptions for the applicable hospitals, or Level 3 inputs. 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.

HealthSouth Corporation and Subsidiaries
Notes to Condensed Consolidated Financial Statements

The following is a summary of the activity related to our Redeemable noncontrolling interests during the six months ended June 30, 2013 and 2012 (in millions):

| | Six Months Ended June 30, | |
|---|---------------------------|--------|
| | 2013 | 2012 |
| Balance at beginning of period | \$7.2 | \$7.3 |
| Net income attributable to noncontrolling interests | 2.6 | 1.9 |
| Distributions declared | (1.9 |) (2.2 |
| Contribution to joint venture | 6.2 | — |
| Balance at end of period | \$14.1 | \$7.0 |

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 on the condensed consolidated statements of operations for the three and six months ended June 30, 2013 and 2012 (in millions):

| | Three Months Ended | | Six Months Ended June | |
|---|--------------------|--------|-----------------------|--------|
| | June 30, | 2012 | 30, | 2012 |
| | 2013 | 2012 | 2013 | 2012 |
| Net income attributable to nonredeemable noncontrolling interests | \$12.5 | \$12.3 | \$25.8 | \$23.9 |
| Net income attributable to redeemable noncontrolling interests | 1.3 | 0.9 | 2.6 | 1.9 |
| Net income attributable to noncontrolling interests | \$13.8 | \$13.2 | \$28.4 | \$25.8 |

HealthSouth Corporation and Subsidiaries
Notes to Condensed Consolidated Financial Statements

6. 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, 2013 | Fair Value | Fair Value Measurements at Reporting Date Using | | | Valuation Technique ⁽¹⁾ |
|---|------------|--|---|---|------------------------------------|
| | | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) | |
| Other current assets: | | | | | |
| Current portion of restricted marketable securities | \$8.4 | \$— | \$8.4 | \$— | M |
| Other long-term assets: | | | | | |
| Restricted marketable securities | 41.8 | — | 41.8 | — | M |
| As of December 31, 2012 | | | | | |
| Other current assets: | | | | | |
| Current portion of restricted marketable securities | \$16.4 | \$— | \$16.4 | \$— | M |
| Other long-term assets: | | | | | |
| Restricted marketable securities | 39.4 | — | 39.4 | — | M |

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

In addition to assets and liabilities recorded at fair value on a recurring basis, we are also required to record assets and liabilities at fair value on a nonrecurring basis. Generally, assets are recorded at fair value on a nonrecurring basis as a result of impairment charges or similar adjustments made to the carrying value of the applicable assets. During the three and six months ended June 30, 2013 and 2012, 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, to the consolidated financial statements accompanying the 2012 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, 2013 | | As of December 31, 2012 | |
|--|---------------------|----------------------|-------------------------|----------------------|
| | Carrying Amount | Estimated Fair Value | Carrying Amount | Estimated Fair Value |
| Long-term debt: | | | | |
| Advances under revolving credit facility | \$73.0 | \$73.0 | \$— | \$— |
| 7.25% Senior Notes due 2018 | 302.8 | 322.6 | 302.9 | 328.6 |
| 8.125% Senior Notes due 2020 | 286.4 | 315.4 | 286.2 | 321.5 |
| 7.75% Senior Notes due 2022 | 280.6 | 300.6 | 280.7 | 306.5 |
| 5.75% Senior Notes due 2024 | 275.0 | 272.3 | 275.0 | 277.1 |
| Other notes payable | 47.7 | 47.7 | 36.8 | 36.8 |
| Financial commitments: | | | | |
| Letters of credit | — | 35.9 | — | 39.5 |

HealthSouth Corporation and Subsidiaries
Notes to Condensed Consolidated Financial Statements

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 2012 Form 10-K.

See also Note 5, Redeemable Noncontrolling Interests.

7. Share-Based Payments

In February 2013, we issued 0.9 million of restricted stock awards to members of our management team and our board of directors. Approximately 0.3 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 2013, 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 14, Share-Based Payments, to the consolidated financial statements accompanying the 2012 Form 10-K.

8. Income Taxes

In April 2013, we entered into closing agreements with the IRS that settled federal income tax matters related to the previous restatement of our 2000 and 2001 financial statements, as well as certain other tax matters, through December 31, 2008. As a result of these closing agreements, we increased our deferred tax assets, primarily our federal net operating loss carryforward ("NOL"), and recorded a net federal income tax benefit of approximately \$115 million in the second quarter of 2013. This federal income tax benefit primarily resulted from an approximate \$283 million increase to our federal NOL on a gross basis.

Our Provision for income tax benefit of \$86.5 million and \$53.0 million for the three and six months ended June 30, 2013, respectively, primarily resulted from the settlement discussed above. It also includes an approximate \$3 million decrease in our valuation allowance related primarily to our capital loss carryforwards. During the second quarter of 2013, we determined a valuation allowance related to these assets was no longer required as sufficient positive evidence existed to substantiate their utilization. This evidence included our partial utilization of these capital loss carryforwards as a result of realizing capital gains in the current year and the identification of sufficient taxable capital gain income within the available capital loss carryforward period.

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

The \$582.3 million of net deferred tax assets included in the accompanying condensed consolidated balance sheet as of June 30, 2013 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, 2013, we maintained a valuation allowance of \$37.2 million due to uncertainties regarding our ability to utilize a portion of our deferred tax assets, primarily related to state NOLs, before they expire. The amount of the valuation allowance has been determined for each tax jurisdiction based on the weight of all available evidence including management's estimates of taxable income for each jurisdiction in which we operate over the periods in which the related deferred tax assets will be recoverable. It is possible we may be required to increase or decrease our valuation allowance at some future time if our forecast of future earnings varies from actual results on a consolidated basis or in the applicable state tax jurisdictions, or if the timing of future tax deductions differs from our expectations. Our reported federal NOL of \$391.9 million (approximately \$1.1 billion on a gross basis) as of June 30, 2013 excludes \$6.3 million related to operating loss carryforwards resulting from excess tax benefits related to share-based awards, the tax

HealthSouth Corporation and Subsidiaries
Notes to Condensed Consolidated Financial Statements

benefits of which, when recognized, will be accounted for as a credit to Capital in excess of par value when they reduce taxes payable.

Our Provision for income tax expense of \$26.9 million and \$56.0 million for the three and six months ended June 30, 2012, respectively, primarily resulted from the application of our estimated effective blended federal and state income tax rate.

We recognize the financial statement effects of uncertain tax positions when it is more likely than not, based on the technical merits, a position will be sustained upon examination by and resolution with the taxing authorities. Total remaining gross unrecognized tax benefits were \$2.4 million and \$78.0 million as of June 30, 2013 and December 31, 2012, respectively. The amount of gross unrecognized tax benefits changed during the three and six months ended June 30, 2013 primarily due to the IRS settlement discussed above.

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

| | Gross Unrecognized Income Tax Benefits | Accrued Interest and Penalties |
|--|---|-----------------------------------|
| Balance at December 31, 2012 | \$78.0 | \$— |
| Gross amount of increases in unrecognized tax benefits related to prior periods | 46.1 | — |
| Decreases in unrecognized tax benefits relating to settlements with taxing authorities | (121.7 |) — |
| Balance at June 30, 2013 | \$2.4 | \$— |

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, 2013 and 2012 was not material. Accrued interest income related to income taxes as of June 30, 2013 and December 31, 2012 was not material.

HealthSouth and its subsidiaries' federal and state income tax returns are periodically examined by various regulatory taxing authorities. In connection with such examinations, we have settled federal income tax examinations with the IRS for all tax years through 2010. We are currently under audit by two states for tax years ranging from 2008 through 2011.

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. We do not expect a material change in our unrecognized tax benefits within the next 12 months due to the closing of the applicable statutes of limitation.

HealthSouth Corporation and Subsidiaries
Notes to Condensed Consolidated Financial Statements

9. Earnings per Common Share

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

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|--------------------------------|---------|------------------------------|---------|
| | 2013 | 2012 | 2013 | 2012 |
| Basic: | | | | |
| Numerator: | | | | |
| Income from continuing operations | \$178.9 | \$56.4 | \$245.2 | \$113.6 |
| Less: Net income attributable to noncontrolling interests included in continuing operations | (13.8) | (13.2) | (28.4) | (25.8) |
| Less: Convertible perpetual preferred stock dividends | (5.8) | (6.0) | (11.5) | (12.4) |
| Less: Repurchase of convertible perpetual preferred stock | — | (0.3) | — | (0.8) |
| Income from continuing operations attributable to HealthSouth common shareholders | 159.3 | 36.9 | 205.3 | 74.6 |
| Income (loss) from discontinued operations, net of tax, attributable to HealthSouth common shareholders | 0.1 | 3.5 | (0.3) | 3.1 |
| Net income attributable to HealthSouth common shareholders | \$159.4 | \$40.4 | \$205.0 | \$77.7 |
| Denominator: | | | | |
| Basic weighted average common shares outstanding | 86.1 | 94.6 | 90.0 | 94.5 |
| Basic earnings per share attributable to HealthSouth common shareholders: | | | | |
| Continuing operations | \$1.85 | \$0.39 | \$2.28 | \$0.79 |
| Discontinued operations | — | 0.04 | — | 0.03 |
| Net income | \$1.85 | \$0.43 | \$2.28 | \$0.82 |
| Diluted: | | | | |
| Numerator: | | | | |
| Income from continuing operations | \$178.9 | \$56.4 | \$245.2 | \$113.6 |
| Less: Net income attributable to noncontrolling interests included in continuing operations | (13.8) | (13.2) | (28.4) | (25.8) |
| Income from continuing operations attributable to HealthSouth common shareholders | 165.1 | 43.2 | 216.8 | 87.8 |
| Income (loss) from discontinued operations, net of tax, attributable to HealthSouth common shareholders | 0.1 | 3.5 | (0.3) | 3.1 |
| Net income attributable to HealthSouth common shareholders | \$165.2 | \$46.7 | \$216.5 | \$90.9 |
| Denominator: | | | | |
| Diluted weighted average common shares outstanding | 99.8 | 108.0 | 103.4 | 108.3 |
| Diluted earnings per share attributable to HealthSouth common shareholders: | | | | |
| Continuing operations | \$1.66 | \$0.39 | \$2.09 | \$0.79 |
| Discontinued operations | — | 0.04 | — | 0.03 |
| Net income | \$1.66 | \$0.43 | \$2.09 | \$0.82 |

HealthSouth Corporation and Subsidiaries
Notes to Condensed Consolidated Financial Statements

Diluted earnings per share report the potential dilution that could occur if securities or other contracts to issue common stock were exercised or converted into common stock. These potential shares include convertible perpetual preferred stock, restricted stock awards, dilutive stock options, and restricted stock units. For the three and six months ended June 30, 2013, the number of potential shares approximated 13.7 million and 13.4 million, respectively. For the three and six months ended June 30, 2012, the number of potential shares approximated 13.4 million and 13.8 million, respectively. For the three and six months ended June 30, 2013, approximately 11.6 million of the potential shares related to our Convertible perpetual preferred stock. For the three and six months ended June 30, 2012, approximately 12.0 million and 12.5 million of the potential shares, respectively, related to our Convertible perpetual preferred stock. For the three and six months ended June 30, 2012, adding back the dividends for the Convertible perpetual preferred stock to our Income from continuing operations attributable to HealthSouth common shareholders causes a per share increase when calculating diluted earnings per common share resulting in an anti-dilutive per share amount. Therefore, basic and diluted earnings per common share are the same for the three and six months ended June 30, 2012.

Options to purchase approximately 1.2 million and 1.8 million shares of common stock were outstanding as of June 30, 2013 and 2012, respectively, but were not included in the computation of diluted weighted-average shares because to do so would have been antidilutive.

On February 15, 2013, our board of directors approved an increase in our existing common stock repurchase authorization from \$125 million to \$350 million. During the first quarter of 2013, we completed a tender offer for our common stock. As a result of the tender offer, we purchased approximately 9.1 million shares at a price of \$25.50 per share for a total cost of approximately \$234.1 million, including fees and expenses relating to the tender offer. The remaining repurchase authorization expired at the end of the tender offer.

On July 25, 2013, our board of directors approved the initiation of a quarterly cash dividend on our common stock of \$0.18 per share. The first quarterly dividend will be payable on or about October 15, 2013 to stockholders of record as of the close of business on October 1, 2013. Future dividend payments are subject to declaration by our board of directors.

See Note 11, Convertible Perpetual Preferred Stock, and Note 18, Earnings per Common Share, to the consolidated financial statements accompanying the 2012 Form 10-K for additional information related to common stock, common stock warrants, and convertible perpetual preferred stock.

10. 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.

Litigation By and Against Former Independent Auditor—

In March 2003, claims on behalf of HealthSouth were brought against Ernst & Young, LLP in a stockholder derivative lawsuit initially filed in the Circuit Court of Jefferson County, Alabama on August 28, 2002 and captioned Tucker v. Scrushy. The Tucker derivative litigation, including the claims against various other defendants and the \$2.9 billion judgment against Mr. Scrushy, our former chairman and chief executive officer, is more fully described in “Derivative Litigation” and “Litigation Against Richard M. Scrushy” in Note 19, Contingencies and Other Commitments, to the consolidated financial statements accompanying the 2012 Form 10-K. The Tucker complaint alleges that from 1996 through 2002, when Ernst & Young served as our independent auditor, Ernst & Young acted recklessly and with gross negligence in performing its duties, and specifically that Ernst & Young failed to perform reviews and audits of our financial statements with due professional care as required by law and by its contractual agreements with us. The claims further allege Ernst & Young either knew of or, in the exercise of due care, should have discovered and investigated the fraudulent and improper accounting practices being directed by certain officers and employees, and should have reported them to our board of directors and the audit committee. The claims seek compensatory and punitive damages, disgorgement of fees received from us by Ernst & Young, and attorneys’ fees and costs.

On March 18, 2005, Ernst & Young filed a lawsuit captioned Ernst & Young LLP v. HealthSouth Corp. in the Circuit Court of Jefferson County, Alabama. The complaint alleges we provided Ernst & Young with fraudulent management

HealthSouth Corporation and Subsidiaries
Notes to Condensed Consolidated Financial Statements

representation letters, financial statements, invoices, bank reconciliations, and journal entries in an effort to conceal accounting fraud. Ernst & Young claims that as a result of our actions, Ernst & Young's reputation has been injured and it has and will incur damages, expenses, and legal fees. On April 1, 2005, we answered Ernst & Young's claims and asserted counterclaims related or identical to those asserted in the Tucker action. Upon Ernst & Young's motion, the Alabama state court referred Ernst & Young's claims and our counterclaims to arbitration pursuant to a clause in the engagement agreements between HealthSouth and Ernst & Young. In August 2006, we and the derivative plaintiffs agreed to jointly prosecute the claims against Ernst & Young in arbitration.

