HEALTHSOUTH CORP
Form 10-Q
October 28, 2014

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, DC 20549

FORM 10-Q

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

For the quarterly period ended September 30, 2014
OR

o	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 (State or Other Jurisdiction of Incorporation or Organization)	63-0860407 (I.R.S. Employer Identification No.)
3660 Grandview Parkway, Suite 200 Birmingham, Alabama (Address of Principal Executive Offices)	35243 (Zip Code)

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

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

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

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

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

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

The registrant had 87,752,931 shares of common stock outstanding, net of treasury shares, as of October 21, 2014.

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NOTE TO READERS

As used in this report, the terms "HealthSouth," "we," "us," "our," and the "Company" refer to HealthSouth Corporation and it 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 ability to create shareholder value, or our projected capital expenditures. In some cases, you can identify forward-looking statements by terminology such as "may," "will," "could," "should," "expect," "plan," "anticipate," "l "intend," "estimate," "predict," "project," "target," "potential," or "continue" or the negative of these terms or other comparabl 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 events or 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, 2013, as well as 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 rules and regulations of the healthcare industry at either or both of the federal and state levels, including those contemplated now and in the future as part of national healthcare reform and deficit reduction such as the transformation of the current healthcare system to coordinated care delivery and payment models, the reinstatement of the "75% Rule," or the introduction of site neutral payments with skilled nursing facilities for certain conditions, and related increases in the costs of complying with such changes;

- reductions or delays in, or suspension of, reimbursement for our services by governmental or private payors, including our ability to obtain and retain favorable arrangements with third-party payors;
- 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, and the potential reputational harm associated with those claims;
- the ability of each of our hospitals to maintain licensure, certification, and accreditation necessary to operate and receive reimbursement;
- 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 and avoidance of unforeseen exposure to liabilities;
- any adverse outcome of various lawsuits, claims, and legal or regulatory proceedings, including the ongoing investigations initiated by the U.S. Department of Health and Human Services, Office of the Inspector General;
- increased costs of defending and insuring against alleged professional liability and other claims and the ability to predict the costs related to such claims;
- potential incidents affecting the proper operation, availability, or security of our information systems, including unauthorized access to or theft of patient or other sensitive information;
- the price of our common or preferred stock as it affects our willingness and ability to repurchase shares and the financial and accounting effects of any repurchases;
- our ability and willingness to continue to declare and pay dividends on our common stock;
- our ability to attract and retain key management personnel; and
- general conditions in the economy and capital markets, including any instability or uncertainty related to political disputes or impasses over the United States federal budget or similar matters affecting federal spending.

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 or their effects on the value of our securities.

PART I. FINANCIAL INFORMATION
Item 1. Financial Statements (Unaudited)
HealthSouth Corporation and Subsidiaries
Condensed Consolidated Statements of Operations
(Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
	(In Millions)			
Net operating revenues	$596.9	$564.0	$1,792.5	$1,701.1
Less: Provision for doubtful accounts	(8.2)	(8.0)	(25.0)	(22.4)
Net operating revenues less provision for doubtful accounts	588.7	556.0	1,767.5	1,678.7
Operating expenses:				
Salaries and benefits	290.0	269.5	861.4	817.7
Other operating expenses	89.4	82.2	260.2	241.3
Occupancy costs	10.3	11.7	31.1	35.8
Supplies	26.6	25.5	82.0	78.3
General and administrative expenses	27.5	28.8	88.4	88.5
Depreciation and amortization	27.4	24.3	80.2	69.5
Government, class action, and related settlements	—	(21.3)	(0.8)	(23.3)
Professional fees—accounting, tax, and legal	4.0	4.2	7.6	7.8
Total operating expenses	475.2	424.9	1,410.1	1,315.6
Interest expense and amortization of debt discounts and fees	27.8	25.3	83.5	73.9
Other income	(0.2)	(0.6)	(30.1)	(3.2)
Equity in net income of nonconsolidated affiliates	(1.9)	(2.0)	(8.8)	(8.2)
Income from continuing operations before income tax expense (benefit)	87.8	108.4	312.8	300.6
Provision for income tax expense (benefit)	22.1	35.2	91.4	(17.8)
Income from continuing operations	65.7	73.2	221.4	318.4
(Loss) income from discontinued operations, net of tax	(0.9)	(0.9)	2.8	(1.2)
Net income	64.8	72.3	224.2	317.2
Less: Net income attributable to noncontrolling interests	(14.7)	(14.1)	(44.3)	(42.5)
Net income attributable to HealthSouth	50.1	58.2	179.9	274.7
Less: Convertible perpetual preferred stock dividends	(1.6)	(5.7)	(4.7)	(17.2)
Net income attributable to HealthSouth common shareholders	$48.5	$52.5	$175.2	$257.5

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
	(In Millions, Except Per Share Data)			
Weighted average common shares outstanding:				
Basic	86.5	86.2	86.8	88.7
Diluted	100.5	100.4	100.7	102.4
Earnings per common share:				
Basic earnings per share attributable to HealthSouth common shareholders:				
Continuing operations	$0.56	$0.61	$1.96	$2.87
Discontinued operations	(0.01)	(0.01)	0.03	(0.01)
Net income	$0.55	$0.60	$1.99	$2.86
Diluted earnings per share attributable to HealthSouth common shareholders:				
Continuing operations	$0.53	$0.59	$1.82	$2.69
Discontinued operations	(0.01)	(0.01)	0.03	(0.01)
Net income	$0.52	$0.58	$1.85	$2.68
Cash dividends per common share	$0.21	$0.18	$0.57	$0.18
Amounts attributable to HealthSouth common shareholders:				
Income from continuing operations	$51.0	$59.1	$177.1	$275.9
(Loss) income from discontinued operations, net of tax	(0.9)	(0.9)	2.8	(1.2)
Net income attributable to HealthSouth	$50.1	$58.2	$179.9	$274.7

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

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
	(In Millions)			
COMPREHENSIVE INCOME				
Net income	$64.8	$72.3	$224.2	$317.2
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	(0.2)	—	0.5	(0.8)
Reclassifications to net income	—	0.1	(0.5)	(0.9)
Other comprehensive (loss) income before income taxes	(0.2)	0.1	—	(1.7)
Provision for income tax benefit related to other comprehensive (loss) income items	0.1	—	—	0.1
Other comprehensive (loss) income, net of tax	(0.1)	0.1	—	(1.6)
Comprehensive income	64.7	72.4	224.2	315.6
Comprehensive income attributable to noncontrolling interests	(14.7)	(14.1)	(44.3)	(42.5)
Comprehensive income attributable to HealthSouth	$50.0	$58.3	$179.9	$273.1

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

HealthSouth Corporation and Subsidiaries
Condensed Consolidated Balance Sheets
(Unaudited)

	September 30, 2014	December 31, 2013
	(In Millions)	
Assets		
Current assets:		
Cash and cash equivalents	$272.3	$64.5
Accounts receivable, net of allowance for doubtful accounts of $24.2 in 2014; $23.1 in 2013	261.6	261.8
Deferred income tax assets	138.9	139.0
Other current assets	110.2	115.1
Total current assets	783.0	580.4
Property and equipment, net	994.6	910.5
Goodwill	491.7	456.9
Intangible assets, net	99.9	88.2
Deferred income tax assets	255.3	354.3
Other long-term assets	169.5	144.1
Total assets	$2,794.0	$2,534.4
Liabilities and Shareholders’ Equity		
Current liabilities:		
Current portion of long-term debt	$208.5	$12.3
Accounts payable	54.8	61.9
Accrued expenses and other current liabilities	251.4	237.4
Total current liabilities	514.7	311.6
Long-term debt, net of current portion	1,441.4	1,505.2
Other long-term liabilities	139.7	142.2
	2,095.8	1,959.0
Commitments and contingencies		
Convertible perpetual preferred stock	93.2	93.2
Redeemable noncontrolling interests	12.2	13.5
Shareholders’ equity:		
HealthSouth shareholders’ equity		
Common stock, $.01 par value; 200,000,000 shares authorized; issued: 104,011,178 in 2014; 102,648,302 in 2013	1.0	1.0
Capital in excess of par value	2,828.0	2,849.4
Accumulated deficit	(1,921.2)	(2,101.1)
Accumulated other comprehensive loss	(0.1)	(0.1)
Treasury stock, at cost (16,255,544 shares in 2014 and 14,654,436 shares in 2013)	(458.1)	(404.6)
Total HealthSouth shareholders’ equity	449.6	344.6
Noncontrolling interests	143.2	124.1
Total shareholders’ equity	592.8	468.7
Total liabilities and shareholders’ equity	$2,794.0	$2,534.4

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)

	Nine Months Ended September 30, 2014 (In Millions)							
	HealthSouth Common Shareholders							
	Number of Common Shares Outstanding	Common Stock	Capital in Excess of Par Value	Accumulated Deficit	Accumulated Other Comprehensive Loss	Treasury Stock	Noncontrolling Interests	Total
Balance at beginning of period	88.0	$1.0	$2,849.4	$(2,101.1)	$(0.1)	$(404.6)	$124.1	$468.7
Net income	—	—	—	179.9	—	—	38.9	218.8
Receipt of treasury stock	(0.3)	—	—	—	—	(9.7)	—	(9.7)
Dividends declared on common stock	—	—	(50.6)	—	—	—	—	(50.6)
Dividends declared on convertible perpetual preferred stock	—	—	(4.7)	—	—	—	—	(4.7)
Stock-based compensation	—	—	19.3	—	—	—	—	19.3
Stock options exercised	0.3	—	7.4	—	—	—	—	7.4
Stock warrants exercised	0.2	—	6.3	—	—	—	—	6.3
Distributions declared	—	—	—	—	—	—	(33.7)	(33.7)
Repurchases of common stock in open market	(1.3)	—	—	—	—	(43.1)	—	(43.1)
Consolidation of Fairlawn Rehabilitation Hospital	—	—	—	—	—	—	14.0	14.0
Other	0.9	—	0.9	—	—	(0.7)	(0.1)	0.1
Balance at end of period	87.8	$1.0	$2,828.0	$(1,921.2)	$(0.1)	$(458.1)	$143.2	$592.8

	Nine Months Ended September 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	—	—	—	274.7	—	—	38.4	313.1
Receipt of treasury stock	(0.3)	—	—	—	—	(5.8)	—	(5.8)
Dividends declared on common stock	—	—	(15.9)	—	—	—	—	(15.9)
Dividends declared on convertible perpetual preferred stock	—	—	(17.2)	—	—	—	—	(17.2)

