HEALTHSOUTH CORP
Form 10-Q
May 09, 2007

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, DC 20549

FORM 10-Q

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d)

OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended March 31, 2007

Commission File Number 000-14940

HealthSouth Corporation

(Exact name of Registrant as specified in its Charter)

Delaware	**63-0860407**
(State or Other Jurisdiction of Incorporation or Organization)	**(I.R.S. Employer Identification No.)**
One HealthSouth Parkway Birmingham, Alabama	**35243**
(Address of Principal Executive Offices)	**(Zip Code)**

(205) 967-7116

(Registrant s telephone number)

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. Large accelerated filer x Accelerated filer o Non-Accelerated filer o

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

The registrant had 78,735,788 shares of common stock outstanding, net of treasury shares, as of April 30, 2007.

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HealthSouth Corporation and Subsidiaries

Condensed Consolidated Balance Sheets

(Unaudited)

	March 31, 2007	December 31, 2006
	(In Millions, Except Share Data)	
Assets		
Current assets:		
Cash and cash equivalents	$ 26.2	$ 27.2
Current portion of restricted cash	53.8	67.8
Current portion of restricted marketable securities	16.4	37.5
Accounts receivable, net of allowance for doubtful accounts of $36.9 in 2007; $36.4 in 2006	224.3	217.3
Insurance recoveries receivable	230.0	230.0
Other current assets	81.1	78.1
Current assets held for sale	217.4	222.4
Total current assets	849.2	880.3
Property and equipment, net	792.3	811.5
Goodwill	406.1	406.1
Intangible assets, net	29.5	30.4
Investment in and advances to nonconsolidated affiliates	39.6	40.2
Assets held for sale	794.1	830.9
Income tax refund receivable	207.0	218.8
Other long-term assets	120.0	142.6
Total assets	$ 3,237.8	$ 3,360.8
Liabilities and Shareholders Deficit		
Current liabilities:		
Current portion of long-term debt	$ 44.0	$ 33.6
Accounts payable	62.5	67.5
Accrued expenses and other current liabilities	405.0	362.0
Refunds due patients and other third-party payors	15.6	12.8
Government, class action, and related settlements	523.3	570.6
Current liabilities held for sale	196.7	215.0
Total current liabilities	1,247.1	1,261.5
Long-term debt, net of current portion	3,294.5	3,343.1
Liabilities held for sale	44.6	40.6
Other long-term liabilities	253.7	241.7
	4,839.9	4,886.9
Commitments and contingencies		
Minority interest in equity of consolidated affiliates	262.5	271.1
Convertible perpetual preferred stock, $.10 par value; 1,500,000 shares authorized; 400,000 issued in 2007 and 2006; liquidation preference of $1,000 per share	387.4	387.4
Shareholders deficit:		
Common stock, $.01 par value; 200,000,000 shares authorized; issued: 88,086,727 in 2007; 87,999,513 in 2006	0.9	0.9
Capital in excess of par value	2,847.1	2,849.5
Accumulated deficit	(4,774.7)	(4,713.9)
Accumulated other comprehensive (loss) income	(1.8)	1.6
Treasury stock, at cost (9,350,939 shares in 2007 and 9,320,001 shares in 2006)	(323.4)	(322.6)
Notes receivable from shareholders, officers, and management employees	(0.1)	(0.1)
Total shareholders deficit	(2,252.0)	(2,184.6)
Total liabilities and shareholders deficit	$ 3,237.8	$ 3,360.8

The accompanying notes to condensed consolidated financial

statements are an integral part of these condensed balance sheets.

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HealthSouth Corporation and Subsidiaries

Condensed Consolidated Statements of Operations and Comprehensive Loss

(Unaudited)

	Three Months Ended March 31, 2007	**2006**
	(In Millions, Except Per Share Data)	
Net operating revenues	$ 448.6	$ 441.6
Operating expenses:		
Salaries and benefits	217.4	206.4
Other operating expenses	70.3	63.6
General and administrative expenses	44.7	40.9
Supplies	26.3	25.6
Professional fees accounting, tax, and legal	21.8	48.6
Depreciation and amortization	18.2	20.2
Occupancy costs	13.3	13.1
Provision for doubtful accounts	10.6	7.4
Loss on disposal of assets		0.9
Government, class action, and related settlements expense	(12.2)	4.3
Total operating expenses	410.4	431.0
Loss on early extinguishment of debt		361.1
Interest expense and amortization of debt discounts and fees	58.5	59.9
Other income	(4.8)	(3.8)
Loss on interest rate swap	4.3	3.8
Equity in net income of nonconsolidated affiliates	(2.7)	(1.9)
Minority interests in earnings of consolidated affiliates	8.8	10.6
Loss from continuing operations before income tax expense	(25.9)	(419.1)
Provision for income tax expense	3.3	13.7
Loss from continuing operations	(29.2)	(432.8)
Loss from discontinued operations, net of income tax expense	(27.4)	(2.3)
Net loss	$ (56.6)	$ (435.1)
Convertible perpetual preferred dividends	(6.5)	
Net loss available to common shareholders	$ (63.1)	$ (435.1)
Comprehensive loss:		
Net loss	$ (56.6)	$ (435.1)
Other comprehensive loss, net of tax:		
Foreign currency translation adjustment	0.1	(0.4)
Unrealized loss on available-for-sale securities	(3.5)	
Other comprehensive loss	(3.4)	(0.4)
Comprehensive loss	$ (60.0)	$ (435.5)
Weighted average common shares outstanding:		
Basic	78.7	79.5
Diluted	92.1	83.0
Basic and diluted loss per common share:		
Loss from continuing operations available to common shareholders	$ (0.45)	$ (5.44)
Loss from discontinued operations, net of income tax expense	(0.35)	(0.03)
Net loss per share available to common shareholders	$ (0.80)	$ (5.47)