The trial phase of the arbitration process began on July 12, 2010 before a three-person arbitration panel selected under rules of the American Arbitration Association (the "AAA"). On December 18, 2012, the AAA panel granted Ernst & Young's motion to dismiss our claims on the grounds that HealthSouth is not permitted to pursue its claims since certain of its former officers and employees committed fraudulent acts. The panel also denied and dismissed Ernst & Young's claims against us. On December 18, 2012, we, together with the stockholder derivative plaintiffs, filed a notice of appeal of the panel's decision in the Circuit Court of Jefferson County, Alabama. On December 28, 2012, we filed a motion to vacate the decision. We assert that the panel's decision is contrary to the Federal Arbitration Act and the duties of a public accounting firm to its corporate clients, and that the arbitrators exceeded their authority by entering an award contrary to Alabama law. On April 25, 2013, the court denied our motion to vacate. On June 4, 2013, we filed a notice of appeal to the Supreme Court of Alabama seeking review of the Circuit Court's denial of our motion to vacate the arbitration panel's decision. Once the record on appeal is deemed complete, briefing will begin on that appeal. At this time, we do not know how long the appellate process will take.

Based on the ruling of the arbitration panel, we do not believe there is a reasonable possibility of a loss that might result from an adverse judgment or a settlement of this case.

General Medicine Action—

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

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

The complaint filed by General Medicine against us in the Alabama Action alleges that while Horizon/CMS was our wholly owned subsidiary, General Medicine was an existing creditor of Horizon/CMS by virtue of the breach of contract claim underlying the Settlement. The complaint also alleges we caused Horizon/CMS to transfer its assets to us for less than a reasonably equivalent value or, in the alternative, with the actual intent to defraud creditors of Horizon/CMS, including General Medicine, in violation of the Alabama Uniform Fraudulent Transfer Act. General

Medicine further alleges in its amended complaint that we are liable for the Consent Judgment despite not being a party to it because as Horizon/CMS's parent we failed to observe corporate formalities in our operation and ownership of Horizon/CMS, misused our control of Horizon/CMS, stripped assets from Horizon/CMS, and engaged in other conduct which amounted to a fraud on Horizon/CMS's creditors. General Medicine has requested relief including recovery of the unpaid amount of the Consent Judgment, the avoidance of the

HealthSouth Corporation and Subsidiaries
Notes to Condensed Consolidated Financial Statements

subject transfers of assets, attachment of the assets transferred to us, appointment of a receiver over the transferred properties, and a monetary judgment for the value of properties transferred.

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

In 2008, after we obtained discovery concerning the circumstances that led to the entry of the Consent Judgment, we filed a motion in the Michigan Action asking the court to set aside the Consent Judgment on grounds that it was the product of fraud on the court and collusion by the parties. On May 21, 2009, the court granted our motion to set aside the Consent Judgment on grounds that it was the product of fraud on the court. On March 9, 2010, General Medicine filed an appeal of the court's decision to the Sixth Circuit Court of Appeals. The parties agreed to a voluntary stay of the Alabama Action pending the outcome of General Medicine's appeal to the Sixth Circuit Court of Appeals. On April 10, 2012, the Sixth Circuit Court of Appeals reversed the lower court's ruling and reinstated the Consent Judgment. Due to the conclusion of the appeal in the Michigan Action, General Medicine requested reactivation of the Alabama Action in the Circuit Court of Jefferson County, Alabama. On January 10, 2013, we filed a motion for partial summary judgment in the Alabama Action seeking a declaration that the Consent Judgment obtained by General Medicine is not enforceable against us because, among other reasons, it was the result of collusion. On February 27, 2013, the court denied our motion and reserved the issue of collusion for a later time. The court issued a supplemental order on April 11, 2013, clarifying its February 27, 2013 ruling. The court's rulings provide that the Consent Judgment is admissible as evidence of General Medicine's claim in the Alabama Action but the amount of the Consent Judgment is not binding on us. Therefore, we remain free to present evidence challenging the amount of the damages figure contained in the Consent Judgment, including the value of the underlying contract-related claim that is the basis for the Consent Judgment. The court further ruled that we may develop and present evidence that the Consent Judgment is void in its entirety as the product of collusion by General Medicine and Horizon/CMS. The court also indicated it concurred with the Sixth Circuit Court of Appeals that the Consent Judgment did nothing more than establish Horizon/CMS's liability to General Medicine and did not establish the merits of General Medicine's separate fraudulent conveyance claims against HealthSouth. The Alabama Action is still in the discovery phase and has been set for trial beginning in June 2014.

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

Other Litigation—

We have been named as a defendant in a lawsuit filed March 28, 2003 by several individual stockholders in the Circuit Court of Jefferson County, Alabama, captioned Nichols v. HealthSouth Corp. The plaintiffs allege that we, some of our former officers, and our former investment bank engaged in a scheme to overstate and misrepresent our earnings and financial position. The plaintiffs are seeking compensatory and punitive damages. This case was consolidated with the Tucker case for discovery and other pretrial purposes and was stayed in the Circuit Court on August 8, 2005. The plaintiffs filed an amended complaint on November 9, 2010 to which we responded with a motion to dismiss filed on December 22, 2010. During a hearing on February 24, 2012, plaintiffs' counsel indicated his intent to dismiss certain claims against us. Instead, on March 9, 2012, the plaintiffs amended their complaint to include additional securities fraud claims against HealthSouth and add several former officers to the lawsuit. 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. At this time, we do not know when the court will rule on the motion to remand. 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

HealthSouth Corporation and Subsidiaries
Notes to Condensed Consolidated Financial Statements

judgment or settlement is probable in this matter, and it is also not possible to estimate the amount of loss, if any, or range of possible loss that might result from an adverse judgment or settlement of this case.

We were named as a defendant in a lawsuit filed March 3, 2009 by an individual in the Court of Common Pleas, Richland County, South Carolina, captioned Sulton v. HealthSouth Corp, et al. The plaintiff alleged that certain treatment he received at a HealthSouth facility complicated a pre-existing infectious injury. The plaintiff sought recovery for pain and suffering, medical expenses, punitive damages, and other damages. On July 30, 2010, the jury in this case returned a verdict in favor of the plaintiff for \$12.3 million in damages. We appealed that verdict, and on November 21, 2012, the Supreme Court of South Carolina reversed the jury verdict in its entirety and remanded the case to the court of common pleas for retrial. On March 8, 2013, the Court of Common Pleas, Richland County, South Carolina approved our comprehensive settlement agreement with the plaintiff in the Sulton case. While the terms of the settlement are confidential, the amount paid to the plaintiff to settle all claims was not material to us and was less than amounts previously accrued. See Note 10, Self-Insured Risks, to the consolidated financial statements accompanying the 2012 Form 10-K.

HHS-OIG 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 U.S. Department of Health and Human Services, Office of the Inspector General (the “HHS-OIG”). The subpoena is in connection with an investigation of possible false or otherwise improper claims submitted to Medicare and Medicaid and requests documents and materials relating to this closed LTCH’s patient admissions, length of stay, and discharge matters.

On March 4, 2013, we received document subpoenas addressed to four of our wholly owned hospitals and issued from the Miami Lakes, Florida office of the HHS-OIG. These hospitals process all of their Medicare claims through the same Medicare administrative contractor, Cahaba Government Benefit Administrators, LLC. Each subpoena is in connection with an investigation of alleged improper or fraudulent claims submitted to Medicare and Medicaid and requests 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. The subpoenas also request complete copies of medical records for 100 patients treated at each of these hospitals between September 2008 and June 2012.

We are cooperating fully with the HHS-OIG 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 privy to the information contained in the complaint are the relator, the federal government, and the presiding court. It is possible that qui tam lawsuits have been filed against us and that we are unaware of such filings or have been ordered by the presiding court not to discuss or disclose the filing of such lawsuits. We may be subject to liability under one or more undisclosed qui tam cases brought pursuant to the False Claims Act.

It is our obligation as a participant in Medicare and other federal healthcare programs to routinely conduct audits and reviews of the accuracy of our billing systems and other regulatory compliance matters. As a result of these reviews, we have made, and will continue to make, disclosures to the HHS-OIG and 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.

In March 2008, we sold our corporate campus to Daniel Corporation (“Daniel”), a Birmingham, Alabama-based real estate company. The sale included a deferred purchase price component related to an incomplete 13-story building located on

20

HealthSouth Corporation and Subsidiaries
Notes to Condensed Consolidated Financial Statements

the property, often referred to as the Digital Hospital. Under the agreement, Daniel is obligated upon sale of its interest in the building to pay to us 40% of the net profit realized from the sale. In June 2013, Daniel sold the building to Trinity Medical Center. We are currently in discussions with Daniel to finalize the amount owed to us in connection with the sale of the building.

11. 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 Intercompany payable in the accompanying condensed consolidating balance sheets.

As described in Note 8, Long-term Debt, to the consolidated financial statements accompanying the 2012 Form 10-K, the terms of our credit agreement restrict us from declaring or paying cash dividends on our common stock unless:

(1) we are not in default under our credit agreement and (2) the amount of the dividend, when added to the aggregate amount of certain other defined payments made during the same fiscal year, does not exceed certain maximum thresholds. However, as described in Note 11, Convertible Perpetual Preferred Stock, to the consolidated financial statements accompanying the 2012 Form 10-K, our preferred stock generally provides for the payment of cash dividends, subject to certain limitations.

In the third quarter of 2012, we revised our condensed consolidating statement of cash flows for the six months ended June 30, 2012 to adjust cash flows from operating activities to eliminate equity in earnings from affiliates, which is a noncash activity. The impact of this revision, along with other immaterial classification revisions, was to decrease cash flows from operating activities (and, correspondingly increase cash flows from financing activities) during the applicable periods for HealthSouth Corporation, Guarantor Subsidiaries, and Nonguarantor Subsidiaries, with an offset to Eliminating Entries, as shown in the table below (in millions). This revision is not material to the related financial statements for any prior periods and had no impact on our condensed consolidated statement of cash flows for the six months ended June 30, 2012.

| | For the Six Months Ended June 30, 2012 |
|---------------------------|---|
| HealthSouth Corporation | \$ 137.0 |
| Guarantor Subsidiaries | 10.8 |
| Nonguarantor Subsidiaries | 7.3 |

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

| | Three Months Ended June 30, 2013 | | | | |
|---|--|------------------------|---------------------------|---------------------|--------------------------|
| | HealthSouth Corporation (In Millions) | Guarantor Subsidiaries | Nonguarantor Subsidiaries | Eliminating Entries | HealthSouth Consolidated |
| Net operating revenues | \$4.8 | \$399.7 | \$177.4 | \$(17.4) |) \$564.5 |
| Less: Provision for doubtful accounts | — | (4.7) |) (2.3) |) — | (7.0) |
| Net operating revenues less provision for doubtful accounts | 4.8 | 395.0 | 175.1 | (17.4) |) 557.5 |
| Operating expenses: | | | | | |
| Salaries and benefits | 6.3 | 188.9 | 82.0 | (3.6) |) 273.6 |
| Other operating expenses | 4.5 | 58.7 | 26.2 | (8.4) |) 81.0 |
| Occupancy costs | 1.1 | 11.8 | 4.4 | (5.4) |) 11.9 |
| Supplies | — | 18.5 | 8.1 | — | 26.6 |
| General and administrative expenses | 29.5 | — | — | — | 29.5 |
| Depreciation and amortization | 2.2 | 15.9 | 5.0 | — | 23.1 |
| Government, class action, and related settlements | (2.0) |) — | — | — | (2.0) |
| Professional fees—accounting, tax, and legal | 2.2 | — | — | — | 2.2 |
| Total operating expenses | 43.8 | 293.8 | 125.7 | (17.4) |) 445.9 |
| Interest expense and amortization of debt discounts and fees | 22.3 | 1.7 | 0.7 | (0.3) |) 24.4 |
| Other income | — | (0.7) |) (1.5) |) 0.3 | (1.9) |
| Equity in net income of nonconsolidated affiliates | (1.3) |) (2.0) |) — | — | (3.3) |
| Equity in net income of consolidated affiliates | (113.7) |) (11.4) |) — | 125.1 | — |
| Management fees | (25.6) |) 19.3 | 6.3 | — | — |
| Income from continuing operations before income tax (benefit) expense | 79.3 | 94.3 | 43.9 | (125.1) |) 92.4 |
| Provision for income tax (benefit) expense | (85.6) |) (6.5) |) 5.6 | — | (86.5) |
| Income from continuing operations | 164.9 | 100.8 | 38.3 | (125.1) |) 178.9 |
| Income (loss) from discontinued operations, net of tax | 0.3 | 0.1 | (0.3) |) — | 0.1 |
| Net Income | 165.2 | 100.9 | 38.0 | (125.1) |) 179.0 |
| Less: Net income attributable to noncontrolling interests | — | — | (13.8) |) — | (13.8) |
| Net income attributable to HealthSouth | \$165.2 | \$100.9 | \$24.2 | \$(125.1) |) \$165.2 |
| Comprehensive income | \$163.4 | \$100.9 | \$38.0 | \$(125.1) |) \$177.2 |
| Comprehensive income attributable to HealthSouth | \$163.4 | \$100.9 | \$24.2 | \$(125.1) |) \$163.4 |