Stock-based compensation	—	—	19.0	—	—	—	—	19.0
Stock options exercised	0.3	—	7.5	—	—	—	—	7.5
Distributions declared	—	—	—	—	—	—	(30.1)	(30.1)
Repurchases of common stock through tender offer	(9.1)	—	—	—	—	(234.1)	—	(234.1)
Other	0.8	—	4.5	—	(1.6)	(1.0)	0.1	2.0
Balance at end of period	87.4	$ 1.0	$ 2,874.5	$ (2,150.0)	$ (0.2)	$ (404.2)	$ 120.9	$ 442.0

The accompanying notes to condensed consolidated financial statements are an integral part of these condensed statements.
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HealthSouth Corporation and Subsidiaries
Condensed Consolidated Statements of Cash Flows
(Unaudited)

	Nine Months Ended September 30,	
	2014	2013
	(In Millions)	
Cash flows from operating activities:		
Net income	$224.2	$317.2
(Income) loss from discontinued operations	(2.8)	1.2
Adjustments to reconcile net income to net cash provided by operating activities—		
Provision for doubtful accounts	25.0	22.4
Provision for government, class action, and related settlements	(0.8)	(23.3)
Depreciation and amortization	80.2	69.5
Equity in net income of nonconsolidated affiliates	(8.8)	(8.2)
Distributions from nonconsolidated affiliates	9.4	9.6
Stock-based compensation	19.3	19.0
Deferred tax expense (benefit)	81.6	(20.8)
Gain on consolidation of Fairlawn Rehabilitation Hospital	(27.2)	—
Other	13.0	6.0
(Increase) decrease in assets—		
Accounts receivable	(48.7)	(26.5)
Other assets	8.9	(4.5)
Increase (decrease) in liabilities—		
Accounts payable	3.7	9.9
Other liabilities	(7.6)	(0.7)
Premium received on bond issuance	6.3	—
Net cash used in operating activities of discontinued operations	(1.0)	(1.4)
Total adjustments	153.3	51.0
Net cash provided by operating activities	374.7	369.4

(Continued)

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

	Nine Months Ended September 30,	
	2014	2013
	(In Millions)	
Cash flows from investing activities:		
Purchases of property and equipment	(133.9)	(166.8)
Capitalized software costs	(12.6)	(15.6)
Acquisition of business, net of cash acquired	(15.9)	(28.9)
Proceeds from sale of restricted investments	0.3	16.9
Proceeds from sale of Digital Hospital	—	10.8
Purchase of restricted investments	(2.5)	(8.1)
Other	2.3	(5.5)
Net cash used in investing activities	(162.3)	(197.2)
Cash flows from financing activities:		
Proceeds from bond issuance	175.0	—
Principal borrowings on notes	—	15.2
Borrowings on revolving credit facility	65.0	147.0
Payments on revolving credit facility	(110.0)	(112.0)
Repurchases of common stock, including fees and expenses	(43.1)	(234.1)
Dividends paid on common stock	(47.4)	—
Dividends paid on convertible perpetual preferred stock	(4.7)	(17.2)
Distributions paid to noncontrolling interests of consolidated affiliates	(39.6)	(34.1)
Other	0.2	(4.8)
Net cash used in financing activities	(4.6)	(240.0)
Increase (decrease) in cash and cash equivalents	207.8	(67.8)
Cash and cash equivalents at beginning of period	64.5	132.8
Cash and cash equivalents at end of period	$272.3	$65.0

The accompanying notes to condensed consolidated financial statements are an integral part of these condensed statements.
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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 in terms of patients treated and discharged, revenues, and number of hospitals. 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 20, 2014 (the "2013 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, 2013 has been derived from audited financial statements, but it does not include all disclosures required by GAAP. However, we believe the disclosures are adequate to make the information presented not misleading.

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

See also Note 2, Business Combinations.

Net Operating Revenues—

During the three and nine months ended September 30, 2014 and 2013, we derived consolidated Net operating revenues from the following payor sources:

	Three Months Ended September 30,				Nine Months Ended September 30,			
	2014		2013		2014		2013	
Medicare	73.5	%	74.1	%	74.1	%	74.5	%
Medicaid	2.2	%	1.5	%	1.8	%	1.2	%
Workers' compensation	1.1	%	1.3	%	1.2	%	1.3	%
Managed care and other discount plans, including Medicare Advantage	18.8	%	18.7	%	18.6	%	18.5	%
Other third-party payors	1.8	%	1.7	%	1.7	%	1.7	%
Patients	1.1	%	1.1	%	1.0	%	1.1	%
Other income	1.5	%	1.6	%	1.6	%	1.7	%
Total	100.0	%	100.0	%	100.0	%	100.0	%

See Note 1, Summary of Significant Accounting Policies, to the consolidated financial statements accompanying the 2013 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 June 2014, we acquired an additional 30% equity interest from UMass Memorial Health Care, our joint venture partner in Fairlawn Rehabilitation Hospital ("Fairlawn") in Worcester, Massachusetts. This transaction increased our ownership interest from 50% to 80% and resulted in a change in accounting for this hospital from the equity method of accounting to a consolidated entity. As a result of our consolidation of this hospital and the remeasurement of our previously held equity interest at fair value, Goodwill increased by $34.8 million, and we recorded a $27.2 million gain as part of Other income during the nine months ended September 30, 2014. The transaction was funded using cash on hand. See also Note 9, Income Taxes.

We entered into this transaction to increase our ownership in this profitable hospital and continue to grow our core business by consolidating its operations. None of the goodwill resulting from this transaction is deductible for federal income tax purposes. The goodwill reflects our expectations of our ability to continue to serve the consolidated hospital's historical patient base as well as 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 Fairlawn 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):

Total current assets	$12.1
Property and equipment, net	30.4
Identifiable intangible assets:	
Noncompete agreement (useful life of 3 years)	0.4
Tradename (useful life of 20 years)	2.5
Certificate of need (useful life of 20 years)	9.7
License (useful life of 20 years)	2.0
Goodwill	34.8
Total assets acquired	91.9
Total current liabilities assumed	(7.8)
Total long-term liabilities assumed	(14.1)
Net assets acquired	$70.0

HealthSouth Corporation and Subsidiaries
Notes to Condensed Consolidated Financial Statements

Our reported Net operating revenues and Net income for the three and nine months ended September 30, 2014 include operating results for Fairlawn from June 1, 2014 through September 30, 2014. The following table summarizes the results of operations of the above mentioned entity 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, 2013 (in millions):

	Net Operating Revenues	Net Income Attributable to HealthSouth
Acquired entity only: Actual from acquisition date to September 30, 2014	$15.4	$2.6
Combined entity: Supplemental pro forma from 07/01/2014-09/30/2014*	596.9	50.1
Combined entity: Supplemental pro forma from 07/01/2013-09/30/2013	574.8	59.3
Combined entity: Supplemental pro forma from 01/01/2014-09/30/2014	1,811.3	181.6
Combined entity: Supplemental pro forma from 01/01/2013-09/30/2013	1,734.4	278.0

*Pro forma amounts equal reported operating results due to the acquisition of Fairlawn effective June 1, 2014.

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
Fair value of assets acquired, net of $5.1 million of cash acquired in 2014	$—	$—	$52.0	$15.6
Goodwill	—	—	34.8	13.7
Fair value of liabilities assumed	—	—	(21.9)	(0.4)
Fair value of noncontrolling interest owned by joint venture partner	—	—	(14.0)	—
Fair value of equity interest prior to acquisition	—	—	(35.0)	—
Net cash paid for acquisitions	$—	$—	$15.9	$28.9

See Note 2, Business Combinations, to the 2013 Form 10-K for information regarding the acquisition completed in 2013.

3. Investments in and Advances to Nonconsolidated Affiliates

As of September 30, 2014 and December 31, 2013, we had $10.8 million and $20.3 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 nine partially owned subsidiaries, of which eight 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 September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
Net operating revenues	$7.8	$16.2	$44.1	$55.4
Operating expenses	(3.3)	(10.3)	(22.7)	(32.5)
Income from continuing operations, net of tax	4.2	4.4	28.2	18.4
Net income	4.2	4.4	28.2	18.4

See also Note 2, Business Combinations.

4. Long-term Debt

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

	September 30, 2014	December 31, 2013
Credit Agreement—		
Advances under revolving credit facility	$—	$45.0
Term loan facility	—	—
Bonds payable—		
7.25% Senior Notes due 2018	272.3	272.4
8.125% Senior Notes due 2020	286.9	286.6
7.75% Senior Notes due 2022	252.4	252.5
5.75% Senior Notes due 2024	456.3	275.0
2.0% Convertible Senior Subordinated Notes due 2043	255.8	249.5
Other notes payable	41.9	47.6
Capital lease obligations	84.3	88.9
	1,649.9	1,517.5
Less: Current portion	(208.5)	(12.3)
Long-term debt, net of current portion	$1,441.4	$1,505.2

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
October 1 through December 31, 2014*	$273.3	$274.2
2015	9.0	9.0
2016	9.0	9.0
2017	8.1	8.1
2018	8.6	8.6
2019	11.5	11.5
Thereafter	1,389.1	1,329.5
Total	$1,708.6	$1,649.9

*See discussion below regarding the notice and redemption of our 7.25% Senior Notes due 2018.

On September 18, 2014, we issued an additional $175 million of our existing 5.75% Senior Notes due 2024 at a price of 103.625% of the principal amount, which resulted in approximately $182 million in net proceeds from the public offering. The additional notes will be governed by the previously executed agreements for our 5.75% Senior Notes due 2024.

On September 22, 2014, we amended our existing credit agreement to, among other things:

- add a new $150 million term loan facility in addition to our existing $600 million revolving credit facility;
- permit additional restricted payments so long as the senior secured leverage ratio remains less than or equal to 1.75x (previously 1.50x);
- increase the amount of permitted capital expenditures in a given year from $250 million to $300 million; and
- set the maturity date for both the revolving credit and term loan facilities to September 20, 2019, which represents a one-year extension for our existing revolving credit facility.

We may borrow amounts under the term loan facility on or before March 31, 2015. Amounts drawn under the term loan facility are subject to the same applicable interest rate schedule as amounts drawn under our existing revolving credit facility, which rate is currently LIBOR plus 1.75 percent. Amounts drawn under the term loan facility are payable in equal consecutive quarterly installments, commencing on March 31, 2015, of 1.25% of the aggregate principal amount of the term loan outstanding as of March 31, 2015. We have the right at any time to prepay, in whole or in part, any borrowing under the term loan facility.