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)

	Three Months Ended March 31, 2007	2006
	(In Millions)	
Net cash used in operating activities	$ (5.8)	$ (73.1)
Cash flows from investing activities:		
Capital expenditures	(6.0)	(7.1)
Proceeds from disposal of assets		3.1
Proceeds from sale and maturities of marketable securities		31.2
Proceeds from sale and maturities of restricted marketable securities	65.0	
Purchase of investments		(8.1)
Purchase of restricted investments	(10.0)	
Proceeds from sale of equity interests of consolidated affiliates	2.3	10.0
Repurchase of equity interests of consolidated affiliates	(1.6)	(2.6)
Net cash settlement on interest rate swap	0.6	
Net change in restricted cash	14.0	15.5
Other	0.3	(0.1)
Net cash (used in) provided by investing activities of discontinued operations	(1.4)	8.3
Net cash provided by investing activities	63.2	50.2
Cash flows from financing activities:		
Checks in excess of bank balance	26.1	(11.3)
Principal borrowing on notes		3,050.0
Principal payments on debt	(5.2)	(3,400.0)
Borrowings on revolving credit facility	10.0	50.0
Payments on revolving credit facility	(40.0)	
Principal payments under capital lease obligations	(3.2)	(3.4)
Issuance of convertible perpetual preferred stock		400.0
Dividends paid on convertible perpetual preferred stock	(6.5)	
Preferred stock issuance costs		(12.6)
Debt amendment and issuance costs	(11.1)	(66.7)
Distributions to minority interests of consolidated affiliates	(23.1)	(19.2)
Other	(0.1)	(0.1)
Net cash used in financing activities of discontinued operations	(0.8)	(2.0)
Net cash used in financing activities	(53.9)	(15.3)
Effect of exchange rate on cash and cash equivalents	0.1	(0.4)
Increase (decrease) in cash and cash equivalents	3.6	(38.6)
Cash and cash equivalents at beginning of period	27.2	166.4
Cash and cash equivalents of divisions and facilities held for sale at beginning of period	14.1	11.2
Less: Cash and cash equivalents of divisions and facilities held for sale at end of period	(18.7)	(22.2)
Cash and cash equivalents at end of period	$ 26.2	$ 116.8

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 one of the largest providers of health care services in the United States, with a focus in the inpatient rehabilitation industry. References herein to HealthSouth, the Company, we, our, or us refer to HealthSouth Corporation and its subsidiaries unless otherwise stated or indicated by context.

The accompanying unaudited condensed consolidated financial statements of HealthSouth Corporation and Subsidiaries should be read in conjunction with the consolidated financial statements and accompanying notes filed with the United States Securities and Exchange Commission (the SEC) in HealthSouth s Current Report on Form 8-K filed on March 30, 2007 (the March 2007 Form 8-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 (GAAP) have been omitted in these interim statements, as allowed by such SEC rules and regulations. The condensed consolidated balance sheet as of December 31, 2006 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.

On August 14, 2006, we announced that we would begin exploring a range of strategic alternatives to enhance stockholder value and to reposition our primary focus on the post-acute care sector. As a result of the exploration of such alternatives, the following events occurred in the first quarter of 2007:

1. As previously reported, on January 27, 2007, we entered into an agreement with Select Medical Corporation (Select Medical), a privately owned operator of specialty hospitals and outpatient rehabilitation facilities, to sell our outpatient rehabilitation division for approximately $245 million in cash, subject to certain adjustments. This transaction closed on May 1, 2007. See also Note 6, *Assets Held for Sale and Results of Discontinued Operations*.
2. As previously reported, on March 25, 2007, we entered into an agreement to sell our surgery centers division to ASC Acquisition LLC (the Buyer), a Delaware limited liability company and newly formed affiliate of TPG Partners V, L.P. (TPG), a private investment partnership. The purchase price consists of cash consideration of $920 million, subject to certain adjustments, and a contingent option to acquire up to a 5% equity interest in the new company. This transaction is expected to be completed in the third quarter of 2007 and is subject to customary closing conditions.
3. Our board of directors determined that it is in the best interest of the Company and its stockholders to divest our diagnostic division. During the first quarter of 2007, our financial advisor for this divestiture, Deutsche Bank Securities, Inc., in conjunction with our management, continued the solicitation of interest from third parties regarding their desire to acquire our diagnostic division. As a result of these actions, this division meets the criteria of Financial Accounting Standards Board (FASB) Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, to be classified as held for sale. In addition, on April 19, 2007, we entered into an agreement with an affiliate of The Gores Group, a private equity firm, to sell our diagnostic division for approximately $47.5 million. This transaction is expected to be completed by the end of June or early in the third quarter of 2007 and is subject to customary closing conditions.