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

| | Three Months Ended June 30, 2012 | | | | |
|---|--|------------------------|---------------------------|---------------------|--------------------------|
| | HealthSouth Corporation (In Millions) | Guarantor Subsidiaries | Nonguarantor Subsidiaries | Eliminating Entries | HealthSouth Consolidated |
| Net operating revenues | \$3.2 | \$384.4 | \$159.9 | \$(14.1) |) \$533.4 |
| Less: Provision for doubtful accounts | 0.2 | (5.0) | (1.7) | — | (6.5) |
| Net operating revenues less provision for doubtful accounts | 3.4 | 379.4 | 158.2 | (14.1) |) 526.9 |
| Operating expenses: | | | | | |
| Salaries and benefits | 5.8 | 180.4 | 74.6 | (3.4) |) 257.4 |
| Other operating expenses | 3.8 | 54.3 | 23.5 | (6.6) |) 75.0 |
| Occupancy costs | 1.1 | 11.0 | 4.3 | (4.1) |) 12.3 |
| Supplies | — | 18.7 | 7.2 | — | 25.9 |
| General and administrative expenses | 28.0 | — | — | — | 28.0 |
| Depreciation and amortization | 2.1 | 14.1 | 3.8 | — | 20.0 |
| Professional fees—accounting, tax, and legal | 5.5 | — | — | — | 5.5 |
| Total operating expenses | 46.3 | 278.5 | 113.4 | (14.1) |) 424.1 |
| Interest expense and amortization of debt discounts and fees | 20.8 | 1.9 | 0.6 | (0.3) |) 23.0 |
| Other income | — | (0.1) | (0.6) | 0.3 | (0.4) |
| Equity in net income of nonconsolidated affiliates | (0.8) | (2.3) | — | — | (3.1) |
| Equity in net income of consolidated affiliates | (69.1) | (5.1) | — | 74.2 | — |
| Management fees | (24.2) | 18.6 | 5.6 | — | — |
| Income from continuing operations before income tax (benefit) expense | 30.4 | 87.9 | 39.2 | (74.2) |) 83.3 |
| Provision for income tax (benefit) expense | (15.6) | 32.9 | 9.6 | — | 26.9 |
| Income from continuing operations | 46.0 | 55.0 | 29.6 | (74.2) |) 56.4 |
| Income from discontinued operations, net of tax | 0.7 | 0.8 | 2.0 | — | 3.5 |
| Net Income | 46.7 | 55.8 | 31.6 | (74.2) |) 59.9 |
| Less: Net income attributable to noncontrolling interests | — | — | (13.2) | — | (13.2) |
| Net income attributable to HealthSouth | \$46.7 | \$55.8 | \$18.4 | \$(74.2) |) \$46.7 |
| Comprehensive income | \$46.9 | \$55.8 | \$31.6 | \$(74.2) |) \$60.1 |
| Comprehensive income attributable to HealthSouth | \$46.9 | \$55.8 | \$18.4 | \$(74.2) |) \$46.9 |

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

| | Six Months Ended June 30, 2013 | | | | | |
|---|--|------------------------|---------------------------|---------------------|--------------------------|---|
| | HealthSouth Corporation (In Millions) | Guarantor Subsidiaries | Nonguarantor Subsidiaries | Eliminating Entries | HealthSouth Consolidated | |
| Net operating revenues | \$9.7 | \$811.6 | \$350.0 | \$(34.2 |) \$1,137.1 | |
| Less: Provision for doubtful accounts | — | (10.0 |) (4.4 |) — | (14.4 |) |
| Net operating revenues less provision for doubtful accounts | 9.7 | 801.6 | 345.6 | (34.2 |) 1,122.7 | |
| Operating expenses: | | | | | | |
| Salaries and benefits | 14.1 | 377.6 | 163.7 | (7.2 |) 548.2 | |
| Other operating expenses | 8.7 | 115.1 | 52.0 | (16.7 |) 159.1 | |
| Occupancy costs | 2.2 | 23.7 | 8.6 | (10.4 |) 24.1 | |
| Supplies | — | 37.1 | 15.7 | — | 52.8 | |
| General and administrative expenses | 59.7 | — | — | — | 59.7 | |
| Depreciation and amortization | 4.3 | 31.1 | 9.8 | — | 45.2 | |
| Government, class action, and related settlements | (2.0 |) — | — | — | (2.0 |) |
| Professional fees—accounting, tax, and legal | 3.6 | — | — | — | 3.6 | |
| Total operating expenses | 90.6 | 584.6 | 249.8 | (34.3 |) 890.7 | |
| Interest expense and amortization of debt discounts and fees | 44.4 | 3.3 | 1.5 | (0.6 |) 48.6 | |
| Other income | (0.3 |) (0.7 |) (2.3 |) 0.7 | (2.6 |) |
| Equity in net income of nonconsolidated affiliates | (2.2 |) (4.0 |) — | — | (6.2 |) |
| Equity in net income of consolidated affiliates | (183.5 |) (16.9 |) — | 200.4 | — | |
| Management fees | (51.4 |) 39.4 | 12.0 | — | — | |
| Income from continuing operations before income tax (benefit) expense | 112.1 | 195.9 | 84.6 | (200.4 |) 192.2 | |
| Provision for income tax (benefit) expense | (104.2 |) 34.8 | 16.4 | — | (53.0 |) |
| Income from continuing operations | 216.3 | 161.1 | 68.2 | (200.4 |) 245.2 | |
| Income (loss) from discontinued operations, net of tax | 0.2 | 0.3 | (0.8 |) — | (0.3 |) |
| Net Income | 216.5 | 161.4 | 67.4 | (200.4 |) 244.9 | |
| Less: Net income attributable to noncontrolling interests | — | — | (28.4 |) — | (28.4 |) |
| Net income attributable to HealthSouth | \$216.5 | \$161.4 | \$39.0 | \$(200.4 |) \$216.5 | |
| Comprehensive income | \$214.8 | \$161.4 | \$67.4 | \$(200.4 |) \$243.2 | |
| Comprehensive income attributable to HealthSouth | \$214.8 | \$161.4 | \$39.0 | \$(200.4 |) \$214.8 | |

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

| | Six Months Ended June 30, 2012 | | | | |
|---|--|------------------------|---------------------------|---------------------|--------------------------|
| | HealthSouth Corporation (In Millions) | Guarantor Subsidiaries | Nonguarantor Subsidiaries | Eliminating Entries | HealthSouth Consolidated |
| Net operating revenues | \$6.5 | \$776.7 | \$317.0 | \$(28.2) |) \$1,072.0 |
| Less: Provision for doubtful accounts | (0.3) |) (9.1) |) (3.4) |) — | (12.8) |
| Net operating revenues less provision for doubtful accounts | 6.2 | 767.6 | 313.6 | (28.2) |) 1,059.2 |
| Operating expenses: | | | | | |
| Salaries and benefits | 13.0 | 362.8 | 149.4 | (6.8) |) 518.4 |
| Other operating expenses | 7.9 | 107.5 | 46.5 | (13.1) |) 148.8 |
| Occupancy costs | 2.2 | 22.2 | 8.7 | (8.3) |) 24.8 |
| Supplies | — | 37.7 | 14.7 | — | 52.4 |
| General and administrative expenses | 58.0 | — | — | — | 58.0 |
| Depreciation and amortization | 4.2 | 27.7 | 7.6 | — | 39.5 |
| Professional fees—accounting, tax, and legal | 9.1 | — | — | — | 9.1 |
| Total operating expenses | 94.4 | 557.9 | 226.9 | (28.2) |) 851.0 |
| Interest expense and amortization of debt discounts and fees | 41.9 | 3.8 | 1.2 | (0.6) |) 46.3 |
| Other income | (0.4) |) (0.1) |) (1.4) |) 0.6 | (1.3) |
| Equity in net income of nonconsolidated affiliates | (1.9) |) (4.5) |) — | — | (6.4) |
| Equity in net income of consolidated affiliates | (138.1) |) (10.8) |) — | 148.9 | — |
| Management fees | (48.8) |) 37.9 | 10.9 | — | — |
| Income from continuing operations before income tax (benefit) expense | 59.1 | 183.4 | 76.0 | (148.9) |) 169.6 |
| Provision for income tax (benefit) expense | (31.1) |) 68.7 | 18.4 | — | 56.0 |
| Income from continuing operations | 90.2 | 114.7 | 57.6 | (148.9) |) 113.6 |
| Income from discontinued operations, net of tax | 0.7 | 0.5 | 1.9 | — | 3.1 |
| Net Income | 90.9 | 115.2 | 59.5 | (148.9) |) 116.7 |
| Less: Net income attributable to noncontrolling interests | — | — | (25.8) |) — | (25.8) |
| Net income attributable to HealthSouth | \$90.9 | \$115.2 | \$33.7 | \$(148.9) |) \$90.9 |
| Comprehensive income | \$91.9 | \$115.2 | \$59.5 | \$(148.9) |) \$117.7 |
| Comprehensive income attributable to HealthSouth | \$91.9 | \$115.2 | \$33.7 | \$(148.9) |) \$91.9 |

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

| | As of June 30, 2013 | | | | |
|---|--|------------------------|---------------------------|---------------------|--------------------------|
| | HealthSouth Corporation (In Millions) | Guarantor Subsidiaries | Nonguarantor Subsidiaries | Eliminating Entries | HealthSouth Consolidated |
| Assets | | | | | |
| Current assets: | | | | | |
| Cash and cash equivalents | \$65.0 | \$1.7 | \$2.0 | \$— | \$68.7 |
| Accounts receivable, net | 0.1 | 191.2 | 82.4 | — | 273.7 |
| Deferred income tax assets | 106.5 | 19.7 | 11.3 | — | 137.5 |
| Other current assets | 58.0 | 12.8 | 93.6 | (52.8) | 111.6 |
| Total current assets | 229.6 | 225.4 | 189.3 | (52.8) | 591.5 |
| Property and equipment, net | 14.1 | 585.9 | 193.3 | — | 793.3 |
| Goodwill | — | 279.8 | 177.4 | — | 457.2 |
| Intangible assets, net | 19.9 | 47.4 | 19.5 | — | 86.8 |
| Deferred income tax assets | 343.9 | 33.5 | 67.4 | — | 444.8 |
| Other long-term assets | 69.6 | 21.9 | 46.6 | — | 138.1 |
| Intercompany receivable | 1,372.9 | — | — | (1,372.9) | — |
| Total assets | \$2,050.0 | \$1,193.9 | \$693.5 | \$(1,425.7) | \$2,511.7 |
| Liabilities and Shareholders' Equity (Deficit) | | | | | |
| Current liabilities: | | | | | |
| Accounts payable | \$7.6 | \$36.3 | \$13.4 | \$— | \$57.3 |
| Accrued expenses and other current liabilities | 164.2 | 66.6 | 76.3 | (52.8) | 254.3 |
| Total current liabilities | 171.8 | 102.9 | 89.7 | (52.8) | 311.6 |
| Long-term debt, net of current portion | 1,220.2 | 61.3 | 38.2 | — | 1,319.7 |
| Other long-term liabilities | 41.0 | 11.7 | 78.7 | — | 131.4 |
| Intercompany payable | — | 350.4 | 1,024.5 | (1,374.9) | — |
| | 1,433.0 | 526.3 | 1,231.1 | (1,427.7) | 1,762.7 |
| Commitments and contingencies | | | | | |
| Convertible perpetual preferred stock | 342.2 | — | — | — | 342.2 |
| Redeemable noncontrolling interests | — | — | 14.1 | — | 14.1 |
| Shareholders' equity (deficit): | | | | | |
| HealthSouth shareholders' equity (deficit) | 274.8 | 667.6 | (669.6) | 2.0 | 274.8 |
| Noncontrolling interests | — | — | 117.9 | — | 117.9 |
| Total shareholders' equity (deficit) | 274.8 | 667.6 | (551.7) | 2.0 | 392.7 |
| Total liabilities and shareholders' equity (deficit) | \$2,050.0 | \$1,193.9 | \$693.5 | \$(1,425.7) | \$2,511.7 |

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

| | As of December 31, 2012 | | | | |
|---|--|------------------------|---------------------------|---------------------|--------------------------|
| | HealthSouth Corporation (In Millions) | Guarantor Subsidiaries | Nonguarantor Subsidiaries | Eliminating Entries | HealthSouth Consolidated |
| Assets | | | | | |
| Current assets: | | | | | |
| Cash and cash equivalents | \$131.3 | \$0.3 | \$1.2 | \$— | \$132.8 |
| Accounts receivable, net | 0.2 | 178.8 | 70.3 | — | 249.3 |
| Deferred income tax assets | 106.5 | 19.7 | 11.3 | — | 137.5 |
| Other current assets | 30.6 | 15.1 | 89.0 | (17.5) | 117.2 |
| Total current assets | 268.6 | 213.9 | 171.8 | (17.5) | 636.8 |
| Property and equipment, net | 13.1 | 549.9 | 185.0 | — | 748.0 |
| Goodwill | — | 266.1 | 171.2 | — | 437.3 |
| Intangible assets, net | 18.1 | 41.5 | 13.6 | — | 73.2 |
| Deferred income tax assets | 340.7 | 0.9 | 51.9 | — | 393.5 |
| Other long-term assets | 69.9 | 21.3 | 44.2 | — | 135.4 |
| Intercompany receivable | 1,244.3 | — | — | (1,244.3) | — |
| Total assets | \$1,954.7 | \$1,093.6 | \$637.7 | \$(1,261.8) | \$2,424.2 |
| Liabilities and Shareholders' Equity (Deficit) | | | | | |
| Current liabilities: | | | | | |
| Accounts payable | \$7.7 | \$28.0 | \$9.6 | \$— | \$45.3 |
| Accrued expenses and other current liabilities | 128.7 | 73.7 | 70.7 | (17.5) | 255.6 |
| Total current liabilities | 136.4 | 101.7 | 80.3 | (17.5) | 300.9 |
| Long-term debt, net of current portion | 1,147.3 | 64.2 | 28.4 | — | 1,239.9 |
| Other long-term liabilities | 37.8 | 11.2 | 81.5 | — | 130.5 |
| Intercompany payable | — | 517.4 | 1,021.4 | (1,538.8) | — |
| | 1,321.5 | 694.5 | 1,211.6 | (1,556.3) | 1,671.3 |
| Commitments and contingencies | | | | | |
| Convertible perpetual preferred stock | 342.2 | — | — | — | 342.2 |
| Redeemable noncontrolling interests | — | — | 7.2 | — | 7.2 |
| Shareholders' equity (deficit): | | | | | |
| HealthSouth shareholders' equity (deficit) | 291.0 | 399.1 | (693.6) | 294.5 | 291.0 |
| Noncontrolling interests | — | — | 112.5 | — | 112.5 |
| Total shareholders' equity (deficit) | 291.0 | 399.1 | (581.1) | 294.5 | 403.5 |
| Total liabilities and shareholders' equity (deficit) | \$1,954.7 | \$1,093.6 | \$637.7 | \$(1,261.8) | \$2,424.2 |