On August 29, 2014, we gave notice of, and made an irrevocable commitment for, the redemption of all the outstanding principal amount of our 7.25% Senior Notes due 2018. On October 1, 2014, we used the net proceeds from the additional offering of our 5.75% Senior Notes due 2024, a $75 million draw under our term loan facility, and cash on hand to execute the redemption. Pursuant to the terms of the 7.25% Senior Notes due 2018, this redemption was made at a price of 103.625%, which resulted in a total cash outlay of approximately $281 million to retire the approximately $271 million in principal. Additionally, on October 24, 2014, we gave notice of the redemption of approximately $25 million of the outstanding principal amount of our existing 7.75% Senior Notes due 2022. Pursuant to the terms of the 7.75% Senior Notes due 2022, this optional redemption will represent 10% of the outstanding principal amount of the notes at a price of 103%, which will result in a total cash outlay of approximately $26 million when the transaction closes in December 2014. As a result of these redemptions, we expect to record an approximate $13 million loss on early extinguishment of debt in the fourth quarter of 2014.

For additional information regarding our indebtedness, see Note 8, Long-term Debt, to the consolidated financial statements accompanying the 2013 Form 10-K.

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5. Redeemable Noncontrolling Interests

The following is a summary of the activity related to our Redeemable noncontrolling interests during the nine months ended September 30, 2014 and 2013 (in millions):

	Nine Months Ended September 30,	
	2014	2013
Balance at beginning of period	$13.5	$7.2
Net income attributable to noncontrolling interests	5.4	4.1
Distributions declared	(6.7)	(3.6)
Contribution to joint venture	—	6.2
Balance at end of period	$12.2	$13.9

The following table reconciles the net income attributable to nonredeemable Noncontrolling interests, as recorded in the shareholders' equity section of the condensed consolidated balance sheets, and the net income attributable to Redeemable noncontrolling interests, as recorded in the mezzanine section of the condensed consolidated balance sheets, to the Net income attributable to noncontrolling interests presented in the condensed consolidated statements of operations for the three and nine months ended September 30, 2014 and 2013 (in millions):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
Net income attributable to nonredeemable noncontrolling interests	$12.9	$12.6	$38.9	$38.4
Net income attributable to redeemable noncontrolling interests	1.8	1.5	5.4	4.1
Net income attributable to noncontrolling interests	$14.7	$14.1	$44.3	$42.5

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6. Fair Value Measurements

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

		Fair Value Measurements at Reporting Date Using			
As of September 30, 2014	Fair Value	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Valuation Technique [1]
Other current assets:					
Current portion of restricted marketable securities	$4.3	$—	$4.3	$—	M
Other long-term assets:					
Restricted marketable securities	45.9	—	45.9	—	M
As of December 31, 2013					
Other current assets:					
Current portion of restricted marketable securities	$4.7	$—	$4.7	$—	M
Other long-term assets:					
Restricted marketable securities	42.9	—	42.9	—	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 months ended September 30, 2014, 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 a result of our consolidation of Fairlawn and the remeasurement of our previously held equity interest at fair value, we recorded a $27.2 million gain as part of Other income during the nine months ended September 30, 2014. We determined the fair value of our previously held equity interest using the income approach. The income approach included the use of the hospital’s projected operating results and cash flows discounted using a rate that reflects market participant assumptions for the hospital. The projected operating results used management’s best estimates of economic and market conditions over the forecasted period including assumptions for pricing and volume, operating expenses, and capital expenditures. See Note 2, Business Combinations. During the three and nine months ended September 30, 2013, we did not record any material gains or losses related to our nonfinancial assets and liabilities that are recognized or disclosed at fair value in the financial statements on a nonrecurring basis as part of our continuing operations.

During the three and nine months ended September 30, 2013, we recorded an impairment charge of $1.1 million as part of our results of discontinued operations. This charge related to a hospital that was closed in 2011. We determined the fair value of the impaired long-lived assets at the hospital based on an offer from a potential buyer.

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As discussed in Note 1, Summary of Significant Accounting Policies, “Fair Value Measurements,” to the consolidated financial statements accompanying the 2013 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 September 30, 2014		As of December 31, 2013	
	Carrying Amount	Estimated Fair Value	Carrying Amount	Estimated Fair Value
Long-term debt:				
Advances under revolving credit facility	$—	$—	$45.0	$45.0
7.25% Senior Notes due 2018	272.3	281.3	272.4	291.4
8.125% Senior Notes due 2020	286.9	306.0	286.6	319.4
7.75% Senior Notes due 2022	252.4	269.0	252.5	275.0
5.75% Senior Notes due 2024	456.3	456.2	275.0	273.6
2.00% Convertible Senior Subordinated Notes due 2043	255.8	349.2	249.5	339.7
Other notes payable	41.9	41.9	47.6	47.6
Financial commitments:				
Letters of credit	—	31.8	—	36.5

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 2013 Form 10-K.

See also Note 5, Redeemable Noncontrolling Interests, and Note 8, Assets and Liabilities in and Results of Discontinued Operations.

7. Share-Based Payments

In February 2014, we issued 0.6 million of restricted stock awards to members of our management team and our board of directors. Approximately 0.2 million of these awards contain only a service condition, while the remainder contain both a service and a performance or market condition. For the awards that include a performance or market condition, the number of shares that will ultimately be granted to employees may vary based on the Company’s performance during the applicable two-year performance measurement period. Additionally, in February 2014, we granted 0.1 million stock options to members of our management team. The fair value of these awards and options was determined using the policies described in Note 1, Summary of Significant Accounting Policies, and Note 13, Share-Based Payments, to the consolidated financial statements accompanying the 2013 Form 10-K.

8. Assets and Liabilities in and Results of Discontinued Operations

In connection with the 2007 sale of our surgery centers division (now known as Surgical Care Affiliates, or “SCA”) to ASC Acquisition LLC, an affiliate of TPG Partners V, L.P. (“TPG”), a private investment partnership, we received an option, subject to terms and conditions set forth below, to purchase up to a 5% equity interest in SCA. The price of the option is equal to the original issuance price of the units subscribed for by TPG and certain other co-investors in connection with the acquisition plus a 15% premium, compounded annually. The option has a term of ten years and is exercisable upon certain liquidity events, including a public offering of SCA’s shares of common stock that results in 30% or more of SCA’s common stock being listed or traded on a national securities exchange. On November 4, 2013, SCA announced the closing of its initial public offering, which was not a qualifying liquidity event.

During the second quarter of 2014, we entered into an amendment to the option agreement that requires us to settle the option net of our exercise price. The addition of this new feature resulted in the option becoming a derivative that must be recorded as an asset or liability on our condensed consolidated balance sheet and marked to market each period. As of

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September 30, 2014, the fair value of this option was $5.1 million and is included in Other long-term assets in our condensed consolidated balance sheet. Income from discontinued operations, net of tax for the three and nine months ended September 30, 2014 included a $1.6 million loss and $5.1 million net gain, respectively, resulting from the initial recording of this option as a derivative and its fair value adjustments during the 2014 periods presented.

The fair value of the option and related adjustments were determined using a lattice model. Inputs into the model included the historical price volatility of SCA's common stock, the risk free interest rate, and probability factors for the timing of when the option will be exercisable, or Level 3 inputs.

For additional information regarding discontinued operations, see Note 15, Assets and Liabilities in and Results of Discontinued Operations, to the consolidated financial statements accompanying the 2013 Form 10-K.

9. Income Taxes

Our Provision for income tax expense of $22.1 million and $91.4 million for the three and nine months ended September 30, 2014, respectively, primarily resulted from the application of our estimated effective blended federal and state income tax rates, which were reduced as a result of the nontaxable gain discussed in Note 2, Business Combinations, related to our acquisition of an additional 30% equity interest in Fairlawn and our election to claim certain tax credits. As a result of the Fairlawn transaction, we released the deferred tax liability associated with the outside tax basis of our investment in Fairlawn because we now possess sufficient ownership to allow for the historical outside tax basis difference to be resolved through a tax-free transaction in the future.

In April 2013, we entered into closing agreements with the Internal Revenue Service 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 expense of $35.2 million for the three months ended September 30, 2013 primarily resulted from the application of our estimated effective blended federal and state income tax rate offset by a decrease in our valuation allowance due to changes in certain state tax laws and provision to return adjustments made as a result of the filing of our federal income tax return for 2012. Our Provision for income tax benefit of $17.8 million for the nine months ended September 30, 2013 primarily resulted from the IRS settlement discussed above. It also included an approximate $4 million decrease in our valuation allowance related primarily to our capital loss carryforwards and changes in certain state tax laws. During the second quarter of 2013, we determined a valuation allowance related to our capital loss carryforwards was no longer required as sufficient positive evidence existed to substantiate their utilization. This evidence included our partial utilization of these assets 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 certain cumulative changes in ownership interests of significant stockholders over a three-year period exceed 50%. Section 382 imposes an annual limitation on the use of certain carryforward 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 $394.2 million of net deferred tax assets included in the accompanying condensed consolidated balance sheet as of September 30, 2014 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 September 30, 2014, we maintained a valuation allowance of $30.3 million due to uncertainties regarding our ability to utilize a portion of our 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

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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 $240.7 million (approximately $688 million on a gross basis) as of September 30, 2014 excludes $11.3 million related to operating loss carryforwards resulting from excess tax benefits related to share-based awards, the tax benefits of which, when recognized, will be accounted for as a credit to Capital in excess of par value when they reduce taxes payable.

Total remaining gross unrecognized tax benefits were $0.4 million and $1.1 million as of September 30, 2014 and December 31, 2013, respectively, none of which would affect our effective tax rate if recognized. A reconciliation of the beginning and ending liability for unrecognized tax benefits is as follows (in millions):

	Gross Unrecognized Income Tax Benefits	Accrued Interest and Penalties
Balance at December 31, 2013	$1.1	$0.3
Gross amount of increases in unrecognized tax benefits related to prior periods	—	0.1
Gross amount of decreases in unrecognized tax benefits related to prior periods	(0.7)	(0.3)
Balance at September 30, 2014	$0.4	$0.1

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 nine months ended September 30, 2014 and 2013 was not material. Accrued interest income related to income taxes as of September 30, 2014 and December 31, 2013 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 2007 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.