As a result of the foregoing, our surgery centers, outpatient, and diagnostic divisions are reported as held for sale in our condensed consolidated balance sheets and in discontinued operations in our condensed consolidated

HealthSouth Corporation and Subsidiaries

Notes to Condensed Consolidated Financial Statements

statements of operations and comprehensive loss and our condensed consolidated statements of cash flows in accordance with FASB Statement No. 144.

The proceeds of these divestitures will be used to deleverage the Company, thereby allowing us to pursue growth opportunities in inpatient rehabilitative care and complementary post-acute businesses. In March 2007, we amended our Credit Agreement (as defined in Note 9, *Long-term Debt*, to the consolidated financial statements included in our March 2007 Form 8-K) and received the appropriate lender approvals for our divestiture activities. There can be no assurances that the surgery centers division and diagnostic division transactions described above will be consummated on the terms set forth above, if at all.

Historically, we have reported five segments: inpatient, surgery centers, outpatient, diagnostic, and corporate and other. Based on our strategic focus in the inpatient rehabilitation industry and the reclassification of our surgery centers, outpatient, and diagnostic divisions to discontinued operations, we have modified our segment reporting from five reportable segments to one reportable segment in the first quarter of 2007. Amounts historically reported as part of our corporate and other segment, which primarily represented the corporate overhead costs associated with our operating divisions, are no longer considered a reportable segment by our chief operating decision maker due to our strategic repositioning as a pure-play post-acute care provider and the change in the manner in which we now manage the Company. Rather, these corporate overhead costs are now presented on the line entitled *General and administrative expenses* in our condensed consolidated statements of operations and comprehensive loss (see Reclassifications below). Therefore, the condensed consolidated results of operations of the Company presented herein represent the continuing operations of our inpatient division, including corporate overhead. Our condensed consolidated results of operations include overhead costs associated with managing and providing shared services to our surgery centers, outpatient, and diagnostic divisions, even though these divisions qualify as discontinued operations.

See also Note 5, *Long-term Debt*, for information regarding the allocation of interest expense to discontinued operations.

Reclassifications

Certain financial results have been reclassified to conform to the current period presentation. Such reclassifications primarily relate to the qualification of our surgery centers, outpatient, and diagnostic divisions as held for sale and discontinued operations under FASB Statement No. 144. These reclassifications also relate to inpatient facilities we closed or sold in the three months ended March 31, 2007 that qualify under FASB Statement No. 144 to be reported as discontinued operations. We reclassified our condensed consolidated balance sheet as of December 31, 2006 to show the assets and liabilities of these qualifying divisions and facilities as held for sale. We also reclassified our condensed consolidated statement of operations and comprehensive loss and our condensed consolidated statement of cash flows for the three months ended March 31, 2006 to show the results of those qualifying divisions and facilities as discontinued operations. In conjunction with our segment change described above, we also reclassified certain expenses considered to be corporate overhead historically reported primarily within the lines entitled *Salaries and benefits* and *Other operating expenses* into *General and administrative expenses* in our condensed consolidated statements of operations and comprehensive loss. These expenses primarily include administrative expenses such as corporate accounting, internal controls, legal, and information technology services.

Marketable Securities

As disclosed in Note 1, *Summary of Significant Accounting Policies*, Marketable Securities, to the consolidated financial statements included in our March 2007 Form 8-K, we record all investments in debt and equity securities with readily determinable fair values and for which we do not exercise significant influence as available-for-sale securities in accordance with FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*.

HealthSouth Corporation and Subsidiaries

Notes to Condensed Consolidated Financial Statements

As of December 31, 2006, we had approximately $71.1 million of restricted marketable securities included in our condensed consolidated balance sheet, of which approximately $33.6 million is included in *Other long-term assets*. These marketable securities represent assets held at our wholly owned insurance captive, HCS, Ltd. (HCS), in the Cayman Islands. HCS handles professional liability, workers compensation, and other insurance claims on behalf of HealthSouth. These funds are committed to pay third-party administrators for claims incurred and are restricted by insurance regulations and requirements in the Cayman Islands. During the first quarter of 2007, it was determined that there was excess cash and investments associated with HCS. We received the permission of the Cayman Islands Monetary Authority to advance approximately $65.0 million of these excess funds from HCS to HealthSouth. The funds advanced to HealthSouth included cash that resulted from the liquidation of certain of these marketable securities. HealthSouth used the advance to fund current operations.