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

| | Six Months Ended June 30, 2013 | | | | | |
|---|--|------------------------|---------------------------|---------------------|--------------------------|---|
| | HealthSouth Corporation (In Millions) | Guarantor Subsidiaries | Nonguarantor Subsidiaries | Eliminating Entries | HealthSouth Consolidated | |
| Net cash provided by operating activities | \$53.1 | \$137.2 | \$36.5 | \$— | \$226.8 | |
| Cash flows from investing activities: | | | | | | |
| Purchases of property and equipment | (3.1 |) (51.8 |) (14.1 |) — | (69.0 |) |
| Capitalized software costs | (4.9 |) (5.5 |) (1.5 |) — | (11.9 |) |
| Acquisition of business, net of cash acquired | — | (28.9 |) — | — | (28.9 |) |
| Proceeds from sale of restricted investments | — | — | 10.3 | — | 10.3 | |
| Purchase of restricted investments | — | — | (5.4 |) — | (5.4 |) |
| Net change in restricted cash | (0.2 |) — | 4.9 | — | 4.7 | |
| Other | — | (0.7 |) (0.5 |) — | (1.2 |) |
| Net cash used in investing activities | (8.2 |) (86.9 |) (6.3 |) — | (101.4 |) |
| Cash flows from financing activities: | | | | | | |
| Principal payments on debt, including pre-payments | — | (0.7 |) — | — | (0.7 |) |
| Principal borrowings on notes | — | — | 11.4 | — | 11.4 | |
| Borrowings on revolving credit facility | 132.0 | — | — | — | 132.0 | |
| Payments on revolving credit facility | (59.0 |) — | — | — | (59.0 |) |
| Principal payments under capital lease obligations | (0.2 |) (4.7 |) (1.8 |) — | (6.7 |) |
| Repurchase of common stock, including fees and expenses | (234.1 |) — | — | — | (234.1 |) |
| Dividends paid on convertible perpetual preferred stock | (11.5 |) — | — | — | (11.5 |) |
| Distributions paid to noncontrolling interests of consolidated affiliates | — | — | (23.9 |) — | (23.9 |) |
| Other | 3.0 | — | — | — | 3.0 | |
| Change in intercompany advances | 58.6 | (43.5 |) (15.1 |) — | — | |
| Net cash used in financing activities | (111.2 |) (48.9 |) (29.4 |) — | (189.5 |) |
| (Decrease) increase in cash and cash equivalents | (66.3 |) 1.4 | 0.8 | — | (64.1 |) |
| Cash and cash equivalents at beginning of period | 131.3 | 0.3 | 1.2 | — | 132.8 | |
| Cash and cash equivalents at end of period | \$65.0 | \$1.7 | \$2.0 | \$— | \$68.7 | |

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

| | Six Months Ended June 30, 2012 | | | | |
|---|--|------------------------|---------------------------|---------------------|--------------------------|
| | HealthSouth Corporation (In Millions) | Guarantor Subsidiaries | Nonguarantor Subsidiaries | Eliminating Entries | HealthSouth Consolidated |
| Net cash provided by operating activities | \$12.2 | \$125.4 | \$57.7 | \$(0.3) |) \$195.0 |
| Cash flows from investing activities: | | | | | |
| Purchases of property and equipment | (2.8) |) (52.8) |) (27.2) |) — | (82.8) |
| Capitalized software costs | (11.4) |) (0.1) |) (0.1) |) — | (11.6) |
| Acquisition of business, net of cash acquired | — | (2.1) |) — | — | (2.1) |
| Proceeds from sale of restricted investments | — | — | 0.2 | — | 0.2 |
| Purchase of restricted investments | — | — | (4.4) |) — | (4.4) |
| Net change in restricted cash | (0.1) |) — | 4.7 | — | 4.6 |
| Other | — | 0.1 | — | — | 0.1 |
| Net cash provided by investing activities of discontinued operations | — | 3.3 | 4.4 | — | 7.7 |
| Net cash used in investing activities | (14.3) |) (51.6) |) (22.4) |) — | (88.3) |
| Cash flows from financing activities: | | | | | |
| Principal borrowings on notes | 7.3 | — | (7.3) |) — | — |
| Principal payments on debt, including pre-payments | (4.1) |) (0.6) |) — | — | (4.7) |
| Borrowings on revolving credit facility | 40.0 | — | — | — | 40.0 |
| Payments on revolving credit facility | (50.0) |) — | — | — | (50.0) |
| Principal payments under capital lease obligations | (0.1) |) (4.4) |) (1.2) |) — | (5.7) |
| Repurchase of convertible perpetual preferred stock | (46.0) |) — | — | — | (46.0) |
| Dividends paid on convertible perpetual preferred stock | (13.1) |) — | — | — | (13.1) |
| Distributions paid to noncontrolling interests of consolidated affiliates | — | — | (24.0) |) — | (24.0) |
| Contributions from consolidated affiliates | — | — | 7.9 | — | 7.9 |
| Other | (0.1) |) — | — | — | (0.1) |
| Change in intercompany advances | 79.9 | (68.3) |) (11.9) |) 0.3 | — |
| Net cash provided by (used in) financing activities | 13.8 | (73.3) |) (36.5) |) 0.3 | (95.7) |
| Increase (decrease) in cash and cash equivalents | 11.7 | 0.5 | (1.2) |) — | 11.0 |
| | 26.0 | 1.3 | 2.8 | — | 30.1 |

| | | | | | |
|--|--------|-------|-------|-----|--------|
| Cash and cash equivalents at beginning of period | | | | | |
| Cash and cash equivalents at end of period | \$37.7 | \$1.8 | \$1.6 | \$— | \$41.1 |

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, 2012 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, 2012 (the "2012 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 ii 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, to the 2012 Form 10-K.

Executive Overview

Our Business

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. While our national network of inpatient hospitals stretches across 28 states and Puerto Rico, we are concentrated in the eastern half of the United States and Texas. As of June 30, 2013, we operated 103 inpatient rehabilitation hospitals (including two hospitals that operate as joint ventures which we account for using the equity method of accounting), 22 outpatient rehabilitation satellite clinics (operated by our hospitals), and 25 licensed, hospital-based home health agencies. In addition to HealthSouth hospitals, we manage three inpatient rehabilitation units through management contracts. For additional information about our business, see Item 1, Business, of the 2012 Form 10-K.

2013 Overview

Our 2013 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;
- continuing to expand our services to more patients who require inpatient rehabilitative services by constructing and opportunistically acquiring new hospitals in new markets; and
- considering additional shareholder value-enhancing strategies such as repurchases of our common and preferred stock and common stock dividends, recognizing that some of these actions may increase our leverage ratio.

During the three months ended June 30, 2013, discharge growth of 6.3% coupled with a 0.3% increase in net patient revenue per discharge generated 6.5% growth in net patient revenue from our hospitals compared to the three months ended June 30, 2012. Discharge growth included a 3.3% increase in same-store discharges. During the six months ended June 30, 2013, discharge growth of 5.2% coupled with a 1.7% increase in net patient revenue per discharge generated 6.9% growth in net patient revenue from our hospitals compared to the six months ended June 30, 2012. Discharge growth included a 2.8% increase in same-store discharges. Our growth in net patient revenue per discharge was negatively impacted by the effect of sequestration for Medicare patients during the 2013 periods presented. See the "Results of Operations" section of this Item for additional information. Our 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.

Our growth efforts thus far in 2013 have included the following:

- acquired Walton Rehabilitation Hospital, a 58-bed inpatient rehabilitation hospital in Augusta, Georgia, in April 2013;
- acquired land for a new 50-bed inpatient rehabilitation hospital in Modesto, California. Construction is expected to begin in the third quarter of 2014;

began accepting patients at our newly built, 40-bed inpatient rehabilitation hospital in Littleton, Colorado in May 2013;

- began accepting patients at our newly built, 34-bed inpatient rehabilitation hospital in Stuart, Florida in June 2013. This hospital is a joint venture with Martin Health System;

- added 10 beds to existing hospitals; and

- continued development of the following de novo hospitals:

| Location | # of Beds | Actual / Expected Construction Start Date | Expected Operational Date |
|---|-----------|---|---------------------------|
| Altamonte Springs, Florida | 50 | Q3 2013 | Q4 2014 |
| Newnan, Georgia | 50 | Q4 2013 | Q4 2014 |
| Awarded CON, but Award Remains Under Appeal | | | |
| Middletown, Delaware* | 34 | TBD | TBD |
| Franklin, Tennessee | 40 | TBD | TBD |

* In June 2013, Delaware enacted legislation that authorizes, subject to certain conditions, construction of a 34-bed inpatient rehabilitation hospital in Middletown, Delaware. We are evaluating this legislation, as well as its impact on us, and the pending litigation challenging the validity of the certificate of need previously awarded us in Middletown.

We also completed a tender offer for our common stock during the first quarter of 2013. As a result of the tender offer, we repurchased approximately 9.1 million shares at a price of \$25.50 per share for a total cost of \$234.1 million, including fees and expenses relating to the tender offer. In addition, during the second quarter of 2013, we amended our credit agreement to, among other things, permit unlimited restricted payments so long as the senior secured leverage ratio remains less than or equal to 1.5x and extend the revolver maturity from August 2017 to June 2018. See the “Liquidity and Capital Resources” section of this Item.

In addition, in April 2013, we entered into closing agreements with the IRS that settled federal income tax matters related to the previous restatement of our 2000 and 2001 financial statements, as well as certain other tax matters, through December 31, 2008. As a result of these closing agreements, we increased our deferred tax assets, primarily our federal net operating loss carryforward (“NOL”), and recorded a net income tax benefit of approximately \$115 million in the second quarter of 2013. This income tax benefit primarily resulted from an approximate \$283 million increase to our federal NOL on a gross basis. See Note 8, Income Taxes, to the condensed consolidated financial statements included in Item 1, Financial Statements (Unaudited), of this report.

Business Outlook

We believe our business outlook remains reasonably positive primarily for two reasons. First, demographic trends, specifically the aging of the population, will increase long-term demand for inpatient rehabilitative services. While we treat patients of all ages, most of our patients are persons 65 and older (the average age of a HealthSouth patient is 72 years) and have conditions such as strokes, hip fractures, and a variety of debilitating neurological conditions that are generally nondiscretionary in nature. We believe the demand for inpatient rehabilitative healthcare services will continue to increase as the U.S. population ages and life expectancies increase. The number of Medicare-eligible patients is expected to grow approximately 3% per year for the foreseeable future, creating an attractive market. We believe these market factors align with our strengths in, and focus on, inpatient rehabilitative care. Unlike many of our competitors that may offer inpatient rehabilitation as one of many secondary services, inpatient rehabilitation is our core business. In addition, we believe we can address the demand for inpatient rehabilitative services in markets where we currently do not have a presence by constructing or acquiring new hospitals.

Second, we are the industry leader in this growing sector. As the nation’s largest owner and operator of inpatient rehabilitation hospitals, we differentiate ourselves from our competitors based on our broad platform of clinical expertise, the quality of our clinical outcomes, the application of rehabilitative technology, and the sustainability of best practices. We have invested considerable resources into clinical and management systems and protocols that have allowed us to consistently lower costs. Our commitment to technology also includes the ongoing implementation of our rehabilitation-specific electronic clinical

information system. We believe this system will improve patient care and safety, enhance staff recruitment and retention, and set the stage for connectivity with referral sources and health information exchanges. Our hospitals also participate in The Joint Commission's Disease-Specific Care Certification Program. Under this program, Joint Commission accredited organizations, like our hospitals, may seek certification for chronic diseases or conditions such as brain injury or stroke rehabilitation by demonstrating compliance with national standards, demonstrating the effective use of evidence-based clinical practice guidelines to manage and optimize patient care, and demonstrating an organized approach to performance measurement and evaluation of clinical outcomes. Obtaining such certifications demonstrates our commitment to excellence in providing disease-specific care. Currently, 94 of our hospitals hold one or more disease-specific certifications. We also account for approximately 80% of all Joint Commission accredited Stroke Centers of Excellence nationwide.

Healthcare has always been a highly regulated industry, and we have cautioned our stakeholders that future Medicare payment rates could be at risk. While the Medicare reimbursement environment may be challenging, the demand for inpatient rehabilitative services is expected to grow. HealthSouth has a proven track record of adapting to and succeeding in a highly regulated environment, and we believe we are well-positioned to continue to succeed and grow. Further, we believe the regulatory and reimbursement risks discussed throughout this report may present us with opportunities to grow by acquiring or consolidating the operations of other inpatient rehabilitation providers in our highly fragmented industry. We have been disciplined in creating a capital structure that is flexible with no significant debt maturities prior to 2018. Over the past few years, we have redeemed our most expensive debt and reduced our interest expense. We have invested in our core business and created an infrastructure that enables us to provide high-quality care on a cost-effective basis. Our balance sheet remains strong. Our leverage ratio is within our target range, we have ample 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 invest our cash and return value to stakeholders including bed additions, de novos, acquisitions of other inpatient rehabilitation hospitals, purchases of leased properties, repurchases of our common and preferred stock, common stock dividends, and repayment of long-term debt. Specifically, on July 25, 2013, our board of directors approved the initiation of a quarterly cash dividend on our common stock of \$0.18 per share. In addition, our board of directors authorized the optional redemption of 10% of the outstanding principal amount of our existing 7.25% Senior Notes due 2018 and 7.75% Senior Notes due 2022 pursuant to the terms of these senior notes. See the "Liquidity and Capital Resources - Authorizations for Returning Capital to Stakeholders" section of this Item for additional information. For these and other reasons, we believe we will be able to adapt to any changes in reimbursement and sustain our business model. We also believe we will be in a position to take action should a properly sized and priced acquisition or consolidation opportunity arise.

Key Challenges

The healthcare industry is currently facing many well-publicized regulatory and reimbursement challenges. It always has been a highly regulated industry, and the inpatient rehabilitation sector is no exception. Successful healthcare providers are those who provide high-quality, cost-effective care and have the ability to adjust to changes in the regulatory environment. We believe we have the necessary capabilities—scale, infrastructure, and management—to adapt to and 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 licensure or certification of our hospitals, 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 beds to existing hospitals. Ensuring continuous compliance with these 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 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 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.

See also Item 1, Business, “Sources of Revenues” and “Regulation,” and Item 1A, Risk Factors, to the 2012 Form 10-K and Note 10, Contingencies and Other Commitments, “HHS-OIG Investigations,” to the condensed consolidated financial statements included in Item 1, Financial Statements (Unaudited), of this report.