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10. Earnings per Common Share

The following table sets forth the computation of basic and diluted earnings per common share (in millions, except per share amounts):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
Basic:				
Numerator:				
Income from continuing operations	$65.7	$73.2	$221.4	$318.4
Less: Net income attributable to noncontrolling interests included in continuing operations	(14.7)	(14.1)	(44.3)	(42.5)
Less: Income allocated to participating securities	(0.5)	(0.6)	(2.1)	(4.1)
Less: Convertible perpetual preferred stock dividends	(1.6)	(5.7)	(4.7)	(17.2)
Income from continuing operations attributable to HealthSouth common shareholders	48.9	52.8	170.3	254.6
(Loss) income from discontinued operations, net of tax, attributable to HealthSouth common shareholders	(0.9)	(0.9)	2.8	(1.2)
Net income attributable to HealthSouth common shareholders	$48.0	$51.9	$173.1	$253.4
Denominator:				
Basic weighted average common shares outstanding	86.5	86.2	86.8	88.7
Basic earnings per share attributable to HealthSouth common shareholders:				
Continuing operations	$0.56	$0.61	$1.96	$2.87
Discontinued operations	(0.01)	(0.01)	0.03	(0.01)
Net income	$0.55	$0.60	$1.99	$2.86
Diluted:				
Numerator:				
Income from continuing operations	$65.7	$73.2	$221.4	$318.4
Less: Net income attributable to noncontrolling interests included in continuing operations	(14.7)	(14.1)	(44.3)	(42.5)
Add: Interest on convertible debt, net of tax	2.3	—	6.8	—
Income from continuing operations attributable to HealthSouth common shareholders	53.3	59.1	183.9	275.9
(Loss) income from discontinued operations, net of tax, attributable to HealthSouth common shareholders	(0.9)	(0.9)	2.8	(1.2)
Net income attributable to HealthSouth common shareholders	$52.4	$58.2	$186.7	$274.7
Denominator:				
Diluted weighted average common shares outstanding	100.5	100.4	100.7	102.4
Diluted earnings per share attributable to HealthSouth common shareholders:				
Continuing operations	$0.53	$0.59	$1.82	$2.69
Discontinued operations	(0.01)	(0.01)	0.03	(0.01)
Net income	$0.52	$0.58	$1.85	$2.68

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
Basic weighted average common shares outstanding	86.5	86.2	86.8	88.7
Convertible perpetual preferred stock	3.2	11.6	3.2	11.6
Convertible senior subordinated notes	8.2	—	8.1	—
Restricted stock awards, dilutive stock options, and restricted stock units	2.6	2.6	2.6	2.1
Diluted weighted average common shares outstanding	100.5	100.4	100.7	102.4

Options to purchase approximately 0.1 million shares of common stock were outstanding as of September 30, 2014 and 2013, but were not included in the computation of diluted weighted-average shares because to do so would have been antidilutive.

On February 14, 2014, our board of directors approved an increase in our existing common stock repurchase authorization from $200 million to $250 million. The repurchase authorization does not require the repurchase of a specific number of shares, has an indefinite term, and is subject to termination at any time by our board of directors. During the nine months ended September 30, 2014, we repurchased 1.3 million shares of our common stock in the open market for $43.1 million using cash on hand.

On February 14, 2014, our board of directors declared a cash dividend of $0.18 per common share that was paid on April 15, 2014 to stockholders of record on April 1, 2014. On May 1, 2014, our board of directors declared a cash dividend of $0.18 per common share that was paid on July 15, 2014 to stockholders of record on July 1, 2014. On July 17, 2014, our board of directors approved an increase in our quarterly dividend and declared a cash dividend of $0.21 per common share paid on October 15, 2014 to stockholders of record on October 1, 2014. On October 21, 2014, our board of directors declared a cash dividend of $0.21 per share, payable on January 15, 2015 to stockholders of record on January 2, 2015. As of September 30, 2014 and December 31, 2013, accrued common stock dividends of $18.7 million and $15.8 million were included in Accrued expenses and other current liabilities in our condensed consolidated balance sheet. Future dividend payments are subject to declaration by our board of directors.

As discussed more fully in Note 10, Convertible Perpetual Preferred Stock, to the consolidated financial statements accompanying the 2013 Form 10-K, the agreement underlying our preferred stock includes antidilutive protection that requires adjustments to the number of shares of common stock issuable upon conversion and the exercise price for common stock upon the occurrence of certain events, including payment of cash dividends on our common stock after a de minimis threshold. At issuance, the preferred stock had a conversion price of $30.50 per share, which was equal to an initial conversion rate of 32.7869 shares of common stock per share of preferred stock. Additionally, our convertible notes (see Note 8, Long-term Debt, to the consolidated financial statements accompanying the 2013 Form 10 K) also include similar antidilutive protection that requires adjustments to the number of shares of common stock issuable upon conversion and the exercise price for common stock upon the occurrence of certain events, including payment of cash dividends on our common stock after a de minimis threshold. At issuance, the convertible notes had a conversion price of $39.65 per share, which was equal to an initial conversion rate of 25.2194 shares per $1,000 principal amount of the convertible notes. The payment of dividends beginning in October 2013 has triggered, from time to time, the antidilutive adjustment provisions of the preferred stock and convertible notes. As of October 2, 2014, the resulting exercise prices of the preferred stock and convertible notes were $29.70 and $38.82 per share, respectively, and the resulting conversion rates were 33.6700 and 25.7582 for each preferred share and for each $1,000 principal amount of the convertible notes, respectively.

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In January 2004, we repaid our then-outstanding 3.25% Convertible Debentures using the net proceeds of a loan arranged by Credit Suisse First Boston. In connection with this transaction, we issued ten million warrants with an expiration date of January 16, 2014 to the lender to purchase shares of our common stock. The following table summarizes information relating to these warrants and their activity from December 31, 2013 through their expiration date (number of warrants in millions):

	Number of Warrants	Weighted Average Exercise Price
Common stock warrants outstanding as of December 31, 2013	2.9	$32.50
Cashless exercise	(1.8)	32.16
Cash exercise	(1.0)	32.16
Expired	(0.1)	32.16
Common stock warrants outstanding as of January 16, 2014	—	

The above exercises resulted in the issuance of 0.2 million shares of common stock during the nine months ended September 30, 2014. Cash exercises resulted in gross proceeds of $6.3 million during the nine months ended September 30, 2014.

See Note 10, Convertible Perpetual Preferred Stock, and Note 17, Earnings per Common Share, to the consolidated financial statements accompanying the 2013 Form 10-K for additional information related to common stock, common stock warrants, and convertible perpetual preferred stock.

11. Contingencies and Other Commitments

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

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 By and Against Former Independent Auditor” in Note 18, Contingencies and Other Commitments, to the consolidated financial statements accompanying the 2013 Form 10-K. The Tucker complaint alleged 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 alleged 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 sought 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 alleged we provided Ernst & Young with fraudulent management representation letters, financial statements, invoices, bank reconciliations, and journal entries in an effort to conceal accounting fraud. Ernst & Young claimed that as a result of our actions, Ernst & Young’s reputation had been injured and it incurred 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 was 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 asserted that the panel’s decision was 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. On June 13, 2014, the Supreme Court of Alabama affirmed the decision by the circuit court. On June 27, 2014, we filed an application for rehearing with the Supreme Court of Alabama. On August 22, 2014, the Supreme Court of Alabama denied our application, and as a result, we consider this litigation matter concluded.

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 (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 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 defenses and a counterclaim against General Medicine that the Consent Judgment is the product of collusion by General Medicine and Meadowbrook. 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. 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 amount of General Medicine’s damages claim against Horizon/CMS or the merits of General Medicine's separate fraudulent conveyance claims against HealthSouth.

On January 9, 2014 and on February 18, 2014, the court in the Alabama Action entered rulings based on General Medicine’s stipulation that it would not rely on the Consent Judgment to prove the amount of its damages claim against Horizon/CMS, which rulings together provided that the $376 million damages figure contained in the Consent Judgment is not admissible at trial and that the issue of collusion with respect to the amount of the Consent Judgment is now moot. Instead of relying on the Consent Judgment to prove damages against Horizon/CMS, General Medicine will be required to prove the amount of any damages it has against Horizon/CMS. General Medicine did, however, indicate it would rely on the Consent Judgment to prove its status as a creditor of Horizon/CMS and that Horizon/CMS is indebted to General Medicine for breaching the 1995 services contract. On March 31, 2014, General Medicine filed a motion seeking partial summary judgment and requesting dismissal of our defenses and counterclaim which allege the Consent Judgment was the product of collusion. In opposition to the motion, we argued the Consent Judgment is collusive in its entirety, not just with respect to the $376 million damages figure, and there has never been a valid adjudication that Horizon/CMS breached its 1995 services contract with General Medicine or that Horizon/CMS is indebted to General Medicine for any amount. On July 15, 2014, the court issued an order denying General Medicine’s motion for partial summary judgment.

On May 3, 2014, the Consent Judgment expired under applicable Michigan law without renewal by General Medicine. Based on the expiration, on July 23, 2014, we filed a motion for summary judgment requesting dismissal of General Medicine’s lawsuit against us on grounds that General Medicine is no longer a “creditor” of Horizon/CMS, which is an essential element of the fraudulent transfer and alter ego claims against us, and that General Medicine’s lawsuit against us is now moot. On August 13, 2014, the court denied our motion for summary judgment.

The trial began on September 15, 2014. On September 16, 2014, the court issued a provisional ruling precluding us from offering any evidence at trial that the Consent Judgment was the product of collusion by General Medicine and Meadowbrook, unless General Medicine opens the door by introducing evidence of the $376 million amount of the Consent Judgment. On September 18, 2014, the court granted General Medicine’s motion for a mistrial based on certain statements made during opening statements. The Alabama Action has been reset for trial beginning on March 9, 2015.

On September 24, 2014, we filed a petition for writ of mandamus with the Supreme Court of Alabama requesting that it review the trial court’s August 13, 2014 order denying our motion for summary judgment. A petition for writ of mandamus is a discretionary appeal, rather than an appeal as a matter of right. If the supreme court agrees to hear our petition, it will direct the parties to submit briefs on the merits and will most likely stay the March 9, 2015 trial until it renders a decision. If it does not agree to hear our petition, then the case is expected to proceed to trial on that date.

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

Other Litigation—

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. On September 27, 2013, the federal court remanded the case back to state court. We intend to vigorously defend ourselves in this case. Based on the stage of litigation, review of the current facts and circumstances as we understand them, the nature of the underlying claim, the results of the proceedings to date, and the nature and scope of the defense we continue to mount, we do not believe an adverse judgment or settlement is probable in this matter, and it is also not possible to estimate the amount of loss, if any, or range of possible loss that might result from an adverse judgment or settlement of this case.