Recent Accounting Pronouncements

Since the filing of our 2006 Annual Report on Form 10-K (the 2006 Form 10-K), we do not believe any recently issued, but not yet effective, accounting standards will have a material effect on our consolidated financial position, results of operations, or cash flows.

2. Liquidity:

We are highly leveraged. As of March 31, 2007, we had approximately $3.3 billion of long-term debt outstanding, including approximately $140.0 million drawn under our $400 million revolving credit facility (excluding approximately $21.5 million utilized under the revolving letter of credit subfacility). Amounts were drawn from the revolving credit facility primarily due to the timing of interest payments, government settlement payments (as discussed in Note 9, *Settlements*), costs incurred related to our divestiture activities, and fees associated with the amendment to our Credit Agreement (see Note 5, *Long-term Debt*, to these condensed consolidated financial statements and Note 9, *Long-term Debt*, to the consolidated financial statements included in our March 2007 Form 8-K). Based on our current borrowing capacity and leverage ratio required under our Credit Agreement, we do not believe there is significant risk in our ability to make additional draws under our revolving credit facility, if needed.

The biggest risk relating to our high leverage is the possibility that a substantial down-turn in operating earnings could jeopardize our ability to service our debt payment obligations. See Note 1, *Summary of Significant Accounting Policies*, to the consolidated financial statements included in our March 2007 Form 8-K for a discussion of risks and uncertainties facing us. Changes in our business or other factors may occur that might have a material adverse impact on our financial position, results of operations, and cash flows.

3. Guarantees:

In conjunction with the sale of certain facilities in prior periods, HealthSouth assigned the leases of certain properties to certain purchasers and, as a condition of the lease, agreed to act as a guarantor of the purchaser s performance on the lease. Should the purchaser fail to pay the rent due on these leases, the lessor would have contractual recourse against us.

As of March 31, 2007, we had entered into nine such lease guarantee arrangements. The remaining terms of these leases range from 4 months to 147 months. If we were required to perform under all such guarantees, the maximum amount we would be required to pay approximates $21.7 million.

We have not recorded a liability for these guarantees, as we do not believe it is probable we will have to perform under these agreements. If we are required to perform under these guarantees, we could potentially have recourse against the purchaser for recovery of any amounts paid. These guarantees are not secured by any assets under the leases. As of March 31, 2007, we have not been required to perform under any such lease guarantees.

HealthSouth Corporation and Subsidiaries

Notes to Condensed Consolidated Financial Statements

4. Investment in and Advances to Nonconsolidated Affiliates:

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

	Three Months Ended March 31, 2007	2006
Net operating revenues	$ 16.7	$ 14.9
Operating expenses	(10.4)	(10.0)
Income from continuing operations	6.3	4.9
Net income	$ 6.2	$ 4.6

5. Long-term Debt:

Our long-term financing obligations outstanding consist of the following (in millions):

	March 31, 2007	December 31, 2006
Advances under $400 million revolving credit facility	$ 140.0	$ 170.0
Term Loan Facility	2,034.6	2,039.8
Bonds Payable		
7.000% Senior Notes due 2008	5.0	5.0
10.750% Senior Subordinated Notes due 2008	30.2	30.2
8.500% Senior Notes due 2008	9.4	9.4
8.375% Senior Notes due 2011	0.3	0.3
7.625% Senior Notes due 2012	1.5	1.5
Floating Rate Senior Notes due 2014	375.0	375.0
10.75% Senior Notes due 2016	616.1	615.9
Notes payable to banks and others at interest rates from 9.8% to 12.9%	5.0	5.0
Capital lease obligations	121.4	124.6
	3,338.5	3,376.7
Less: Current portion	(44.0)	(33.6)
Long-term debt, less current portion	$ 3,294.5	$ 3,343.1

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
April 1 through December 31, 2007	$ 25.8	$ 25.3
2008	80.3	79.6
2009	36.9	36.2
2010	37.6	36.8
2011	33.3	32.4
2012	171.5	170.5
Thereafter	2,962.0	2,957.7
Total	$ 3,347.4	$ 3,338.5

HealthSouth Corporation and Subsidiaries

Notes to Condensed Consolidated Financial Statements

As discussed in Note 1, *Basis of Presentation*, we closed the transaction to sell our outpatient division to Select Medical on May 1, 2007. As of May 7, 2007, we had used approximately $197 million of the net proceeds from this transaction to reduce debt outstanding under our Credit Agreement.

Due to the requirements under our Credit Agreement to use the net proceeds from each divestiture (as discussed in Note 1, *Basis of Presentation*) to repay obligations outstanding under our Credit Agreement, and in accordance with the guidance in Emerging Issues Task Force Issue No. 87-24, Allocation of Interest to Discontinued Operations, we allocated the interest expense on the debt that is required to be repaid as a result of the disposal transactions to discontinued operations in all periods presented. The following table provides information regarding our total *Interest expense and amortization of debt discounts and fees* presented in our condensed consolidated statements of operations and comprehensive loss for both continuing and discontinued operations (in millions):

	Three Months Ended March 31,			
	2007		**2006**	
Continuing operations:				
Interest expense	$	56.5	$	51.1
Amortization of debt discounts	0.1		1.1	
Amortization of consent fees/bond issue costs	0.5		5.0	
Amortization of loan fees	1.4		2.7	
Total interest expense and amortization of debt discounts and fees for continuing operations	58.5		59.9	
Discontinued operations:				
Interest expense	24.4		26.2	
Total interest expense for discontinued operations	24.4		26.2	
Total interest expense and amortization of debt discounts and fees	$	82.9	$	86.1

For a description of our indebtedness, see Note 9, *Long-term Debt*, to the consolidated financial statements included in our March 2007 Form 8-K.