Our challenges related to reduced Medicare reimbursement are discussed in Item 1, Business, “Regulatory and Reimbursement Challenges,” and Item 1A, Risk Factors, of the 2012 Form 10 K. We currently estimate sequestration will result in a net decrease in our Net operating revenues of approximately \$28 million in 2013. Unless the United States Congress acts to change or eliminate sequestration, it will continue to result in a 2% decrease to reimbursements otherwise due from Medicare, after taking into consideration other changes to reimbursement rates such as market basket updates. 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. For example, the Health Subcommittee of the Ways and Means Committee of the United States House of Representatives recently held a hearing to examine legislative proposals contained in President Obama’s fiscal year 2014 budget submission to Congress that would affect post-acute care providers, which includes, among other issues, elevating the 60% Rule to a 75% Rule and paying rehabilitation hospitals nursing home-based rates for certain conditions (also referred to as “site-neutral payment”). As a point of follow-up to this hearing, we provided constructive input on legislative and regulatory initiatives as well as information on the quality of care and value that inpatient rehabilitation hospitals bring to the Medicare program and its beneficiaries to the Ways and Means Health Subcommittee, and we will continue providing such input to policymakers. We cannot predict what alternative or additional deficit reduction initiatives, Medicare payment reductions, or post acute care reforms, if any, will ultimately be enacted into law, or the timing or effect any such initiatives or reductions will have on us. If enacted, such initiatives or reductions would likely be challenging for all providers, would likely have the effect of limiting Medicare beneficiaries’ access to healthcare services, and could have an adverse impact on our financial position, results of operations, and cash flows. However, we believe our efficient cost structure and substantial owned real estate coupled with the steps we have taken to reduce our debt and corresponding debt service obligations should allow us to absorb, adjust to, or mitigate any potential initiative or payment reductions more easily than most other inpatient rehabilitation providers.

Changes to Our Operating Environment Resulting from Healthcare Reform. Our challenges related to healthcare reform are discussed in Item 1, Business, “Regulatory and Reimbursement Challenges,” and “Sources of Revenue — Medicare Reimbursement,” and Item 1A, Risk Factors, to the 2012 Form 10-K. Many provisions within the 2010 Healthcare Reform Laws (as defined in Item 1, Business, “Regulatory and Reimbursement Challenges” to the 2012 Form 10-K) have impacted, or could in the future impact, our business. Most notably for us are the reductions to our annual market basket updates, including productivity adjustments and future payment reforms such as Accountable Care Organizations and bundled payments.

In May 2013, the United States Centers for Medicare and Medicaid Services released its notice of proposed rulemaking for fiscal year 2014 (the “2014 Rule”) for inpatient rehabilitation facilities (“IRFs”) under the prospective payment system (“IRF PPS”). The proposed rule would implement a net 1.8% market basket increase effective for discharges between October 1, 2013 and September 30, 2014, calculated as follows:

| | |
|-----------------------------|-----------------|
| Market basket update | 2.5% |
| Healthcare reform reduction | 30 basis points |
| Productivity adjustment | 40 basis points |

The proposed rule also includes other pricing changes that impact our hospital-by-hospital base rate for Medicare reimbursement. Such changes include, but are not limited to, updates to the IRF-PPS facility-level rural adjustment factor, low-income patient factor, teaching status adjustment factor, and updates to the outlier fixed loss threshold. Based on our analysis which utilizes, among other things, the acuity of our patients over the 12-month period prior to the rule’s release and incorporates other adjustments included in the proposed rule, we believe the 2014 Rule will result in a net increase to our Medicare payment rates of approximately 2.0% effective October 1, 2014.

Given the complexity and the number of changes in the 2010 Healthcare Reform Laws, we cannot predict their ultimate impact. We will continue to evaluate these laws, and, based on our track record, we believe we can adapt to these regulatory 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. The majority of patients we serve experience significant physical and cognitive disabilities due to medical conditions, such as neurological disorders, strokes, hip fractures, head injuries, and spinal cord injuries, that are generally nondiscretionary in nature and which require rehabilitative healthcare services in an inpatient setting. In addition, because most of our patients are persons 65 and older, our patients generally have insurance coverage through Medicare. However, we do treat some patients with medical conditions that are discretionary in nature. During periods of economic uncertainty, patients may choose to forgo discretionary procedures. Because approximately 94% of our patients are referred to us by acute care hospitals, if these patients continue to forgo procedures and acute care providers report soft volumes, it may be more challenging for us to maintain our recent volume growth rates.

Recruiting and Retaining High-Quality Personnel. See Item 1A, Risk Factors, of the 2012 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 hospitals 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 inpatient rehabilitative services.

These key challenges notwithstanding, we have a strong business model, a strong balance sheet, and a proven track record of achieving strong financial and operational results. We are in a position to continue to grow, adapt to external events, and create value for our shareholders in 2013 and beyond.

Results of Operations

Payor Mix

During the three and six months ended June 30, 2013 and 2012, we derived consolidated Net operating revenues from the following payor sources:

| | Three Months Ended June 30, | | Six Months Ended June 30, | | |
|---------------------------------------|-----------------------------|---------|---------------------------|---------|---|
| | 2013 | 2012 | 2013 | 2012 | |
| Medicare | 74.6 | % 72.9 | % 74.6 | % 73.3 | % |
| Medicaid | 1.0 | % 1.3 | % 1.1 | % 1.2 | % |
| Workers' compensation | 1.2 | % 1.5 | % 1.3 | % 1.5 | % |
| Managed care and other discount plans | 18.4 | % 19.6 | % 18.4 | % 19.5 | % |
| Other third-party payors | 1.7 | % 1.8 | % 1.7 | % 1.7 | % |
| Patients | 1.2 | % 1.3 | % 1.2 | % 1.3 | % |
| Other income | 1.9 | % 1.6 | % 1.7 | % 1.5 | % |
| 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 2012 Form 10-K.

Our Results

For the three and six months ended June 30, 2013 and 2012, our consolidated results of operations were as follows:

| | Three Months Ended | | Percentage | Six Months Ended | | Percentage | |
|---|--------------------|---------|---------------|------------------|-----------|---------------|----------|
| | June 30, | 2012 | Change | June 30, | 2012 | Change | |
| | 2013 | 2012 | 2013 vs. 2012 | 2013 | 2012 | 2013 vs. 2012 | |
| (In Millions, Except Percentage Change) | | | | | | | |
| Net operating revenues | \$564.5 | \$533.4 | 5.8 | % | \$1,137.1 | \$1,072.0 | 6.1 |
| Less: Provision for doubtful accounts | (7.0) | (6.5) | 7.7 | % | (14.4) | (12.8) | 12.5 |
| Net operating revenues less provision for doubtful accounts | 557.5 | 526.9 | 5.8 | % | 1,122.7 | 1,059.2 | 6.0 |
| Operating expenses: | | | | | | | |
| Salaries and benefits | 273.6 | 257.4 | 6.3 | % | 548.2 | 518.4 | 5.7 |
| Hospital-related expenses: | | | | | | | |
| Other operating expenses | 81.0 | 75.0 | 8.0 | % | 159.1 | 148.8 | 6.9 |
| Occupancy costs | 11.9 | 12.3 | (3.3) | % | 24.1 | 24.8 | (2.8) |
| Supplies | 26.6 | 25.9 | 2.7 | % | 52.8 | 52.4 | 0.8 |
| General and administrative expenses | 29.5 | 28.0 | 5.4 | % | 59.7 | 58.0 | 2.9 |
| Depreciation and amortization | 23.1 | 20.0 | 15.5 | % | 45.2 | 39.5 | 14.4 |
| Government, class action, and related settlements | (2.0) | — | (100.0) | % | (2.0) | — | (100.0) |
| Professional fees—accounting, tax, and legal | 2.2 | 5.5 | (60.0) | % | 3.6 | 9.1 | (60.4) |
| Total operating expenses | 445.9 | 424.1 | 5.1 | % | 890.7 | 851.0 | 4.7 |
| Interest expense and amortization of debt discounts and fees | 24.4 | 23.0 | 6.1 | % | 48.6 | 46.3 | 5.0 |
| Other income | (1.9) | (0.4) | 375.0 | % | (2.6) | (1.3) | 100.0 |
| Equity in net income of nonconsolidated affiliates | (3.3) | (3.1) | 6.5 | % | (6.2) | (6.4) | (3.1) |
| Income from continuing operations before income tax (benefit) expense | 92.4 | 83.3 | 10.9 | % | 192.2 | 169.6 | 13.3 |
| Provision for income tax (benefit) expense | (86.5) | 26.9 | (421.6) | % | (53.0) | 56.0 | (194.6) |
| Income from continuing operations | 178.9 | 56.4 | 217.2 | % | 245.2 | 113.6 | 115.8 |
| Income (loss) from discontinued operations, net of tax | 0.1 | 3.5 | (97.1) | % | (0.3) | 3.1 | (109.7) |
| Net income | 179.0 | 59.9 | 198.8 | % | 244.9 | 116.7 | 109.9 |
| Less: Net income attributable to noncontrolling interests | (13.8) | (13.2) | 4.5 | % | (28.4) | (25.8) | 10.1 |
| Net income attributable to HealthSouth | \$165.2 | \$46.7 | 253.7 | % | \$216.5 | \$90.9 | 138.2 |

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

| | Three Months Ended June 30, | | Six Months Ended June 30, | | | |
|---|-----------------------------|--------|---------------------------|--------|---|---|
| | 2013 | 2012 | 2013 | 2012 | | |
| Provision for doubtful accounts | 1.2 | % 1.2 | % 1.3 | % 1.2 | % | % |
| Operating expenses: | | | | | | |
| Salaries and benefits | 48.5 | % 48.3 | % 48.2 | % 48.4 | % | % |
| Hospital-related expenses: | | | | | | |
| Other operating expenses | 14.3 | % 14.1 | % 14.0 | % 13.9 | % | % |
| Occupancy costs | 2.1 | % 2.3 | % 2.1 | % 2.3 | % | % |
| Supplies | 4.7 | % 4.9 | % 4.6 | % 4.9 | % | % |
| General and administrative expenses | 5.2 | % 5.2 | % 5.3 | % 5.4 | % | % |
| Depreciation and amortization | 4.1 | % 3.7 | % 4.0 | % 3.7 | % | % |
| Government, class action, and related settlements | (0.4) |)% — | % (0.2) |)% — | % | % |
| Professional fees—accounting, tax, and legal | 0.4 | % 1.0 | % 0.3 | % 0.8 | % | % |
| Total operating expenses | 79.0 | % 79.5 | % 78.3 | % 79.4 | % | % |

Additional information regarding our operating results for the three and six months ended June 30, 2013 and 2012 is as follows:

| | Three Months Ended June 30, | | Percentage Change 2013 vs. 2012 | Six Months Ended June 30, | | Percentage Change 2013 vs. 2012 | | |
|--|---|----------|---------------------------------|---------------------------|-----------|---------------------------------|--------|----|
| | 2013 | 2012 | | 2013 | 2012 | | | |
| | (In Millions, Except Percentage Change) | | | | | | | |
| Net patient revenue—inpatient | \$527.4 | \$495.0 | 6.5 | % | \$1,064.5 | \$995.6 | 6.9 | % |
| Net patient revenue—outpatient and other | 37.1 | 38.4 | (3.4) |)% | 72.6 | 76.4 | (5.0) |)% |
| Net operating revenues | \$564.5 | \$533.4 | 5.8 | % | \$1,137.1 | \$1,072.0 | 6.1 | % |
| | (Actual Amounts) | | | | | | | |
| Discharges | 32,645 | 30,719 | 6.3 | % | 64,775 | 61,590 | 5.2 | % |
| Net patient revenue per discharge | \$16,156 | \$16,114 | 0.3 | % | \$16,434 | \$16,165 | 1.7 | % |
| Outpatient visits | 211,207 | 229,152 | (7.8) |)% | 411,678 | 460,395 | (10.6) |)% |
| Average length of stay (days) | 13.2 | 13.4 | (1.5) |)% | 13.3 | 13.5 | (1.5) |)% |
| Occupancy % | 69.9 | % 69.2 | % 1.0 | % | 70.5 | % 69.7 | % 1.1 | % |
| # of licensed beds | 6,777 | 6,538 | 3.7 | % | 6,777 | 6,538 | 3.7 | % |
| Full-time equivalents* | 16,180 | 15,378 | 5.2 | % | 16,000 | 15,325 | 4.4 | % |
| Employees per occupied bed | 3.43 | 3.41 | 0.6 | % | 3.37 | 3.38 | (0.3) |)% |

Excludes approximately 400 full-time equivalents who are considered part of corporate overhead with their salaries and benefits included in General and administrative expenses in our condensed

* consolidated statements of operations. Full-time equivalents included in the above table represent those 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.

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 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

Net patient revenue from our hospitals was 6.5% higher for the three months ended June 30, 2013 than the three months ended June 30, 2012. This increase was attributable to a 6.3% increase in patient discharges and a 0.3% increase in net patient revenue per discharge. Discharge growth included a 3.3% increase in same-store discharges. Same-store discharges were negatively impacted by the closure of 41 skilled nursing facility beds at two of our hospitals in the first quarter of 2013. Approximately 130 basis points of discharge growth from new stores resulted from the consolidation of St. Vincent Rehabilitation Hospital beginning in the third quarter of 2012, as discussed in Note 7, Investments in and Advances to Nonconsolidated Affiliates, to the consolidated financial statements accompanying the 2012 Form 10-K. The increase in net patient revenue per discharge resulted from Medicare and managed care price adjustments, higher patient acuity, and a higher percentage of Medicare patients, as shown in the above payor mix table. Net patient revenue per discharge was negatively impacted in the second quarter of 2013 by sequestration and the ramping up of operations at three new hospitals. New hospitals are required to treat a minimum of 30 patients for zero revenue as part of the Medicare certification process.

Net patient revenue from our hospitals was 6.9% higher for the six months ended June 30, 2013 than the six months ended June 30, 2012. This increase was attributable to a 5.2% increase in patient discharges and a 1.7% increase in net patient revenue per discharge. Discharge growth included a 2.8% increase in same-store discharges. Discharge growth and net patient revenue per discharge growth for the year-to-date period of 2013 was impacted by the same factors as discussed above for the second quarter of 2013. Sequestration became effective for all discharges after April 1, 2013. Decreased outpatient volumes in both periods of 2013 compared to the same periods of 2012 resulted from the closure of outpatient clinics and continued competition from physicians offering physical therapy services within their own offices. We had 22 and 26 outpatient rehabilitation satellite clinics as of June 30, 2013 and 2012, respectively. Outpatient and other revenues for the three and six months ended June 30, 2013 included \$1.6 million of state provider tax refunds.