Governmental Inquiries and Investigations—

On June 24, 2011, we received a document subpoena addressed to HealthSouth Hospital of Houston, a long-term acute care hospital ("LTCH") we closed in August 2011, and issued from the Dallas, Texas office of the U.S. Department of Health and Human Services, Office of the Inspector General (the "HHS-OIG"). The subpoena stated it was in connection with an investigation of possible false or otherwise improper claims submitted to Medicare and Medicaid and requested documents and materials relating to patient admissions, length of stay, and discharge matters at this closed LTCH. We furnished the documents requested and have heard nothing from HHS-OIG since December 2012.

On March 4, 2013, we received document subpoenas from an office of the HHS-OIG addressed to four of our hospitals. Those subpoenas also requested complete copies of medical records for 100 patients treated at each of those hospitals between September 2008 and June 2012. The investigation is being conducted by the United States Department of Justice (the "DOJ"). On April 24, 2014, we received document subpoenas relating to an additional seven of our hospitals. The new subpoenas reference substantially similar investigation subject matter as the original subpoenas and request materials from the period January 2008 through December 2013. Two of the four hospitals addressed in the original set of subpoenas have received supplemental subpoenas to cover this new time period. The new subpoenas do not include requests for specific patient files, but it is expected that such requests will be made for the new group of hospitals.

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

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

Other Matters—

The False Claims Act, 18 U.S.C. § 287, allows private citizens, called “relators,” to institute civil proceedings alleging violations of the False Claims Act. These qui tam cases are generally sealed by the court at the time of filing. The only parties typically privy to the information contained in the complaint are the relator, the federal government, and the presiding court. It is possible that qui tam lawsuits have been filed against us and that those suits remain under seal or that we are unaware of such filings or prevented by existing law or court order from discussing or disclosing the filing of such suits. We may be subject to liability under one or more undisclosed qui tam cases brought pursuant to the False Claims Act.

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

12. 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.

The terms of our credit agreement allow us to declare and pay cash dividends on our common stock so long as: (1) we are not in default under our credit agreement and (2) our senior secured leverage ratio (as defined in our credit agreement) remains less than or equal to 1.75x. The terms of our senior note indenture allow us to declare and pay cash dividends on our common stock so long as (1) we are not in default, (2) the consolidated coverage ratio (as defined in the indenture) exceeds 2x or we are otherwise allowed under the indenture to incur debt, and (3) we have capacity under the indenture’s restricted payments covenant to declare and pay dividends. See Note 8, Long-term Debt, to the consolidated financial statements accompanying the 2013 Form 10-K.

As described in Note 10, Convertible Perpetual Preferred Stock, to the consolidated financial statements accompanying the 2013 Form 10-K, our preferred stock generally provides for the payment of cash dividends, subject to certain limitations. Our credit agreement and our senior note indenture do not limit the payment of dividends on the preferred stock.

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

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

	Three Months Ended September 30, 2014				
	HealthSouth Corporation (In Millions)	Guarantor Subsidiaries	Nonguarantor Subsidiaries	Eliminating Entries	HealthSouth Consolidated
Net operating revenues	$4.0	$424.5	$191.2	$(22.8)	$596.9
Less: Provision for doubtful accounts	—	(5.7)	(2.5)	—	(8.2)
Net operating revenues less provision for doubtful accounts	4.0	418.8	188.7	(22.8)	588.7
Operating expenses:					
Salaries and benefits	4.1	197.9	91.8	(3.8)	290.0
Other operating expenses	5.0	62.0	31.8	(9.4)	89.4
Occupancy costs	1.1	14.5	4.3	(9.6)	10.3
Supplies	0.1	18.6	7.9	—	26.6
General and administrative expenses	27.5	—	—	—	27.5
Depreciation and amortization	2.3	18.2	6.9	—	27.4
Professional fees—accounting, tax, and legal	4.0	—	—	—	4.0
Total operating expenses	44.1	311.2	142.7	(22.8)	475.2
Interest expense and amortization of debt discounts and fees	25.7	1.7	0.7	(0.3)	27.8
Other income	0.1	—	(0.6)	0.3	(0.2)
Equity in net income of nonconsolidated affiliates	—	(1.9)	—	—	(1.9)
Equity in net income of consolidated affiliates	(62.6)	(7.2)	—	69.8	—
Management fees	(26.8)	20.4	6.4	—	—
Income from continuing operations before income tax (benefit) expense	23.5	94.6	39.5	(69.8)	87.8
Provision for income tax (benefit) expense	(27.5)	39.2	10.4	—	22.1
Income from continuing operations	51.0	55.4	29.1	(69.8)	65.7
Loss from discontinued operations, net of tax	(0.9)	—	—	—	(0.9)
Net Income	50.1	55.4	29.1	(69.8)	64.8
Less: Net income attributable to noncontrolling interests	—	—	(14.7)	—	(14.7)
Net income attributable to HealthSouth	$50.1	$55.4	$14.4	$(69.8)	$50.1
Comprehensive income	$50.0	$55.4	$29.1	$(69.8)	$64.7
Comprehensive income attributable to HealthSouth	$50.0	$55.4	$14.4	$(69.8)	$50.0

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

	Three Months Ended September 30, 2013				
	HealthSouth Corporation (In Millions)	Guarantor Subsidiaries	Nonguarantor Subsidiaries	Eliminating Entries	HealthSouth Consolidated
Net operating revenues	$3.0	$399.7	$179.2	$(17.9)	$564.0
Less: Provision for doubtful accounts	—	(5.6)	(2.4)	—	(8.0)
Net operating revenues less provision for doubtful accounts	3.0	394.1	176.8	(17.9)	556.0
Operating expenses:					
Salaries and benefits	0.1	187.4	85.6	(3.6)	269.5
Other operating expenses	3.2	59.6	27.9	(8.5)	82.2
Occupancy costs	1.0	12.0	4.5	(5.8)	11.7
Supplies	—	17.9	7.6	—	25.5
General and administrative expenses	28.8	—	—	—	28.8
Depreciation and amortization	2.2	16.7	5.4	—	24.3
Government, class action, and related settlements	(21.3)	—	—	—	(21.3)
Professional fees—accounting, tax, and legal	4.2	—	—	—	4.2
Total operating expenses	18.2	293.6	131.0	(17.9)	424.9
Interest expense and amortization of debt discounts and fees	22.4	2.4	0.8	(0.3)	25.3
Other income	(0.4)	—	(0.5)	0.3	(0.6)
Equity in net income of nonconsolidated affiliates	(0.3)	(1.7)	—	—	(2.0)
Equity in net income of consolidated affiliates	(59.7)	(5.5)	—	65.2	—
Management fees	(25.2)	19.2	6.0	—	—
Income from continuing operations before income tax (benefit) expense	48.0	86.1	39.5	(65.2)	108.4
Provision for income tax (benefit) expense	(10.3)	34.9	10.6	—	35.2
Income from continuing operations	58.3	51.2	28.9	(65.2)	73.2
Loss from discontinued operations, net of tax	(0.1)	(0.4)	(0.4)	—	(0.9)
Net Income	58.2	50.8	28.5	(65.2)	72.3
Less: Net income attributable to noncontrolling interests	—	—	(14.1)	—	(14.1)
Net income attributable to HealthSouth	$58.2	$50.8	$14.4	$(65.2)	$58.2
Comprehensive income	$58.3	$50.8	$28.5	$(65.2)	$72.4
Comprehensive income attributable to HealthSouth	$58.3	$50.8	$14.4	$(65.2)	$58.3

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

	Nine Months Ended September 30, 2014				
	HealthSouth Corporation (In Millions)	Guarantor Subsidiaries	Nonguarantor Subsidiaries	Eliminating Entries	HealthSouth Consolidated
Net operating revenues	$11.5	$1,286.4	$561.7	$(67.1)	$1,792.5
Less: Provision for doubtful accounts	—	(17.6)	(7.4)	—	(25.0)
Net operating revenues less provision for doubtful accounts	11.5	1,268.8	554.3	(67.1)	1,767.5
Operating expenses:					
Salaries and benefits	15.9	590.2	266.6	(11.3)	861.4
Other operating expenses	15.0	182.1	90.0	(26.9)	260.2
Occupancy costs	3.1	43.4	13.5	(28.9)	31.1
Supplies	—	57.9	24.1	—	82.0
General and administrative expenses	88.4	—	—	—	88.4
Depreciation and amortization	7.4	54.1	18.7	—	80.2
Government, class action, and related settlements	(0.8)	—	—	—	(0.8)
Professional fees—accounting, tax, and legal	7.6	—	—	—	7.6
Total operating expenses	136.6	927.7	412.9	(67.1)	1,410.1
Interest expense and amortization of debt discounts and fees	76.3	5.9	2.1	(0.8)	83.5
Other income	(0.3)	(28.4)	(2.2)	0.8	(30.1)
Equity in net income of nonconsolidated affiliates	—	(8.8)	—	—	(8.8)
Equity in net income of consolidated affiliates	(233.9)	(21.3)	—	255.2	—
Management fees	(80.7)	61.6	19.1	—	—
Income from continuing operations before income tax (benefit) expense	113.5	332.1	122.4	(255.2)	312.8
Provision for income tax (benefit) expense	(63.5)	122.0	32.9	—	91.4
Income from continuing operations	177.0	210.1	89.5	(255.2)	221.4
Income (loss) from discontinued operations, net of tax	2.9	—	(0.1)	—	2.8
Net Income	179.9	210.1	89.4	(255.2)	224.2
Less: Net income attributable to noncontrolling interests	—	—	(44.3)	—	(44.3)
Net income attributable to HealthSouth	$179.9	$210.1	$45.1	$(255.2)	$179.9
Comprehensive income	$179.9	$210.1	$89.4	$(255.2)	$224.2
Comprehensive income attributable to HealthSouth	$179.9	$210.1	$45.1	$(255.2)	$179.9