On March 12, 2007, we announced that we had amended our existing Credit Agreement to lower the applicable interest rates and modify certain other covenants. The amendment and related supplement reduced the interest rate on our Term Loan Facility to LIBOR plus 2.5% (formerly LIBOR plus 3.25%), as well as reduced the applicable participation rate on the $100 million synthetic letter of credit facility to 2.5% (formerly 3.25%). The amendment also gave us the appropriate approvals required for our divestiture activities.

HealthSouth Corporation and Subsidiaries

Notes to Condensed Consolidated Financial Statements

6. Assets Held for Sale and Results of Discontinued Operations:

For the divisions and facilities identified during the three months ended March 31, 2007 that met the requirements of FASB Statement No. 144, we reclassified our condensed consolidated balance sheet as of December 31, 2006 to show the assets and liabilities of those divisions and facilities as held for sale. We also reclassified our condensed consolidated statement of operations and comprehensive loss and our condensed consolidated statement of cash flows for the three months ended March 31, 2006 to show the results of those divisions and facilities as discontinued operations. The operating results of discontinued operations, including the allocation of $24.1 million and $22.9 million of interest expense in the three months ended March 31, 2007 and 2006, respectively, (as discussed in Note 5, *Long-term Debt*), are as follows (in millions):

	Three Months Ended March 31,	
	2007	**2006**
Net operating revenues	$ 309.3	$ 361.6
Costs and expenses	296.9	362.7
Impairments	35.9	0.5
Loss from discontinued operations	(23.5)	(1.6)
Gain on disposal of assets of discontinued operations		3.5
Income tax expense	(3.9)	(4.2)
Loss from discontinued operations	$ (27.4)	$ (2.3)

As discussed in Note 10, *Contingencies*, we have recorded charges related to ongoing negotiations with certain of our subsidiary partnerships related to the restatement of their historical financial statements. The portion of these charges that is attributable to partnerships of our surgery centers division has been included in our results of discontinued operations. No charges were made to partnerships in our outpatient or diagnostic divisions during the periods presented. We have and may continue to incur additional charges related to these ongoing negotiations with our partners.

As discussed in Note 1, *Summary of Significant Accounting Policies*, to the consolidated financial statements included in our March 2007 Form 8-K, we insure a substantial portion of our professional liability, general liability, and workers compensation risks through a self-insured retention program underwritten by our consolidated wholly owned offshore captive insurance subsidiary, HCS, Ltd., which we fund annually. Expenses for retained professional and general liability risks and workers compensation risks associated with our surgery centers, outpatient, and diagnostic divisions have been included in our results of discontinued operations.

HealthSouth Corporation and Subsidiaries

Notes to Condensed Consolidated Financial Statements

Assets and liabilities held for sale consist of the following (in millions):

	March 31, 2007	December 31, 2006
Assets:		
Cash and cash equivalents	$ 18.7	$ 14.1
Current portion of restricted cash	35.7	35.7
Accounts receivable, net	152.0	157.5
Other current assets	11.0	15.1
Total current assets	217.4	222.4
Property and equipment, net	256.0	287.1
Goodwill	491.3	490.9
Intangible assets, net	19.4	25.7
Other long-term assets	27.4	27.2
Total long-term assets	794.1	830.9
Total assets	$ 1,011.5	$ 1,053.3
Liabilities:		
Current portion of long-term debt	$ 3.4	$ 3.4
Accounts payable	31.1	38.8
Accrued expenses and other current liabilities	85.8	83.9
Refunds due patients and other third-party payors	76.4	88.9
Total current liabilities	196.7	215.0
Long-term debt, net of current portion	21.4	22.2
Other long-term liabilities	23.2	18.4
Total long-term liabilities	44.6	40.6
Total liabilities	$ 241.3	$ 255.6

Refunds due patients and other third-party payors consist primarily of overpayments received from our patients and other third-party payors. In instances where we are unable to determine the party due the refund, these amounts can become subject to escheat property laws and payable to various tax jurisdictions. These liabilities will remain with HealthSouth after each transaction closes. We are negotiating the settlement of these amounts with third-party payors and various tax jurisdictions. The result of these ongoing settlement negotiations may impact the carrying value of these liabilities.