Provision for Doubtful Accounts

The change in our Provision for doubtful accounts as a percent of Net operating revenues in the six months ended June 30, 2013 compared to the same period of 2012 was primarily the result of the aging of non-Medicare-related receivables.

Salaries and Benefits

Salaries and benefits increased in the three and six months ended June 30, 2013 compared to the same periods of 2012 primarily due to increased patient volumes, including an increase in the number of full-time equivalents as a result of our 2012 and 2013 development activities, and increased costs associated with employee medical plan benefits. As disclosed previously, because merit increases were foregone in 2012, management determined the Company would absorb all of the increased costs associated with medical plan benefits to employees in 2013.

Salaries and benefits as a percent of Net operating revenues increased in the second quarter of 2013 compared to the second quarter of 2012 due to the effects of sequestration and the ramping up of operations at three new hospitals. Excluding the three new hospitals added to our portfolio in the second quarter of 2013, employees per occupied bed would have been flat quarter over quarter.

Salaries and benefits as a percent of Net operating revenues decreased in the first half of 2013 compared to the first half of 2012 as a result of the previously disclosed foregone merit increase to employees in anticipation of sequestration, as well as improved productivity. See Item 7, Management's Discussion and Analysis of Financial Condition and Results of Operations, "Results of Operations," to the 2012 Form 10-K.

Hospital-related Expenses

Other Operating Expenses

Other operating expenses increased during both periods of 2013 compared to the same periods of 2012 primarily as a result of increased patient volumes, including new hospitals, and the ongoing implementation of our clinical information system. As a percent of Net operating revenues, Other operating expenses increased during both periods

of 2013 compared to the same periods of 2012 due to the effects of sequestration, the ramping up of operations at three new hospitals, and higher expenses associated with the ongoing implementation of our clinical information system offset by lower self-insurance costs.

Self-insurance costs associated with professional and general liability risks were less in both periods of 2013 than in the same periods of 2012 due to revised actuarial estimates resulting from better-than-expected claims experience in prior years.

Occupancy Costs

Occupancy costs decreased as a percent of Net operating revenues in both periods presented due to our purchase of the land and building previously subject to an operating lease associated with our joint venture hospital in Fayetteville, Arkansas in the second quarter of 2012. Occupancy costs are expected to continue to decrease as a percent of Net operating revenues going forward. See the “Liquidity and Capital Resources - Contractual Obligations” section of this Item.

Supplies

Supplies expense decreased as a percent of Net operating revenues in both periods presented for 2013 compared to the same periods of 2012 due to our supply chain efforts and our continual focus on monitoring and actively managing pharmaceutical costs.

General and Administrative Expenses

General and administrative expenses decreased as a percent of Net operating revenues in the first half of 2013 compared to the same period of 2012 due primarily to our increasing revenue base.

Depreciation and Amortization

Depreciation and amortization increased during the three and six months ended June 30, 2013 compared to the same periods of 2012 due to our increased capital expenditures throughout 2012 and the first quarter of 2013.

Government, class action, and related settlements

The gain included in Government, class action, and related settlements for the three and six months ended June 30, 2013 resulted from the recovery of assets from Richard Scrushy, as discussed in Note 19, Contingencies and Other Commitments, to the consolidated financial statements accompanying the 2012 Form 10-K.

Professional Fees—Accounting, Tax, and Legal

Professional fees—accounting, tax, and legal for the three and six months ended June 30, 2013 and 2012 related primarily to legal and consulting fees for continued litigation and support matters discussed in Note 10, Contingencies and Other Commitments, to the condensed consolidated financial statements included in Part I, Item 1, Financial Statements (Unaudited), of this report. These expenses for the three and six months ended June 30, 2012 also included legal and consulting fees for the pursuit of our remaining income tax benefits as discussed in Note 8, Income Taxes, to the condensed consolidated financial statements included in Part I, Item 1, Financial Statements (Unaudited), of this report. See also Note 17, Income Taxes, and Note 19, Contingencies and Other Commitments, to the consolidated financial statements accompanying the 2012 Form 10-K.

Interest Expense and Amortization of Debt Discounts and Fees

The increase in Interest expense and amortization of debt discounts and fees during the three months ended June 30, 2013 compared to the same period of 2012 was due to an increase in our average borrowings outstanding offset by a decrease in the average cash interest rate. The increase in average borrowings primarily resulted from our issuance of \$275 million aggregate principal amount of 5.75% Senior Notes due 2024 in September 2012. Our average cash interest rate approximated 6.9% during the three months ended June 30, 2013 compared to 7.1% for the same period of 2012.

The increase in Interest expense and amortization of debt discounts and fees during the six months ended June 30, 2013 compared to the same period of 2012 was due to an increase in our average borrowings outstanding, as discussed above for the three month periods presented. Our average cash interest rate approximated 7.1% for the six months ended June 30, 2013 and 2012.

For additional information regarding debt and related interest expense, see Note 4, 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 2012 Form 10-K.

Income from Continuing Operations Before Income Tax (Benefit) Expense

The increase in our pre-tax income from continuing operations in both periods presented for 2013 compared to the same periods of 2012 resulted from increased Net operating revenues and continued disciplined expense management.

Provision for Income Tax (Benefit) Expense

Due to our federal and state net operating loss carryforwards (“NOLs”), we currently estimate our cash income tax expense to be approximately \$6 million to \$12 million per year due primarily to state income tax expense of subsidiaries which have separate state filing requirements, alternative minimum taxes, and federal income taxes for subsidiaries not included in our federal consolidated income tax return. For the three months ended June 30, 2013 and 2012, current income tax (benefit) expense was (\$1.3) million and \$2.2 million, respectively. For the six months ended June 30, 2013 and 2012, current income tax expense was \$0.5 million and \$4.3 million, respectively.

In April 2013, we entered into closing agreements with the IRS that settled federal income tax matters related to the previous restatement of our 2000 and 2001 financial statements, as well as certain other tax matters, through December 31, 2008. As a result of these closing agreements, we increased our deferred tax assets, primarily our federal NOL, and recorded a net income tax benefit of approximately \$115 million in the second quarter of 2013. This income tax benefit primarily resulted from an approximate \$283 million increase to our federal NOL on a gross basis. Our Provision for income tax benefit of \$86.5 million and \$53.0 million for the three and six months ended June 30, 2013, respectively, primarily resulted from the settlement discussed above. It also included an approximate \$3 million decrease in our valuation allowance related primarily to our capital loss carryforwards. During the second quarter of 2013, we determined a valuation allowance related to these assets was no longer required as sufficient positive evidence existed to substantiate their utilization. This evidence included our partial utilization of these capital loss carryforwards as a result of realizing capital gains in the current year and the identification of sufficient taxable capital gain income within the available capital loss carryforward period. Excluding the IRS settlement and the release of the valuation allowance against these capital loss carryforwards, our estimated effective blended federal and state income tax rate for the three and six months ended June 30, 2013 would have been approximately 40% on our pre-tax income from continuing operations attributable to HealthSouth.

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

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 gross unrecognized tax benefits were \$2.4 million and \$78.0 million as of June 30, 2013 and December 31, 2012, respectively. The amount of gross unrecognized tax benefits changed during the six months ended June 30, 2013 primarily due to the settlement with the IRS discussed above.

See Note 8, Income Taxes, to the condensed consolidated financial statements included in Part I, Item 1, Financial Statements (Unaudited), of this report and Note 17, Income Taxes, to the consolidated financial statements accompanying the 2012 Form 10-K.

Net Income Attributable to Noncontrolling Interests

Net income attributable to noncontrolling interests increased during the three and six months ended June 30, 2013 compared to the same periods of 2012 due primarily to the consolidation of St. Vincent Rehabilitation hospital (as discussed in Note 7, Investments in and Advances to Nonconsolidated Affiliates, to the consolidated financial statements accompanying the 2012 Form 10-K), changes at two joint venture hospitals, and improved financial performance at our joint venture hospitals. See Note 5, Redeemable Noncontrolling Interests, to the condensed consolidated financial statements included in Part I, Item 1, Financial Statements (Unaudited), of this report.

Results of Discontinued Operations

The operating results of discontinued operations are as follows (in millions):

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|-----------------------------|-------|---------------------------|-------|
| | 2013 | 2012 | 2013 | 2012 |
| Net operating revenues | \$— | \$0.1 | \$0.2 | \$0.8 |
| Less: Provision for doubtful accounts | 0.5 | (0.4) | 0.1 | (0.2) |
| Net operating revenues less provision for doubtful accounts | 0.5 | (0.3) | 0.3 | 0.6 |
| Costs and expenses | — | (0.5) | 0.5 | 1.1 |
| Income (loss) from discontinued operations | 0.5 | 0.2 | (0.2) | (0.5) |
| Gain on disposal of assets/sale of investments of discontinued operations | — | 5.0 | — | 5.0 |
| Income tax expense | (0.4) | (1.7) | (0.1) | (1.4) |
| Income (loss) from discontinued operations, net of tax | \$0.1 | \$3.5 | \$(0.3) | \$3.1 |

Our results of discontinued operations primarily included five of our long-term acute care hospitals ("LTCHs") (sold in August 2011) and HealthSouth Hospital of Houston (an LTCH closed in August 2011). See Note 16, Assets and Liabilities in and Results of Discontinued Operations, to the consolidated financial statements accompanying the 2012 Form 10-K for additional information.

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.

Maintaining adequate liquidity includes supporting the execution of our operating and strategic plans and allowing us to weather temporary disruptions in the capital markets and general business environment. Maintaining flexibility in our capital structure includes limiting concentrations of debt maturities in any given year, allowing for debt prepayments without onerous penalties, and ensuring our debt agreements are limited in restrictive terms and maintenance covenants.

With these objectives in mind, in June 2013, we amended our credit agreement to, among other things, permit unlimited restricted payments so long as the senior secured leverage ratio remains less than or equal to 1.5x and extend the revolver maturity from August 2017 to June 2018 (see Note 4, Long-term Debt, to the condensed consolidated financial statements included in Part I, Item 1, Financial Statements (Unaudited), of this report). We have been disciplined in creating a capital structure that is flexible with no significant debt maturities prior to 2018. Our balance sheet remains strong. Our leverage ratio is within our target range, we have ample availability under our revolving credit facility, we continue to generate strong cash flows from operations, and we have flexibility with how we choose to invest our cash and return value to stakeholders.

Current Liquidity

As of June 30, 2013, we had \$68.7 million in Cash and cash equivalents. This amount excludes \$44.6 million in Restricted cash and \$50.2 million of restricted marketable securities (\$8.4 million included in Other current assets and \$41.8 million included in Other long-term assets in our condensed consolidated balance sheet as of June 30, 2013). 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 2012 Form 10-K.

In addition to Cash and cash equivalents, as of June 30, 2013, we had \$491.1 million available to us under our revolving credit facility. Our credit agreement governs the majority of our senior secured borrowing capacity and contains a leverage ratio and an interest coverage ratio as financial covenants. Our leverage ratio is defined in our credit agreement as the ratio of consolidated total debt (less up to \$75 million of cash on hand) to Adjusted EBITDA for the trailing four quarters. Our interest coverage ratio is defined in our credit agreement as the ratio of Adjusted EBITDA to consolidated interest expense, excluding the amortization of financing fees, for the trailing four quarters.

As of June 30, 2013, the maximum leverage ratio

40

requirement per our credit agreement was 4.5x and the minimum interest coverage ratio requirement was 2.75x, and we were in compliance with these covenants.

We do not face near-term refinancing risk, as the amounts outstanding under our credit agreement do not mature until 2018, and none of our bonds are due until 2018 and beyond. See the “Contractual Obligations” section below for information related to our contractual obligations as of June 30, 2013.

We anticipate we will continue to generate strong cash flows from operations that, together with availability under our revolving credit facility, will allow us to invest in growth opportunities and continue to improve our existing core business. We also will continue to consider additional shareholder value-enhancing strategies such as repurchases of our common and preferred stock and common stock dividends, recognizing that these actions may increase our leverage ratio. And, we will continue to consider further reductions to our long-term debt. As discussed in Note 9, Earnings per Common Share, to the condensed consolidated financial statements included in Part I, Item 1, Financial Statements (Unaudited), of this report, we repurchased approximately 9.1 million shares of our common stock for \$234.1 million, including fees and expenses relating to the tender offer, during the first quarter of 2013 using a combination of cash on hand and availability under our revolving credit facility to fund the repurchases. See also the “Authorizations for Returning Capital to Stakeholders” section of this Item.

See Item 1A, Risk Factors, of the 2012 Form 10-K for a discussion of risks and uncertainties facing us.

Sources and Uses of Cash

The following table shows the cash flows provided by or used in operating, investing, and financing activities for the six months ended June 30, 2013 and 2012 (in millions):

| | Six Months Ended June 30, | |
|--|---------------------------|----------|
| | 2013 | 2012 |
| Net cash provided by operating activities | \$226.8 | \$195.0 |
| Net cash used in investing activities | (101.4 |) (88.3 |
| Net cash used in financing activities | (189.5 |) (95.7 |
| (Decrease) increase in cash and cash equivalents | \$(64.1 |) \$11.0 |

Operating activities. Net cash provided by operating activities increased during the six months ended June 30, 2013 compared to the same period of 2012 primarily due to increased Net operating revenues and continued disciplined expense management.

Investing activities. The increase in Net cash used in investing activities during the six months ended June 30, 2013 compared to the same period of 2012 primarily resulted from the acquisition of Walton Rehabilitation Hospital. See Note 2, Business Combinations, to the condensed consolidated financial statements included in Item 1, Financial Statements (Unaudited), of this report.

Financing activities. The increase in Net cash used in financing activities during the six months ended June 30, 2013 compared to the same period of 2012 primarily resulted from repurchases of our common stock as part of the tender offer completed in the first quarter of 2013. As discussed above, we repurchased approximately 9.1 million shares of our common stock for \$234.1 million, including fees and expenses relating to the tender offer, during the first quarter of 2013.