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

	Nine Months Ended September 30, 2013				
	HealthSouth Corporation (In Millions)	Guarantor Subsidiaries	Nonguarantor Subsidiaries	Eliminating Entries	HealthSouth Consolidated
Net operating revenues	$9.0	$1,215.1	$529.2	$(52.2)	$1,701.1
Less: Provision for doubtful accounts	—	(15.6)	(6.8)	—	(22.4)
Net operating revenues less provision for doubtful accounts	9.0	1,199.5	522.4	(52.2)	1,678.7
Operating expenses:					
Salaries and benefits	13.5	565.7	249.4	(10.9)	817.7
Other operating expenses	9.1	177.4	79.8	(25.0)	241.3
Occupancy costs	3.1	35.9	13.1	(16.3)	35.8
Supplies	—	55.1	23.2	—	78.3
General and administrative expenses	88.5	—	—	—	88.5
Depreciation and amortization	6.5	47.8	15.2	—	69.5
Government, class action, and related settlements	(23.3)	—	—	—	(23.3)
Professional fees—accounting, tax, and legal	7.8	—	—	—	7.8
Total operating expenses	105.2	881.9	380.7	(52.2)	1,315.6
Interest expense and amortization of debt discounts and fees	66.8	5.7	2.4	(1.0)	73.9
Other income	(0.7)	(0.8)	(2.7)	1.0	(3.2)
Equity in net income of nonconsolidated affiliates	(2.5)	(5.7)	—	—	(8.2)
Equity in net income of consolidated affiliates	(243.3)	(22.3)	—	265.6	—
Management fees	(76.6)	58.7	17.9	—	—
Income from continuing operations before income tax (benefit) expense	160.1	282.0	124.1	(265.6)	300.6
Provision for income tax (benefit) expense	(114.5)	69.7	27.0	—	(17.8)
Income from continuing operations	274.6	212.3	97.1	(265.6)	318.4
Income (loss) from discontinued operations, net of tax	0.1	(0.1)	(1.2)	—	(1.2)
Net Income	274.7	212.2	95.9	(265.6)	317.2
Less: Net income attributable to noncontrolling interests	—	—	(42.5)	—	(42.5)
Net income attributable to HealthSouth	$274.7	$212.2	$53.4	$(265.6)	$274.7
Comprehensive income	$273.1	$212.2	$95.9	$(265.6)	$315.6
Comprehensive income attributable to HealthSouth	$273.1	$212.2	$53.4	$(265.6)	$273.1

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

	As of September 30, 2014				
	HealthSouth Corporation	Guarantor Subsidiaries	Nonguarantor Subsidiaries	Eliminating Entries	HealthSouth Consolidated
	(In Millions)				
Assets					
Current assets:					
Cash and cash equivalents	$266.5	$1.5	4.3	$—	$272.3
Accounts receivable, net	—	186.1	75.5	—	261.6
Deferred income tax assets	85.5	34.5	18.9	—	138.9
Other current assets	40.4	14.1	91.2	(35.5)	110.2
Total current assets	392.4	236.2	189.9	(35.5)	783.0
Property and equipment, net	13.6	753.5	227.5	—	994.6
Goodwill	—	279.6	212.1	—	491.7
Intangible assets, net	12.9	46.2	40.8	—	99.9
Deferred income tax assets	203.4	24.5	27.4	—	255.3
Other long-term assets	74.5	35.3	59.7	—	169.5
Intercompany receivable	1,562.7	—	—	(1,562.7)	—
Total assets	$2,259.5	$1,375.3	$757.4	$(1,598.2)	$2,794.0
Liabilities and Shareholders' Equity					
Current liabilities:					
Current portion of long-term debt	$217.7	$4.1	$4.2	$(17.5)	208.5
Accounts payable	8.8	33.0	13.0	—	54.8
Accrued expenses and other current liabilities	121.3	73.0	75.1	(18.0)	251.4
Total current liabilities	347.8	110.1	92.3	(35.5)	514.7
Long-term debt, net of current portion	1,324.3	85.0	32.1	—	1,441.4
Other long-term liabilities	44.6	12.5	82.6	—	139.7
Intercompany payable	—	431.9	212.5	(644.4)	—
	1,716.7	639.5	419.5	(679.9)	2,095.8
Commitments and contingencies					
Convertible perpetual preferred stock	93.2	—	—	—	93.2
Redeemable noncontrolling interests	—	—	12.2	—	12.2
Shareholders' equity:					
HealthSouth shareholders' equity	449.6	735.8	182.5	(918.3)	449.6
Noncontrolling interests	—	—	143.2	—	143.2
Total shareholders' equity	449.6	735.8	325.7	(918.3)	592.8
Total liabilities and shareholders' equity	$2,259.5	$1,375.3	$757.4	$(1,598.2)	$2,794.0

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

	As of December 31, 2013				
	HealthSouth Corporation	Guarantor Subsidiaries	Nonguarantor Subsidiaries	Eliminating Entries	HealthSouth Consolidated
	(In Millions)				
Assets					
Current assets:					
Cash and cash equivalents	$60.5	$2.3	$1.7	$—	$64.5
Accounts receivable, net	—	184.7	77.1	—	261.8
Deferred income tax assets	85.5	34.5	19.0	—	139.0
Other current assets	37.0	15.8	80.8	(18.5)	115.1
Total current assets	183.0	237.3	178.6	(18.5)	580.4
Property and equipment, net	16.3	698.5	195.7	—	910.5
Goodwill	—	279.6	177.3	—	456.9
Intangible assets, net	18.1	49.6	20.5	—	88.2
Deferred income tax assets	288.8	24.5	41.0	—	354.3
Other long-term assets	64.6	27.1	52.4	—	144.1
Intercompany receivable	1,438.8	—	—	(1,438.8)	—
Total assets	$2,009.6	$1,316.6	$665.5	$(1,457.3)	$2,534.4
Liabilities and Shareholders' Equity					
Current liabilities:					
Current portion of long-term debt	$19.4	$3.8	$6.6	$(17.5)	$12.3
Accounts payable	15.1	32.6	14.2	—	61.9
Accrued expenses and other current liabilities	111.1	67.2	60.1	(1.0)	237.4
Total current liabilities	145.6	103.6	80.9	(18.5)	311.6
Long-term debt, net of current portion	1,381.7	88.1	35.4	—	1,505.2
Other long-term liabilities	44.5	17.4	80.3	—	142.2
Intercompany payable	—	299.2	228.9	(528.1)	—
	1,571.8	508.3	425.5	(546.6)	1,959.0
Commitments and contingencies					
Convertible perpetual preferred stock	93.2	—	—	—	93.2
Redeemable noncontrolling interests	—	—	13.5	—	13.5
Shareholders' equity:					
HealthSouth shareholders' equity	344.6	808.3	102.4	(910.7)	344.6
Noncontrolling interests	—	—	124.1	—	124.1
Total shareholders' equity	344.6	808.3	226.5	(910.7)	468.7
Total liabilities and shareholders' equity	$2,009.6	$1,316.6	$665.5	$(1,457.3)	$2,534.4

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

	Nine Months Ended September 30, 2014				
	HealthSouth Corporation	Guarantor Subsidiaries	Nonguarantor Subsidiaries	Eliminating Entries	HealthSouth Consolidated
	(In Millions)				
Net cash provided by operating activities	$53.5	$206.9	$114.3	$—	$374.7
Cash flows from investing activities:					
Purchases of property and equipment	(11.9)	(97.9)	(24.1)	—	(133.9)
Capitalized software costs	(4.1)	(1.5)	(7.0)	—	(12.6)
Acquisition of business, net of cash acquired	—	—	(15.9)	—	(15.9)
Proceeds from sale of restricted investments	—	—	0.3	—	0.3
Purchase of restricted investments	—	—	(2.5)	—	(2.5)
Other	1.0	1.3	—	—	2.3
Net cash used in investing activities	(15.0)	(98.1)	(49.2)	—	(162.3)
Cash flows from financing activities:					
Proceeds from bond issuance	175.0	—	—	—	175.0
Borrowings on revolving credit facility	65.0	—	—	—	65.0
Payments on revolving credit facility	(110.0)	—	—	—	(110.0)
Repurchases of common stock, including fees and expenses	(43.1)	—	—	—	(43.1)
Dividends paid on common stock	(47.4)	—	—	—	(47.4)
Dividends paid on convertible perpetual preferred stock	(4.7)	—	—	—	(4.7)
Distributions paid to noncontrolling interests of consolidated affiliates	—	—	(39.6)	—	(39.6)
Other	8.7	(3.0)	(5.5)	—	0.2
Change in intercompany advances	124.0	(106.6)	(17.4)	—	—
Net cash provided by (used in) financing activities	167.5	(109.6)	(62.5)	—	(4.6)
Increase (decrease) in cash and cash equivalents	206.0	(0.8)	2.6	—	207.8
Cash and cash equivalents at beginning of period	60.5	2.3	1.7	—	64.5
Cash and cash equivalents at end of period	$266.5	$1.5	$4.3	$—	$272.3

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

	Nine Months Ended September 30, 2013				
	HealthSouth Corporation	Guarantor Subsidiaries	Nonguarantor Subsidiaries	Eliminating Entries	HealthSouth Consolidated
	(In Millions)				
Net cash provided by operating activities	$70.9	$215.6	$82.9	$—	$369.4
Cash flows from investing activities:					
Purchases of property and equipment	(5.2)	(142.3)	(19.3)	—	(166.8)
Capitalized software costs	(4.8)	(7.6)	(3.2)	—	(15.6)
Acquisition of business, net of cash acquired	—	(28.9)	—	—	(28.9)
Proceeds from sale of restricted investments	—	—	16.9	—	16.9
Proceeds from sale of Digital Hospital	10.8	—	—	—	10.8
Purchase of restricted investments	—	—	(8.1)	—	(8.1)
Other	(0.2)	(1.0)	(4.3)	—	(5.5)
Net cash provided by (used in) investing activities	0.6	(179.8)	(18.0)	—	(197.2)
Cash flows from financing activities:					
Principal borrowings on notes	—	—	15.2	—	15.2
Borrowings on revolving credit facility	147.0	—	—	—	147.0
Payments on revolving credit facility	(112.0)	—	—	—	(112.0)
Repurchases of common stock, including fees and expenses	(234.1)	—	—	—	(234.1)
Dividends paid on convertible perpetual preferred stock	(17.2)	—	—	—	(17.2)
Distributions paid to noncontrolling interests of consolidated affiliates	—	—	(34.1)	—	(34.1)
Other	4.6	(6.7)	(2.7)	—	(4.8)
Change in intercompany advances	70.5	(27.5)	(43.0)	—	—
Net cash used in financing activities	(141.2)	(34.2)	(64.6)	—	(240.0)
(Decrease) increase in cash and cash equivalents	(69.7)	1.6	0.3	—	(67.8)
Cash and cash equivalents at beginning of period	131.3	0.3	1.2	—	132.8
Cash and cash equivalents at end of period	$61.6	$1.9	$1.5	$—	$65.0

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, 2013 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, 2013 (the "2013 Form 10-K").

This MD&A is designed to provide the reader with information that will assist in understanding our condensed consolidated financial statements, the changes in certain key items in those financial statements from period to period, and the primary factors that accounted for those changes, as well as how certain accounting principles affect our condensed consolidated financial statements. See "Cautionary Statements Regarding Forward-Looking Statements" on page i of this report for a description of important factors that could cause actual results to differ from expected results. See also Item 1A, Risk Factors, to the 2013 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 September 30, 2014, we operated 103 inpatient rehabilitation hospitals (including one hospital that operates as a joint venture which we account for using the equity method of accounting), 16 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 2013 Form 10-K.