Our condensed consolidated financial statements include all assets, liabilities, revenues, and expenses of less-than-100%-owned affiliates that we control. Accordingly, we have recorded minority interests in the earnings and equity of such entities. As of March 31, 2007 and December 31, 2006, approximately $168.5 million and $183.7 million, respectively, of our consolidated *Minority interest in equity of consolidated affiliates* represents minority interests associated with our surgery centers, outpatient, and diagnostic divisions.

HealthSouth Corporation and Subsidiaries

Notes to Condensed Consolidated Financial Statements

As discussed in Note 1, *Basis of Presentation*, we have entered into an agreement to sell our surgery centers division to an affiliate of TPG. This transaction is expected to close in the third quarter of 2007. The assets and liabilities of the surgery centers division reported as held for sale consist of the following (in millions):

	March 31, 2007	**December 31, 2006**
Assets:		
Cash and cash equivalents	$ 14.9	$ 12.0
Current portion of restricted cash	31.8	31.8
Accounts receivable, net	82.3	84.5
Other current assets	6.2	9.0
Total current assets	135.2	137.3
Property and equipment, net	185.7	181.3
Goodwill	462.9	462.5
Intangible assets, net	15.9	17.8
Investment in and advances to nonconsolidated affiliates	15.9	20.2
Other long-term assets	6.8	3.9
Total long-term assets	687.2	685.7
Total assets	$ 822.4	$ 823.0
Liabilities:		
Current portion of long-term debt	$ 2.2	$ 2.2
Accounts payable	19.2	22.4
Accrued expenses and other current liabilities	51.3	46.8
Refunds due patients and other third-party payors	22.5	26.8
Total current liabilities	95.2	98.2
Long-term debt, net of current portion	17.4	17.9
Other long-term liabilities	12.4	7.3
Total long-term liabilities	29.8	25.2
Total liabilities	$ 125.0	$ 123.4

The operating results of the surgery centers division included in discontinued operations consist of the following (in millions):

	Three Months Ended March 31,	
	2007	**2006**
Net operating revenues	$ 188.0	$ 194.6
Costs and expenses	175.6	189.1
Impairments	3.0	
Income from discontinued operations	9.4	5.5
Gain on disposal of assets of discontinued operations	1.6	11.0
Income tax expense	(3.9)	(4.2)
Income from discontinued operations	$ 7.1	$ 12.3

As a result of the disposition of our surgery centers division, we expect to record an approximate $325 million to $360 million gain on disposal in the third quarter of 2007. In connection with this divestiture, we will enter into a transition services agreement (TSA) with an affiliate of TPG whereby we will continue to provide back office services related to the operations of our surgery centers division. These back office services include certain information technology, accounting and finance, and human resource support services, among others. Services are expected to be provided for periods of up to 12 months, although certain services are subject to short extension periods. TPG will compensate us for these services, as outlined in the TSA. Such compensation is not expected to be material to either HealthSouth or the operations of the surgery centers division.

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As discussed in Note 1, *Basis of Presentation*, during the first quarter of 2007, we entered into an agreement with Select Medical to sell our outpatient rehabilitation division. This transaction closed on May 1, 2007. In connection with the closing of the sale of this division, we entered into a letter agreement with Select Medical whereby we agreed, among other things, that we would retain certain outpatient facilities until certain state regulatory approvals for the transfer of such facilities to Select Medical have been received. In that regard, we entered into agreements with Select Medical whereby Select Medical will manage certain operations of the applicable facilities until such approvals have been received. Approximately $24 million of the $245 million purchase price was withheld pending the transfer of these facilities.

The assets and liabilities of the outpatient division reported as held for sale consist of the following (in millions):

	March 31, 2007	**December 31, 2006**
Assets:		
Cash and cash equivalents	$ 0.6	$ 0.6
Accounts receivable, net	36.9	37.1
Other current assets	1.7	1.5
Total current assets	39.2	39.2
Property and equipment, net	29.5	32.8
Goodwill	28.4	28.4
Intangible assets, net	3.5	3.7
Other long-term assets	0.1	0.3
Total long-term assets	61.5	65.2
Total assets	$ 100.7	$ 104.4
Liabilities:		
Current portion of long-term debt	$ 0.7	$ 0.7
Accounts payable	2.5	2.9
Accrued expenses and other current liabilities	20.0	22.8
Refunds due patients and other third-party payors	40.7	46.7
Total current liabilities	63.9	73.1
Long-term debt, net of current portion	2.1	2.2
Other long-term liabilities	2.8	3.0
Total long-term liabilities	4.9	5.2
Total liabilities	$ 68.8	$ 78.3

The operating results of the outpatient division included in discontinued operations consist of the following (in millions):

	Three Months Ended March 31, 2007	**2006**
Net operating revenues	$ 80.3	$ 89.9
Costs and expenses	73.0	85.6
Impairments	0.2	
Income from discontinued operations	7.1	4.3
Loss on disposal of assets of discontinued operations	(1.2)	(0.2)
Income tax expense		
Income from discontinued operations	$ 5.9	$ 4.1

As a result of the disposition of our outpatient division, we expect to record an approximate $120 million to $155 million gain on disposal in the second quarter of 2007.