Contractual Obligations

Our consolidated contractual obligations as of June 30, 2013 are as follows (in millions):

| | Total | July 1 through December 31, 2013 | 2014 - 2015 | 2016 - 2017 | 2018 and thereafter |
|--|-----------|--|-------------|-------------|------------------------|
| Long-term debt obligations: | | | | | |
| Long-term debt, excluding revolving credit facility and capital lease obligations ^(a) | \$1,192.5 | \$2.2 | \$6.9 | \$3.4 | \$1,180.0 |
| Revolving credit facility | 73.0 | — | — | — | 73.0 |
| Interest on long-term debt ^(b) | 688.1 | 44.1 | 175.3 | 174.7 | 294.0 |
| Capital lease obligations ^(c) | 102.1 | 6.4 | 22.1 | 20.1 | 53.5 |
| Operating lease obligations ^{(d)(e)} | 240.7 | 19.8 | 66.5 | 46.1 | 108.3 |
| Purchase obligations ^{(e)(f)} | 123.9 | 11.7 | 47.0 | 32.5 | 32.7 |
| Other long-term liabilities ^{(g)(h)} | 4.0 | 0.3 | 0.4 | 0.4 | 2.9 |
| Total | \$2,424.3 | \$84.5 | \$318.2 | \$277.2 | \$1,744.4 |

Included in long-term debt are amounts owed on our bonds payable and other notes payable. These borrowings are further explained in Note 4, 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 2012 Form 10-K.

Interest on our fixed rate debt is presented using the stated interest rate. Interest expense on our variable rate debt is estimated using the rate in effect as of June 30, 2013. Interest related to capital lease obligations is excluded from this line. Future minimum payments, which are accounted for as interest, related to sale/leaseback transactions involving real estate accounted for as financings are included in this line (see Note 5, Property and Equipment, and Note 8, Long-term Debt, to the consolidated financial statements accompanying the 2012 Form 10-K). Amounts exclude amortization of debt discounts, amortization of loan fees, or fees for lines of credit that would be included in interest expense in our consolidated statements of operations.

Amounts include interest portion of future minimum capital lease payments.

We lease approximately one third of our hospitals as well as other property and equipment under operating leases in the normal course of business. Some of our hospital leases contain escalation clauses based on changes in the Consumer Price Index while others have fixed escalation terms. The minimum lease payments do not include contingent rental expense. Some lease agreements provide us with the option to renew the lease or purchase the leased property. Our future operating lease obligations would change if we exercised these renewal options and if we entered into additional operating lease agreements. For more information, see Note 5, Property and Equipment, to the consolidated financial statements accompanying the 2012 Form 10-K.

Future operating lease obligations and purchase obligations are not recognized in our condensed consolidated balance sheet.

Purchase obligations include agreements to purchase goods or services that are enforceable and legally binding on HealthSouth and that specify all significant terms, including: fixed or minimum quantities to be purchased; fixed, minimum, or variable price provisions; and the approximate timing of the transaction. Purchase obligations exclude agreements that are cancelable without penalty. Our purchase obligations primarily relate to software licensing and support.

Because their future cash outflows are uncertain, the following noncurrent liabilities are excluded from the table above: general and professional liability and workers' compensation risks, deferred income taxes, and our estimated liability for unsettled litigation. For more information, see Note 10, Self-Insured Risks, Note 17, Income Taxes, and Note 19, Contingencies and Other Commitments, to the consolidated financial statements accompanying the 2012 Form 10-K. Also, at June 30, 2013, we had \$2.4 million of total gross unrecognized tax benefits. See Note 8, Income

Taxes, to the condensed consolidated financial statements included in Part I, Item 1, Financial Statements (Unaudited), of this report. See also the discussion below of our purchases of the real estate associated with leased properties.

^(h) The table above does not include Redeemable noncontrolling interests of \$14.1 million because of the uncertainty surrounding the timing and amounts of any related cash outflows.

Our capital expenditures include costs associated with our hospital refresh program, de novo projects, capacity expansions, technology initiatives, and building and equipment upgrades and purchases. During the six months ended June 30, 2013, we made capital expenditures of approximately \$81 million for property and equipment and capitalized software. These expenditures included costs associated with our de novo projects, technology initiatives, capacity expansions, and our hospital refresh program, as well as our investment in a new hospital to replace our currently leased hospital in Ludlow, Massachusetts. This amount is exclusive of \$28.9 million related to the acquisition of Walton Rehabilitation Hospital in Augusta, Georgia. Based on our year-to-date expenditures through June and the status of our development efforts in CON states, we are decreasing our estimated capital expenditures for 2013 from a range of \$180 million to \$220 million to a range of \$165 million to \$195 million, exclusive of acquisitions and purchases of leased properties (see below). Actual amounts spent will be dependent upon the timing of construction projects. Approximately \$80 million to \$90 million of this budgeted amount is considered nondiscretionary expenditures, which we may refer to in other filings as “maintenance” expenditures.

In July 2013, we purchased the real estate previously subject to an operating lease associated with our hospital in Tallahassee, Florida for approximately \$17 million. In addition, we have given notice of our intent to exercise the purchase option included in four other lease agreements associated with our hospitals. We continue to negotiate with the applicable landlords to finalize the fair value purchase price under the related lease agreements. At this time, we expect to spend up to \$75 million during the second half of 2013 to purchase the real estate associated with these four hospitals.

In March 2008, we sold our corporate campus to Daniel Corporation (“Daniel”), a Birmingham, Alabama-based real estate company. The sale included a deferred purchase price component related to an incomplete 13-story building located on the property, often referred to as the Digital Hospital. Under the agreement, Daniel is obligated upon sale of its interest in the building to pay to us 40% of the net profit realized from the sale. In June 2013, Daniel sold the building to Trinity Medical Center. We are currently in discussions with Daniel to finalize the amount owed to us in connection with the sale of the building, and we expect to receive approximately \$10 million to \$12 million in cash from Daniel during the third quarter of 2013. While all of the cash is expected to be paid to us in the third quarter of 2013, the amount of the gain associated with this transaction will be deferred and amortized as a component of General and administrative expenses over five years, which is the remaining life of our lease agreement with Daniel for the portion of the property we continue to occupy with our corporate office.

Authorizations for Returning Capital to Stakeholders

On February 15, 2013, our board of directors approved an increase in our existing common stock repurchase authorization from \$125 million to \$350 million. Consistent with our strategy of deploying financial resources towards long-term, shareholder value-creating opportunities, during the first quarter of 2013, we completed a tender offer for our common stock. As a result of the tender offer, we purchased approximately 9.1 million shares at a price of \$25.50 per share for a total cost of \$234.1 million, including fees and expenses relating to the tender offer. We used a combination of cash on hand and availability under our revolving credit facility to fund the repurchases. The remaining repurchase authorization expired at the end of the tender offer.

On July 25, 2013, our board of directors approved the initiation of a quarterly cash dividend on our common stock of \$0.18 per share, representing \$0.72 per share annually. The first quarterly dividend has been declared and will be payable on or about October 15, 2013 to stockholders of record as of the close of business on October 1, 2013. We expect quarterly dividends to be paid in January, April, July, and October. However, the actual declaration of any future cash dividends, and the establishment of record and payment dates, will be subject to final approval by our board of directors each quarter after consideration of various factors, including our capital position and the best interests of our stockholders. Cash dividends are expected to be funded using cash flows from operations, cash on hand, and availability under our revolving credit facility.

In addition, our board of directors also authorized the optional redemption of 10% of the outstanding principal amount of our existing 7.25% Senior Notes due 2018 and 7.75% Senior Notes due 2022 pursuant to the terms of these senior notes. Our right to call these bonds at 103% of the principal amount and the discretion provided by this authorization are not synonymous with an exercise of the call option. Repayments under this authorization, if any, are expected to be funded using cash on hand and availability under our revolving credit facility. See Note 4, 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 2012 Form 10-K.

As discussed more fully in Note 18, Earnings per Common Share, to the consolidated financial statements accompanying the 2012 Form 10-K, we issued warrants to purchase up to two million shares of our common stock to certain lenders in connection with a January 2004 debt transaction. Each warrant has an exercise price of \$32.50 per share and expires on January 16, 2014. The agreement underlying these warrants includes an anti-dilutive provision that allows for adjustments to increase the number of shares of common stock purchasable upon exercise and decrease the exercise price for common stock dividends after a de minimis threshold. Additionally, our convertible perpetual preferred stock (see Note 11, Convertible Perpetual Preferred Stock, to the consolidated financial statements accompanying the 2012 Form 10 K) also includes similar anti-dilutive protection that provides for an increase in the number of shares of common stock issuable upon conversion and a decrease in the conversion price to be adjusted for common stock dividends after a de minimis threshold.

The declaration and payment of an \$0.18 per share dividend on our common stock does not trigger an adjustment for either the warrants or the preferred stock because such amount would result in a de minimis adjustment of less than 1% under the respective terms of those securities. Assuming another \$0.18 per share dividend payment and a similar trading price for our common stock in January 2014, an adjustment would likely be required at that time. An adjustment to either or both of the warrants and the preferred stock could result in the inclusion of the underlying common shares in the computation of diluted weighted-average shares outstanding.

Adjusted EBITDA

Management believes Adjusted EBITDA as defined in our credit agreement is a measure of our ability to service our debt and our ability to make capital expenditures. We reconcile Adjusted EBITDA to Net income and to Net cash provided by operating activities.

We use Adjusted EBITDA on a consolidated basis as a liquidity measure. We believe this financial measure on a consolidated basis is important in analyzing our liquidity because it is the key component of certain material covenants contained within our credit agreement, which is discussed in more detail in Note 8, Long-term Debt, to the consolidated financial statements accompanying the 2012 Form 10-K. These covenants are material terms of the credit agreement. Noncompliance with these financial covenants under our credit agreement—our interest coverage ratio and our leverage ratio—could result in our lenders requiring us to immediately repay all amounts borrowed. If we anticipated a potential covenant violation, we would seek relief from our lenders, which would have some cost to us, and such relief might not be on terms favorable to those in our existing credit agreement. In addition, if we cannot satisfy these financial covenants, we would be prohibited under our credit agreement from engaging in certain activities, such as incurring additional indebtedness, making certain payments, and acquiring and disposing of assets. Consequently, Adjusted EBITDA is critical to our assessment of our liquidity.

In general terms, the credit agreement definition of Adjusted EBITDA, referred to as “Adjusted Consolidated EBITDA” there, allows us to add back to consolidated Net income interest expense, income taxes, and depreciation and amortization and then add back to consolidated Net income (1) all unusual or nonrecurring items reducing consolidated Net income (of which only up to \$10 million in a year may be cash expenditures), (2) any losses from discontinued operations and closed locations, (3) costs and expenses, including legal fees and expert witness fees, incurred with respect to litigation associated with stockholder derivative litigation, including the matters related to Ernst & Young LLP and Richard Scruschy discussed in Note 19, Contingencies and Other Commitments, to the consolidated financial statements accompanying the 2012 Form 10-K and Note 10, Contingencies and Other Commitments, to the condensed consolidated financial statements included in Part I, Item 1, Financial Statements (Unaudited), of this report, and (4) share-based compensation expense. We also subtract from consolidated Net income all unusual or nonrecurring items to the extent they increase consolidated Net income.

Under the credit agreement, the Adjusted EBITDA calculation does not include net income attributable to noncontrolling interests and includes (1) gain or loss on disposal of assets, (2) professional fees unrelated to the stockholder derivative litigation, and (3) unusual or nonrecurring cash expenditures in excess of \$10 million. These items may not be indicative of our ongoing performance, so the Adjusted EBITDA calculation presented here includes adjustments for them.

Adjusted EBITDA is not a measure of financial performance under generally accepted accounting principles in the United States of America, and the items excluded from Adjusted EBITDA are significant components in

understanding and assessing financial performance. Therefore, Adjusted EBITDA should not be considered a substitute for Net income or cash flows from operating, investing, or financing activities. Because Adjusted EBITDA is not a measurement determined in accordance with GAAP and is thus susceptible to varying calculations, Adjusted EBITDA, as presented, may not be comparable to other similarly titled measures of other companies. Revenues and expenses are measured in accordance with the policies and procedures described in Note 1, Summary of Significant Accounting Policies, to the consolidated financial statements accompanying the 2012 Form 10-K.

Our Adjusted EBITDA for the three and six months ended June 30, 2013 and 2012 was as follows (in millions):

Reconciliation of Net Income to Adjusted EBITDA

| | Three Months Ended | | Six Months Ended June | |
|--|--------------------|---------|-----------------------|---------|
| | June 30, 2013 | 2012 | 30, 2013 | 2012 |
| Net income | \$179.0 | \$59.9 | \$244.9 | \$116.7 |
| Income from discontinued operations, net of tax, attributable to HealthSouth | (0.1) | (3.5) | 0.3 | (3.1) |
| Provision for income tax (benefit) expense | (86.5) | 26.9 | (53.0) | 56.0 |
| Interest expense and amortization of debt discounts and fees | 24.4 | 23.0 | 48.6 | 46.3 |
| Professional fees—accounting, tax, and legal | 2.2 | 5.5 | 3.6 | 9.1 |
| Government, class action, and related settlements | (2.0) | — | (2.0) | — |
| Net noncash loss on disposal of assets | 1.7 | 0.6 | 1.8 | 1.4 |
| Depreciation and amortization | 23.1 | 20.0 | 45.2 | 39.5 |
| Stock-based compensation expense | 6.5 | 5.9 | 12.8 | 12.0 |
| Net income attributable to noncontrolling interests | (13.8) | (13.2) | (28.4) | (25.8) |
| Adjusted EBITDA | \$134.5 | \$125.1 | \$273.8 | \$252.1 |

Reconciliation of Net Cash Provided by Operating Activities to Adjusted EBITDA

| | Six Months Ended June 30, | |
|--|---------------------------|---------|
| | 2013 | 2012 |
| Net cash provided by operating activities | \$226.8 | \$195.0 |
| Provision for doubtful accounts | (14.4) | (12.8) |
| Professional fees—accounting, tax, and legal | 3.6 | 9.1 |
| Interest expense and amortization of debt discounts and fees | 48.6 | 46.3 |
| Equity in net income of nonconsolidated affiliates | 6.2 | 6.4 |
| Net income attributable to noncontrolling interests in continuing operations | (28.4) | (25.8) |
| Amortization of debt discounts and fees | (2.0) | (1.8) |
| Distributions from nonconsolidated affiliates | (5.0) | (5.5) |
| Current portion of income tax expense | 0.5 | 4.3 |
| Change in assets and liabilities | 36.2 | 38.4 |
| Net cash used in (provided by) operating activities of discontinued operations | 0.2 | (1.7) |
| Other | 1.5 | 0.2 |
| Adjusted EBITDA | \$273.8 | \$252.1 |

Growth in Adjusted EBITDA was due primarily to revenue growth and continued disciplined expense management. Sequestration negatively impacted Adjusted EBITDA by approximately \$8 million and \$9 million during the three and six months ended June 30, 2013, respectively.