2014 Overview

Our 2014 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;
- expanding our services to more patients who require inpatient rehabilitative services by constructing and acquiring new hospitals in new markets;
- continuing our shareholder value-enhancing strategies such as common stock dividends and repurchases of our common stock; and
- positioning the Company for continued success in the evolving healthcare delivery system. This preparation includes continuing the installation of our electronic clinical information system which allows for interfaces with all major acute care electronic medical record systems and health information exchanges, participating in bundling projects and Accountable Care Organizations ("ACOs"), and evaluating potential service line expansions via acquisitions.

During the three months ended September 30, 2014, discharge growth of 3.8% coupled with a 2.7% increase in net patient revenue per discharge generated 6.6% growth in net patient revenue from our hospitals compared to the three months ended September 30, 2013. Discharge growth included a 1.9% increase in same-store discharges. During the nine months ended September 30, 2014, discharge growth of 3.1% coupled with a 3.0% increase in net patient revenue per discharge generated 6.2% growth in net patient revenue from our hospitals compared to the nine months ended September 30, 2013. Discharge growth included a 1.0% increase in same-store discharges. 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 in 2014 have included the continued development of the following de novo hospitals:

Location	# of Beds	Actual / Expected Construction Start Date	Expected Operational Date
Altamonte Springs, Florida	50	Q4 2013	Q4 2014
Newnan, Georgia	50	Q4 2013	Q4 2014
Middletown, Delaware	34	Q4 2013	Q4 2014
Franklin, Tennessee*	40	Q4 2014	Q4 2015
Modesto, California	50	Q4 2014	Q1 2016
Murrieta, California**	50	Q3 2016	Q4 2017

*In August 2014, the Tennessee Court of Appeals upheld the decision of the chancery court approving the award of our certificate of need, which decision allows us to begin building the approved inpatient rehabilitation hospital.

**In August 2014, we acquired land and began the design and permitting process to build an inpatient rehabilitation hospital.

In addition to the continued development of de novo hospitals, we continued our capacity expansions by adding six new beds to existing hospitals during the third quarter of 2014, and we expect to add 45 additional beds during the fourth quarter of 2014.

In April 2014, we signed an agreement with Mountain States Health Alliance to form a joint venture to own and operate a 26-bed, free-standing inpatient rehabilitation hospital in Johnson City, Tennessee. The formation of the joint venture is subject to customary closing conditions, including regulatory approvals. We expect to begin operating the joint venture in the fourth quarter of 2014.

In June 2014, we acquired an additional 30% equity interest from UMass Memorial Health Care, our joint venture partner in Fairlawn Rehabilitation Hospital ("Fairlawn") in Worcester, Massachusetts. This transaction increased our ownership interest from 50% to 80% and resulted in a change in accounting for this hospital from the equity method of accounting to a consolidated entity. As a result of our consolidation of this hospital and the remeasurement of our previously held equity interest at fair value, we recorded a $27.2 million gain as part of Other income during the nine months ended September 30, 2014. The transaction was funded using cash on hand. See Note 1, Basis of Presentation, and Note 2, Business Combinations, to the condensed consolidated financial statements included in Part 1, Item 1, Financial Statements (Unaudited), of this report for additional information.

In October 2014, we formed a joint venture with Memorial Health to obtain regulatory approvals to own and operate a 50-bed inpatient rehabilitation hospital to be known as the Rehabilitation Hospital of Savannah in Savannah, Georgia. Initially, the Rehabilitation Hospital of Savannah will operate in the current location of Memorial Health's 50-bed Rehabilitation Institute on Memorial University Medical Center's campus. The joint venture plans to build a new, 50-bed replacement inpatient rehabilitation hospital, which is expected to be completed in early 2016. The commencement of operations of the joint venture are subject to customary closing conditions, including certain regulatory approvals. We expect to begin operating the inpatient rehabilitation hospital at Memorial University Medical Center in the first half of 2015.

In September 2014, we issued an additional $175 million of our 5.75% Senior Notes due 2024 at a price of 103.625% of the principal amount, which resulted in approximately $182 million in net proceeds from the public offering. We also amended our existing credit agreement to, among other things, add a new $150 million term loan facility to our existing $600 million revolving credit facility and extend the maturity date to September 2019. In October 2014, we used the net proceeds from the additional offering of senior notes, a $75 million draw under our term loan facility, and cash on hand to redeem the outstanding principal amount of our 7.25% Senior Notes due 2018. Pursuant to the terms of the 7.25% Senior Notes due 2018, this redemption was made at a price of 103.625%, which resulted in a total cash outlay of approximately $281 million to retire the approximately $271 million in principal. Additionally, in October 2014, we gave notice of the redemption of approximately $25 million of the outstanding principal amount of our existing 7.75% Senior Notes due 2022. Pursuant to the terms of these senior notes, this optional redemption will represent 10% of the outstanding principal amount of the notes at a price of 103%, which will result in a total cash outlay of approximately $26 million when the transaction closes in December 2014. 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 the "Liquidity and Capital Resources" section of this Item.

We also continued our shareholder value-enhancing strategies by repurchasing 1.3 million shares of our common stock in the open market for $43.1 million during the first and second quarters of 2014. In addition, we continued paying a quarterly cash dividend of $0.18 per share on our common stock in the first three quarters of 2014. On July 17, 2014, our board of directors approved an increase in our quarterly dividend and declared a cash dividend of $0.21 per share, paid on October 15, 2014 to stockholders of record on October 1, 2014. On October 21, 2014, our board of directors declared a cash dividend of $0.21 per share, payable on January 15, 2015 to stockholders of record on January 2, 2015. See the "Liquidity and Capital Resources" section of this Item. In addition, we further strengthened our balance sheet by purchasing the real estate previously subject to a lease associated with our hospital in San Antonio, Texas.

Business Outlook

We believe our business outlook remains positive for two primary reasons. First, demographic trends, specifically the aging of the population, should 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 and associated with the aging process. 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 enrollees is expected to grow approximately 3% per year for the foreseeable future.

Second, we are the industry leader in this growing sector. As the nation's largest owner and operator of inpatient rehabilitation hospitals, we believe we differentiate ourselves from our competitors based on our broad platform of clinical expertise, the quality of our clinical outcomes, the sustainability of best practices, our financial strength, and the application of rehabilitation technology. We have invested considerable resources into clinical and management systems and protocols that have allowed us to consistently produce high-quality outcomes for our patients while continuing to contain cost growth. Our 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 other providers 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 complying with Joint Commission standards, effectively using evidence-based, clinical practice guidelines to manage and optimize patient care, and using 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, 96 of our hospitals hold one or more disease-specific certifications.

We believe these 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.

Longer term, the nature and timing of the transformation of the current healthcare system to coordinated care delivery and payment models is uncertain and will likely remain so for some time. The development of new delivery and payment systems will almost certainly require significant time and resources. Many of the alternative approaches being explored may not work as intended. As outlined in Item 7, Management's Discussion and Analysis of Financial Condition and Results of Operations, "Key Challenges—Changes to Our Operating Environment Resulting from Healthcare Reform" of the 2013 Form 10-K, our goal is to position the Company in a prudent manner to be responsive to industry shifts.

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, 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 2019. 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. We have ample availability under our credit agreement, 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 shareholders including bed additions, de novos, acquisitions, purchases of leased properties, common stock dividends, repurchases of our common and preferred stock, and repayment of long-term debt. Specifically, on

February 14, 2014, our board of directors approved an increase in our existing common stock repurchase authorization from $200 to $250 million. As of September 30, 2014, approximately $207 million remained under this authorization. In addition, on July 17, 2014, our board of directors approved an increase in our quarterly dividend and declared a cash dividend of $0.21 per share, paid on October 15, 2014 to stockholders of record on October 1, 2014. 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 changes in reimbursement and sustain our business model. We also believe we will be in a position to take action should an attractive acquisition or consolidation opportunity arise.

Key Challenges

Currently, the healthcare industry is facing many well-publicized regulatory and reimbursement challenges. The industry is also facing uncertainty associated with the efforts, primarily arising from initiatives included in the 2010 Healthcare Reform Laws (as defined in Item 1, Business, "Regulatory and Reimbursement Challenges" of the 2013 Form 10-K) to identify and implement workable coordinated care delivery models. Successful healthcare providers are those who provide high-quality, cost-effective care and have the ability to adjust to changes in the regulatory and operating environments. We believe we have the necessary capabilities — scale, infrastructure, balance sheet, and management — to adapt to changes and continue to succeed in a highly regulated industry, and we have a proven track record of doing so.

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

- Operating in a Highly Regulated Industry. We are required to comply with extensive and complex laws and regulations at the federal, state, and local government levels. These rules and regulations have affected, or could in the future affect, our business activities by having an impact on the reimbursement we receive for services provided or the costs of compliance, mandating new documentation standards, requiring additional licensure or certification 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 extensive laws and regulations is an operating requirement for all healthcare providers.

We have invested, and will continue to invest, substantial time, effort, and expense in implementing and maintaining 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.

As discussed in Item 1, Business, "Sources of Revenues," and Item 7, Management's Discussion and Analysis of Financial Condition and Results of Operations, "Executive Overview—Key Challenges," of the 2013 Form 10 K, in connection with United States Centers for Medicare and Medicaid Services ("CMS") approved and announced Recovery Audit Contractor ("RAC") audits related to inpatient rehabilitation facilities ("IRFs"), we have received requests to review certain patient files for discharges occurring from 2010 to 2014. To date, the Medicare payments that are subject to these audit requests represent less than 1% of our Medicare patient discharges during those years, and not all of these patient file requests have resulted in payment denial determinations by the RACs. Because we have confidence in the medical judgment of both the referring and the admitting physicians who assess the treatment needs of their patients, we have appealed substantially all RAC denials arising from these audits.

The contracts awarded to RACs by CMS were set to expire in February 2014, but they have been extended and modified pending finalization of new contracts. In late February 2014, CMS announced it would pause the operations of the current RACs until new contracts are awarded, meaning that hospitals would not receive any new requests from RACs until that time. Legal challenges to the contract award process have delayed finalizing the new contracts longer than expected, and as a result, CMS modified the existing RAC contracts to allow some RAC reviews to be restarted on a limited basis. However, once the new contracts are in place, RACs will be able to audit claims for dates of service during the time period covered by the pause in RAC operations. We cannot predict when the legal challenges to the new contracts will be resolved or when CMS will otherwise finalize the new RAC contracts. While we make provisions for these claims based on our historical experience and success rates in the claim adjudication process, we cannot provide assurance as to our future success in the resolution of these and future disputes, nor can we predict or estimate the scope or number of denials that ultimately may be reviewed.