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As discussed in Note 1, *Basis of Presentation*, our diagnostic division met the criteria of FASB Statement No. 144 to be classified as held for sale and discontinued operations as of March 31, 2007. The assets and liabilities of the diagnostic division reported as held for sale consist of the following (in millions):

	March 31, 2007	December 31, 2006
Assets:		
Cash and cash equivalents	$ 1.3	$ 1.0
Accounts receivable, net	27.0	29.4
Other current assets	1.5	2.3
Total current assets	29.8	32.7
Property and equipment, net	40.4	72.3
Intangible assets, net		4.2
Other long-term assets	0.7	0.7
Total long-term assets	41.1	77.2
Total assets	$ 70.9	$ 109.9
Liabilities:		
Current portion of long-term debt	$ 0.6	$ 0.5
Accounts payable	7.5	11.5
Accrued expenses and other current liabilities	8.9	9.1
Refunds due patients and other third-party payors	12.5	14.3
Total current liabilities	29.5	35.4
Long-term debt, net of current portion	1.9	2.1
Other long-term liabilities	4.8	4.5
Total long-term liabilities	6.7	6.6
Total liabilities	$ 36.2	$ 42.0

The operating results of the diagnostic division included in discontinued operations consist of the following (in millions):

	Three Months Ended March 31, 2007	2006
Net operating revenues	$ 38.9	$ 53.4
Costs and expenses	44.7	57.7
Impairments	32.7	0.5
Loss from discontinued operations	(38.5)	(4.8)
Gain on disposal of assets of discontinued operations	0.1	
Income tax expense		
Loss from discontinued operations	$ (38.4)	$ (4.8)

During the three months ended March 31, 2007, we wrote the intangible assets and certain long-lived assets of our diagnostic division down to their estimated fair value based on the estimated net proceeds to be received from the divestiture of the division. This charge is included in impairments in the above results of operations of our diagnostic division.

In connection with the divestiture of our diagnostic division, we will enter into a TSA with an affiliate of The Gores Group whereby we will continue to provide back office services related to the operations of our diagnostic division. These back office services include certain information technology, accounting and finance, and human resource support services, among others. Services are expected to be provided for periods up to 12 months. We will be compensated for these services, as outlined in the TSA. Such compensation is not expected to be material to either HealthSouth or the operations of the diagnostic division.

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7. Income Taxes:

Our *Provision for income tax expense* for the three months ended March 31, 2007 includes the following: (1) current income tax expense of $2.0 million attributable to state income taxes of subsidiaries which have separate state tax filing requirements, income taxes for other subsidiaries that are not included in our federal consolidated income tax return, and interest income accrued with respect to expected income tax refunds resulting from updated prior tax filings which are still in progress, and (2) deferred income tax expense of $1.3 million attributable to future tax liabilities to be incurred by subsidiaries that are not included in our federal consolidated income tax return and increases in the basis difference of certain indefinite-lived assets.

We have significant federal and state net operating losses. We assess the realization of our deferred tax assets quarterly to determine whether an adjustment to the valuation allowance is required. After consideration of all evidence, both positive and negative, management concluded that it is more likely than not that we will not realize a portion of our deferred tax assets. Therefore, a valuation allowance has been established on substantially all of our net deferred tax assets. No valuation allowance has been provided on deferred assets and liabilities attributable to subsidiaries not included within the federal consolidated group. The valuation allowance for the quarter also increased in part as a result of certain deferred tax liabilities that are indefinite-lived, which inherently means that the reversal period of these liabilities is unknown. Therefore, for scheduling the expected utilization of deferred tax assets as required by FASB Statement No. 109, *Accounting for Income Taxes*, these indefinite-lived liabilities cannot be looked upon as a source of future taxable income, and an additional valuation allowance must be established.

Our *Provision for income tax expense* for the same period in 2006 consisted of substantially the same items of current and deferred taxes, excluding an accrual for interest income with respect to expected income tax refunds. Income tax expense for the three months ended March 31, 2007 decreased due to the fact that we filed a request for a tax accounting method change in the first quarter of 2006 which accelerated the amortization of certain indefinite-lived assets. This tax accounting method change gave rise to an additional difference between the book and tax bases of the assets effected and, accordingly, resulted in our recording an additional deferred tax liability and deferred tax expense related to these indefinite-lived assets. The entire impact of this change of approximately $8.3 million was reflected in the three months ended March 31, 2006.

We adopted FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes*, on January 1, 2007. As a result of our adoption of FASB Interpretation No. 48, we recognized a $4.2 million increase to reserves for uncertain tax positions. This increase was accounted for as an addition to *Accumulated deficit* as of January 1, 2007. Including the cumulative effect increase to the reserves for uncertain tax positions, at the beginning of the year, we had approximately $277.2 million of total gross unrecognized tax benefits, of which approximately $253.3 million would affect our effective tax rate if recognized. However, we have a full valuation allowance recorded against our net deferred tax assets. Therefore, the combined effect on our federal effective tax rate would be zero. The amount of the unrecognized tax benefits did not change significantly during the three months ended March 31, 2007. Our continuing practice is to recognize interest and/or penalties related to income tax matters in income tax expense. For the three months ended March 31, 2007, we accrued $0.9 million of interest income. Total accrued interest income was $37.7 million and $36.8 million as of March 31, 2007 and December 31, 2006, respectively. Currently, we estimate a cash settlement with the applicable taxing authority will occur within 12 to 18 months for the majority of these unrecognized tax benefits.