Item 3. Quantitative and Qualitative Disclosures about Market Risk

Our primary exposure to market risk is to changes in interest rates on our long-term debt. We use sensitivity analysis models to evaluate the impact of interest rate changes on these items.

Changes in interest rates have different impacts on the fixed and variable rate portions of our debt portfolio. A change in interest rates impacts the net fair value of our fixed rate debt but has no impact on interest expense or cash flows. Interest rate changes on variable rate debt impact our interest expense and cash flows, but do not impact the net fair value of the underlying debt instruments. Our fixed and variable rate debt (excluding capital lease obligations and other notes payable) as of June 30, 2013 is shown in the following table (in millions):

| | As of June 30, 2013 | | Estimated Fair Value | % of Total | |
|----------------------|---------------------|---------------|-------------------------|---------------|---|
| | Carrying Amount | % of Total | | | |
| Fixed rate debt | \$1,144.8 | 94.0 | % \$1,210.9 | 94.3 | % |
| Variable rate debt | 73.0 | 6.0 | % 73.0 | 5.7 | % |
| Total long-term debt | \$1,217.8 | 100.0 | % \$1,283.9 | 100.0 | % |

Based on the size of our variable rate debt as of June 30, 2013, a 1% increase in interest rates would result in an incremental negative cash flow of approximately \$0.7 million over the next 12 months, while a 1% decrease in interest rates would result in an incremental positive cash flow of approximately \$0.1 million over the next 12 months. A 1% increase in interest rates would result in an approximate \$39.0 million decrease in the estimated net fair value of our fixed rate debt, and a 1% decrease in interest rates would result in an approximate \$31.6 million increase in its estimated net fair value.

Foreign operations, and the related market risks associated with foreign currencies, are currently, and have been, insignificant to our financial position, results of operations, and cash flows.

Item 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

As of the end of the period covered by this report, an evaluation was carried out by our management, including our chief executive officer and chief financial officer, of the effectiveness of our disclosure controls and procedures as defined in Rules 13a-15(e) and 15d-15(e) of the Securities Exchange Act of 1934, as amended. Based on our evaluation, our chief executive officer and chief financial officer concluded that our disclosure controls and procedures were effective as of the end of the period covered by this report.

Changes in Internal Control Over Financial Reporting

There have been no changes in our Internal Control over Financial Reporting during the quarter ended June 30, 2013 that have a material effect on our Internal Control over Financial Reporting.

PART II. OTHER INFORMATION

Item 1. Legal Proceedings

Information relating to certain legal proceedings in which we are involved is included in Note 10, Contingencies and Other Commitments, to the condensed consolidated financial statements contained in Part I, Item 1, Financial Statements (Unaudited), of this report and is incorporated herein by reference and should be read in conjunction with the related disclosure previously reported in our Quarterly Report on Form 10-Q for the quarter ended March 31, 2013 and our Annual Report on Form 10-K for the year ended December 31, 2012 (the "2012 Form 10-K").

Item 1A. Risk Factors

There have been no material changes from the risk factors disclosed in Part I, Item 1A, Risk Factors, of the 2012 Form 10-K. Certain information in those risk factors has been updated by the discussion in the "Executive Overview – Key Challenges" section of Part I, Item 2, Management's Discussion and Analysis of Financial Condition and Results of Operations, of this report, which section is incorporated by reference herein.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

Purchases of Equity Securities

The following table summarizes our repurchases of equity securities during the three months ended June 30, 2013:

| Period | Total Number of Shares (or Units) Purchased | Average Price Paid per Share (or Unit) (\$) | Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs | Maximum Number (or Approximate Dollar Value) of Shares That May Yet Be Purchased Under the Plans or Programs |
|--------------------------------|---|---|--|--|
| April 1 through April 30, 2013 | 1,991 | (1) \$26.10 | — | \$— |
| May 1 through May 31, 2013 | 11,793 | (2) 28.36 | — | — |
| June 1 through June 30, 2013 | 408 | (2) 28.80 | — | — |
| Total | 14,192 | 28.06 | — | — |

These shares were purchased pursuant to previous elections by one or more members of our board of directors to participate in our Directors' Deferred Stock Investment Plan. This plan is a nonqualified deferral plan allowing

- (1) non-employee directors to make advance elections to defer a fixed percentage of their director fees. The plan administrator acquires the shares in the open market. The directors' rights to the shares are nonforfeitable, but the shares are only released to the directors after departure from our board.
- (2) Employees tendered these shares as payment of tax liability incident to the vesting of previously awarded shares of restricted stock.

Dividends

To date, we have not paid cash dividends on our common stock, but on July 25, 2013, our board of directors approved the initiation of a quarterly cash dividend on our common stock of \$0.18 per share, representing \$0.72 per share annually. The first quarterly dividend has been declared and will be payable on or about October 15, 2013 to stockholders of record as of the close of business on October 1, 2013. We expect quarterly dividends to be paid in January, April, July, and October. However, the actual declaration of any future cash dividends, and the establishment of record and payment dates, will be subject to final approval by our board each quarter after consideration of various factors, including our capital position and the best interests of our stockholders.

The "restricted payments" covenant in our credit agreement limits our ability under certain circumstances to declare or pay cash dividends on our common stock. See Note 4, 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 2012 Form 10-K.

Item 5. Other Items

Appointment of Successor Trustee

All of our outstanding senior notes were issued pursuant to an indenture (the “Base Indenture”), dated as of December 1, 2009, between us and The Bank of Nova Scotia Trust Company of New York, as trustee (the “Original Trustee”), as supplemented by subsequent supplemental indentures (collectively with the Base Indenture, the “Indenture”) relating to each respective series of senior notes, the 8.125% Senior Notes due 2020, the 7.25% Senior Notes due 2018, the 7.75% Senior Notes due 2022, and the 5.75% Senior Notes due 2024. The Original Trustee notified us of its intention to discontinue its corporate trust operations and, accordingly, to resign upon the appointment of a successor trustee. Effective July 29, 2013, Wells Fargo Bank, National Association (the “Successor Trustee”), was appointed as successor trustee under the Indenture. The trustee resignation and successor appointment are pursuant to the terms of the Indenture and involve no changes to the terms of the Indenture.

Pursuant to the Indenture, the Successor Trustee has accepted appointment as trustee, registrar and paying agent under the Indenture. The address of the designated corporate trust office of the Successor Trustee is 7000 Central Parkway, Suite 550, Atlanta, GA 30328.

The Successor Trustee, collectively with its affiliates, is a full service financial institution engaged in various activities, which may include securities trading, commercial and investment banking, financial advisory, investment management, investment research, principal investment, hedging, financing, and brokerage activities. The Successor Trustee has engaged in, is engaged in, and may in the future engage in, investment banking and other commercial dealings in the ordinary course of business with us or our affiliates, including acting as underwriter in connection with securities offerings from time to time and providing commitments under our senior secured credit agreement. The Successor Trustee has received, or may in the future receive, customary fees and commissions for these transactions. In the ordinary course of its various business activities, the Successor Trustee may make or hold a broad array of investments and actively trade debt and equity securities (or related derivative securities) and financial instruments (including bank loans) for its own account and for the accounts of its customers, and such investment and securities activities may involve our securities and/or debt. The Successor Trustee may also make investment recommendations and/or publish or express independent research views in respect of our securities or debt and may at any time hold, or recommend to clients that they acquire, long and/or short positions in our securities and debt.

Compensation Arrangements of Certain Officers

Grant of Dividend Equivalent Rights to Holders of Performance-Based Restricted Stock

On July 25, 2013, in connection with the approval of the initiation of a quarterly cash dividend on our common stock, the Company's board of directors (the “Board”) approved, pursuant to the Amended and Restated 2008 Equity Incentive Plan (the “Equity Plan”), the grant of dividend equivalent rights on currently outstanding awards of performance-based restricted stock, or performance share units (“PSUs”). Those rights shall accrue during the associated performance period, but the resulting cash dividends will only be paid (a) to the extent shares of restricted stock are earned at the conclusion of such performance period and (b) if the grantee remains employed at the end of the year following such performance period. Ultimately, each share of common stock earned as a result of performance on the previously disclosed two-year performance metrics and not forfeited will be entitled to the per share cash dividends declared and paid on our common stock while that PSU award has been outstanding. The accrued dividend will not be deemed reinvested or earn interest. The terms of the Company's currently outstanding shares of time-based restricted stock provide for rights to dividends, if and when paid.

The descriptions of the provisions of the Equity Plan are summary in nature and are qualified in their entirety by reference to the full and complete terms of the Equity Plan which is attached as Exhibit 4(d) to the Company's Form S-8 filed on August 2, 2011 and otherwise described in the section captioned “Executive Compensation” in its Definitive Proxy Statement on Schedule 14A filed on April 2, 2013.

Amendment of the Executive Severance Plan

Additionally, on July 25, 2013, the Board amended and restated, effective as of October 14, 2013, the Company's existing Third Amended and Restated Executive Severance Plan (the “Severance Plan”) which provided for amendments that were immaterial in nature and generally for clarification purposes. The material terms of the Severance Plan, a description of which follows, remain unchanged. The named executive officers and senior vice

presidents, and equivalents, of the Company are participants in the Severance Plan. As a condition to receipt of any payment or benefits, participating employees must enter into a restricted covenant and release agreement with noncompete, nonsolicitation, nondisclosure and nondisparagement

requirements. Under the Severance Plan, if a participant's employment is terminated by the participant for good reason or by the Company other than for cause, then the participant is entitled to receive a cash severance payment, health benefits, and the other benefits described below. Voluntary retirement, death, and disability are not payment triggering events.

The cash severance payment would be the multiple (set forth in the table below) of annual base salary then in effect plus any accrued, but unused, paid time off, and accrued, but unpaid, salary. This amount is to be paid in a lump sum within 60 days following the participant's termination date. In addition, except in the event of termination for cause or resignation for lack of good reason, the participants and their dependents continue to be covered by all medical and dental insurance plans and programs, excluding disability, for a period of time set forth in the following table.

| Position | Severance as Multiple of Annual Base Salary | Benefit Plan Continuation Period |
|---------------------------|---|----------------------------------|
| chief executive officer | 3x | 36 months |
| executive vice presidents | 2x | 24 months |
| senior vice presidents | 1x | 12 months |

Amounts paid under the Severance Plan are in lieu of, and not in addition to, any other severance or termination payments under any other plan or agreement with the Company. As a condition to receipt of any payment under the Severance Plan, a participant must waive any entitlement to any other severance or termination payment by us, including any severance or termination payment set forth in any employment arrangement with us. Payments do not include "gross ups" for federal taxes payable on amounts paid under the plan.

Upon the termination of a participant without cause, or his or her resignation for good reason, a prorated portion of any equity award subject to time-based vesting only that is unvested as of the effective date of the termination or resignation will automatically vest. If any restricted stock awards are performance based, the compensation committee of the Board will determine the extent to which the performance goals for those awards have been met and what awards have been earned.

The descriptions of the provisions of the Severance Plan are summary in nature and are qualified in their entirety by reference to the full and complete terms of the Severance Plan which is attached as Exhibit 10.1 to the Company's Form 8-K filed on December 9, 2011 and otherwise described in the section captioned "Severance Arrangements" in its Definitive Proxy Statement on Schedule 14A filed on April 2, 2013.

Item 6. Exhibits

See the Exhibit Index immediately following the signature page of this report.

SIGNATURE

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this Report to be signed on its behalf by the undersigned thereunto duly authorized.

HEALTHSOUTH CORPORATION

By: /s/ Douglas E. Coltharp
Douglas E. Coltharp
Executive Vice President and Chief Financial Officer

Date: July 30, 2013

EXHIBIT INDEX

The exhibits required by Regulation S-K are set forth in the following list and are filed by attachment to this report unless otherwise noted.

| No. | Description |
|------|--|
| 3.1 | Restated Certificate of Incorporation of HealthSouth Corporation, as filed in the Office of the Secretary of State of the State of Delaware on May 21, 1998 (incorporated by reference to HealthSouth's Annual Report on Form 10-K filed with the SEC on June 27, 2005). |
| 3.2 | Certificate of Amendment to the Restated Certificate of Incorporation of HealthSouth Corporation, as filed in the Office of the Secretary of State of the State of Delaware on October 25, 2006 (incorporated by reference to Exhibit 3.1 to HealthSouth's Current Report on Form 8-K filed on October 31, 2006). |
| 3.3 | Amended and Restated Bylaws of HealthSouth Corporation, effective as of October 30, 2009, (incorporated by reference to Exhibit 3.3 to HealthSouth's Quarterly Report on Form 10-Q filed on November 4, 2009). |
| 3.4 | Certificate of Designations of 6.50% Series A Convertible Perpetual Preferred Stock, as filed with the Secretary of State of the State of Delaware on March 7, 2006 (incorporated by reference to Exhibit 3.1 to HealthSouth's Current Report on Form 8-K filed on March 9, 2006). |
| 10.1 | First Amendment to the Third Amended and Restated Credit Agreement, dated June 11, 2013, among HealthSouth Corporation, Barclays Bank PLC, as administrative agent and collateral agent, Citigroup Global Markets Inc., as syndication agent, Bank of America, N.A., Goldman Sachs Lending Partners LLC, and Morgan Stanley Senior Funding, Inc., as co-documentation agents, and various other lenders from time to time. |
| 31.1 | Certification of Chief Executive Officer required by Rule 13a-14(a) or Rule 15d-14(a) of the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. |
| 31.2 | Certification of Chief Financial Officer required by Rule 13a-14(a) or Rule 15d-14(a) of the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. |
| 32.1 | Certification of Chief Executive Officer pursuant to 18 U.S.C. 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. |
| 32.2 | Certification of Chief Financial Officer pursuant to 18 U.S.C. 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. |
| 101 | Sections of the HealthSouth Corporation Quarterly Report on Form 10-Q for the quarter ended June 30, 2013, formatted in XBRL (eXtensible Business Reporting Language), submitted in the following files: |
| | 101.INS XBRL Instance Document |
| | 101.SCH XBRL Taxonomy Extension Schema Document |
| | 101.CAL XBRL Taxonomy Extension Calculation Linkbase Document |

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101.DEF XBRL Taxonomy Extension Definition Linkbase Document
101.LAB XBRL Taxonomy Extension Label Linkbase Document
101.PRE XBRL Taxonomy Extension Presentation Linkbase Document