See also Item 1, Business, “Sources of Revenues” and “Regulation,” and Item 1A, Risk Factors, to the 2013 Form 10 K and Note 11, Contingencies and Other Commitments, “Governmental Inquiries and Investigations,” to the condensed consolidated financial statements included in Part I, Item 1, Financial Statements (Unaudited), of this report.

- Changes to Our Operating Environment Resulting from Healthcare Reform. Our challenges related to healthcare reform are discussed in Item 1, Business, “Sources of Revenue,” Item 1A, Risk Factors, and Item 7, Management’s Discussion and Analysis of Financial Condition and Results of Operations, “Executive Overview—Key Challenges,” to the 2013 Form 10 K.

Many provisions within the 2010 Healthcare Reform Laws have impacted, or could in the future impact, our business. Most notably for us are the reductions to our annual market basket updates, including productivity adjustments, and future payment reforms such as ACOs and bundled payments. Given the complexity and the number of changes in the 2010 Healthcare Reform Laws, we cannot predict their ultimate impact. In addition, the healthcare industry in general is facing uncertainty associated with the efforts, begun in earnest by initiatives included in the 2010 Healthcare Reform Laws, to identify and implement workable coordinated care delivery models. The ultimate nature and timing of the transformation of the healthcare delivery system is uncertain, and will likely remain so for some time. We will continue to evaluate these laws and position the Company for this industry shift. Based on our track record, we believe we can adapt to these regulatory and industry changes. Further, we have engaged, and will continue to engage, actively in discussions with key legislators and regulators to attempt to ensure any healthcare laws or regulations adopted or amended promote our goal of high-quality, cost-effective care.

On July 31, 2014, CMS released its notice of final rulemaking for fiscal year 2015 (the “2015 Rule”) for IRFs under the prospective payment system (“IRF-PPS”). The proposed rule will implement a net 2.2% market basket increase effective for discharges between October 1, 2014 and September 30, 2015, calculated as follows:

Market basket update	2.9%
Healthcare reform reduction	20 basis points
Productivity adjustment	50 basis points

The final rule also includes other changes that impact our hospital-by-hospital base rate for Medicare reimbursement. Such changes include, but are not limited to, freezing the update to the IRF-PPS facility-level rural adjustment factor, low-income patient factor, and teaching status adjustment factor and updating 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 final rule’s release and incorporates other adjustments included in the final rule, we believe the 2015 Rule will result in a net increase to our Medicare payment rates of approximately 2.3% effective October 1, 2014, prior to the impact of sequestration.

Additionally, the final rule introduces, beginning on October 1, 2015, a new data collection requirement that will capture the minutes and mode (individual, group, concurrent, or co-treatment) of therapy by specialty. CMS plans to use this data to potentially support future rule making in this area. Further, the final rule includes revisions to the list of codes used by CMS to presumptively test compliance with the 60% Rule. The post-amputation codes that CMS plans to eliminate represented approximately 0.5% of our 2013 Medicare discharges. CMS also will require reporting of two new quality measures, beginning January 1, 2015, and will conduct validation audits to ensure the completeness and accuracy of the quality data submitted.

In October 2014, the President signed into law the Improving Medicare Post-Acute Care Transformation Act of 2014 (the “IMPACT Act”). The IMPACT Act was developed on a bi-partisan basis by the House Ways and Means and Senate Finance Committees and incorporated feedback from healthcare providers and provider organizations that responded to the Committees’ solicitation of post-acute payment reform ideas and proposals. It directs the United States Department of Health and Human Services (“HHS”), in consultation with healthcare stakeholders, to implement standardized data collection processes for post-acute quality and outcome measures. Although the IMPACT Act does not specifically call for the development of a new post-acute payment system, we believe this act will lay the foundation for possible future post-acute payment policies that would be based on patients’

medical conditions and other clinical factors rather than the setting where the care is provided. It will create additional data reporting requirements for our hospitals and home health agencies, and we expect to fully comply with these requirements. The precise details of these new reporting requirements, including timing and content, will be developed and implemented by CMS through the regulatory process that we expect will take place over the next several years. While we cannot quantify the potential financial effects of the IMPACT Act on HealthSouth, we believe any post-acute payment system that is data-driven and focuses on the needs and underlying medical conditions of post-acute patients ultimately will be a net positive for providers who offer high-quality, cost-effective care. However, it will likely take years for the related quality measures to be established, quality data to be gathered, standardized patient assessment data to be assembled and disseminated, and potential payment policies to be developed, tested, and promulgated. As the nation’s largest owner and operator of inpatient rehabilitation hospitals, we look forward to working with HHS, the Medicare Payment Advisory Commission, and other healthcare stakeholders on these initiatives.

- Maintaining Strong Volume Growth. Various factors may impact our ability to maintain our recent volume growth rates, including competition and increasing regulatory and administrative burdens. In any particular market, we may encounter competition from local or national entities with longer operating histories or other competitive advantages, such as acute care hospitals with their own rehabilitation units and other post-acute providers with relationships with referring acute care hospitals or physicians. Aggressive payment review practices by Medicare contractors, aggressive enforcement of regulatory policies by government agencies, and restrictive or burdensome rules, regulations or statutes governing admissions practices may lead us to not accept patients who would be appropriate for and would benefit from the services we provide. In addition, from time to time, we must get regulatory approval to add beds to our existing hospitals in states with certificate of need laws. This approval may be withheld or take longer than expected. In the case of new store volume growth, the addition of hospitals to our portfolio, whether de novo construction or the product of acquisitions or joint ventures, also may be difficult and take longer than expected.
- Recruiting and Retaining High-Quality Personnel. See Item 1A, Risk Factors, to the 2013 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.

See also Item 1, Business, Item 1A, Risk Factors, and Item 7, Management’s Discussion and Analysis of Financial Condition and Results of Operations, “Executive Overview—Key Challenges,” to the 2013 Form 10 K.

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 attempting to position the Company to respond to changes in the healthcare delivery system and believe we will be ready to take advantage of opportunities that arise as the industry moves to this new stage. We believe we are postured to continue to grow, adapt to external events, and create value for our shareholders in 2014 and beyond.

Results of Operations

Payor Mix

During the three and nine months ended September 30, 2014 and 2013, we derived consolidated Net operating revenues from the following payor sources:

	Three Months Ended September 30,				Nine Months Ended September 30,			
	2014		2013		2014		2013	
Medicare	73.5	%	74.1	%	74.1	%	74.5	%
Medicaid	2.2	%	1.5	%	1.8	%	1.2	%
Workers' compensation	1.1	%	1.3	%	1.2	%	1.3	%
Managed care and other discount plans, including Medicare Advantage	18.8	%	18.7	%	18.6	%	18.5	%
Other third-party payors	1.8	%	1.7	%	1.7	%	1.7	%
Patients	1.1	%	1.1	%	1.0	%	1.1	%
Other income	1.5	%	1.6	%	1.6	%	1.7	%
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 2013 Form 10-K.

Our Results

For the three and nine months ended September 30, 2014 and 2013, our consolidated results of operations were as follows:

	Three Months Ended September 30,		Percentage Change	Nine Months Ended September 30,		Percentage Change
	2014	2013	2014 vs. 2013	2014	2013	2014 vs. 2013
	(In Millions, Except Percentage Change)					
Net operating revenues	$596.9	$564.0	5.8 %	$1,792.5	$1,701.1	5.4 %
Less: Provision for doubtful accounts	(8.2)	(8.0)	2.5 %	(25.0)	(22.4)	11.6 %
Net operating revenues less provision for doubtful accounts	588.7	556.0	5.9 %	1,767.5	1,678.7	5.3 %
Operating expenses:						
Salaries and benefits	290.0	269.5	7.6 %	861.4	817.7	5.3 %
Hospital-related expenses:						
Other operating expenses	89.4	82.2	8.8 %	260.2	241.3	7.8 %
Occupancy costs	10.3	11.7	(12.0)%	31.1	35.8	(13.1)%
Supplies	26.6	25.5	4.3 %	82.0	78.3	4.7 %
General and administrative expenses	27.5	28.8	(4.5)%	88.4	88.5	(0.1)%
Depreciation and amortization	27.4	24.3	12.8 %	80.2	69.5	15.4 %
Government, class action, and related settlements	—	(21.3)	(100.0)%	(0.8)	(23.3)	(96.6)%
Professional fees—accounting, tax, and legal	4.0	4.2	(4.8)%	7.6	7.8	(2.6)%
Total operating expenses	475.2	424.9	11.8 %	1,410.1	1,315.6	7.2 %
Interest expense and amortization of debt discounts and fees	27.8	25.3	9.9 %	83.5	73.9	13.0 %
Other income	(0.2)	(0.6)	(66.7)%	(30.1)	(3.2)	840.6 %
Equity in net income of nonconsolidated affiliates	(1.9)	(2.0)	(5.0)%	(8.8)	(8.2)	7.3 %
Income from continuing operations before income tax expense (benefit)	87.8	108.4	(19.0)%	312.8	300.6	4.1 %
Provision for income tax expense (benefit)	22.1	35.2	(37.2)%	91.4	(17.8)	(613.5)%
Income from continuing operations	65.7	73.2	(10.2)%	221.4	318.4	(30.5)%
(Loss) income from discontinued operations, net of tax	(0.9)	(0.9)	— %	2.8	(1.2)	(333.3)%
Net income	64.8	72.3	(10.4)%	224.2	317.2	(29.3)%
Less: Net income attributable to noncontrolling interests	(14.7)	(14.1)	4.3 %	(44.3)	(42.5)	4.2 %
Net income attributable to HealthSouth	$50.1	$58.2	(13.9)%	$179.9	$274.7	(34.5)%

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

	Three Months Ended September 30,				Nine Months Ended September 30,			
	2014		2013		2014		2013	
Provision for doubtful accounts	1.4	%	1.4	%	1.4	%	1.3	%
Operating expenses:								
Salaries and benefits	48.6	%	47.8	%	48.1	%	48.1	%
Hospital-related expenses:								
Other operating expenses	15.0	%	14.6	%	14.5	%	14.2	%
Occupancy costs	1.7	%	2.1	%	1.7	%	2.1	%
Supplies	4.5	%	4.5	%	4.6	%	4.6	%
General and administrative expenses	4.6	%	5.1	%	4.9	%	5.2	%
Depreciation and amortization	4.6	%	4.3	%	4.5	%	4.1	%
Government, c								