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 our federal income tax liabilities with the Internal Revenue Service (the IRS) for the tax years 1994 through 1995. In May 2006, we received the IRS report and assessment of additional income taxes for the years 1996 through 1998. We filed a formal reply in July 2006 and are currently working to resolve the matters from this report and assessment. We expect to have all remaining open years under audit by the IRS in the near future. Amounts related to these tax deficiencies and other contingencies have been considered by management in its estimate of our potential net recovery of prior income taxes.

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8. Loss per Common Share:

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

	Three Months Ended March 31, 2007	2006
Numerator:		
Loss from continuing operations	$ (29.2)	$ (432.8)
Less: Convertible perpetual preferred stock dividends	(6.5)	
Loss from continuing operations available to common shareholders	(35.7)	(432.8)
Loss from discontinued operations, net of tax	(27.4)	(2.3)
Net loss available to common shareholders	$ (63.1)	$ (435.1)
Denominator:		
Basic weighted average common shares outstanding	78.7	79.5
Diluted weighted average common shares outstanding	92.1	83.0
Basic and diluted loss per common share:		
Loss from continuing operations available to common shareholders	$ (0.45)	$ (5.44)
Loss from discontinued operations, net of tax	(0.35)	(0.03)
Net loss per share available to common shareholders	$ (0.80)	$ (5.47)

Diluted earnings per share report the potential dilution that could occur if securities or other contracts to issue common stock were exercised or converted into common stock. These potential shares include dilutive stock options, restricted stock awards, convertible debentures, restricted stock units, and convertible perpetual preferred stock. For the three months ended March 31, 2007 and 2006, the number of potential shares approximated 13.4 million and 3.5 million, respectively. Including these potential common shares in the denominator resulted in an antidilutive per share amount due to our *Net loss available to common shareholders*. Therefore, no separate computation of diluted loss per share is presented.

Options to purchase approximately 4.0 million and 3.7 million shares of common stock were outstanding as of March 31, 2007 and 2006, respectively, but were not included in the computation of diluted weighted-average shares because to do so would have been antidilutive.

We repaid our 3.25% Convertible Debentures which were due April 1, 2003 from the net proceeds of a loan arranged by Credit Suisse First Boston on January 16, 2004. In connection with this transaction, we issued warrants to the lender to purchase two million shares of our common stock. Each warrant has a term of ten years from the date of issuance and an exercise price of $32.50 per share. The warrants were not assumed exercised for dilutive shares outstanding because they were antidilutive in the period.

In March 2006, we issued 400,000 shares of convertible perpetual preferred stock as part of a recapitalization of HealthSouth. We use the if-converted method to include the convertible perpetual preferred stock in our computation of diluted loss per share.

In September 2006, we agreed to issue approximately 5.0 million shares of common stock and warrants to purchase approximately 8.2 million shares of common stock to settle our class action securities litigation. This agreement received final court approval on January 11, 2007. As of March 31, 2007, these shares of common stock

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and warrants have not been issued and are not included in our basic or diluted common shares outstanding. For additional information, see Note 9, *Settlements*.

9. Settlements:

Medicare Program Settlement

Under the terms of our settlement with the United States, which is described in Note 22, *Medicare Program Settlement*, to the consolidated financial statements accompanying our March 2007 Form 8-K, we agreed to make cash payments to the United States in the aggregate amount of $325 million, plus accrued interest from November 4, 2004 at an annual rate of 4.125%. Through March 31, 2007, we have made payments of approximately $259.7 million (excluding interest), with the remaining balance of $65.3 million (excluding interest) to be paid in quarterly installments ending in the fourth quarter of 2007. As of March 31, 2007 and December 31, 2006, approximately $65.3 million and $86.7 million, respectively, of the cash settlement amount are included in *Government, class action, and related settlements* in our condensed consolidated balance sheets.

SEC Settlement

Under the terms of our settlement with the SEC, which is described in Note 23, *SEC Settlement*, to the consolidated financial statements accompanying our March 2007 Form 8-K, we agreed to pay a $100 million civil penalty and disgorgement of $100 to the SEC in the following installments: $12,500,100 by October 15, 2005; $12.5 million by April 15, 2006; $25.0 million by October 15, 2006; $25.0 million by April 15, 2007; and $25.0 million by October 15, 2007. As of the date of this filing, we are current with all payments required under the above payment schedule. Payments due under the SEC Settlement are included in *Government, class action, and related settlements* in our condensed consolidated balance sheets.

Securities Litigation Settlement

In February 2006, we announced that we had reached a preliminary agreement in principle with the lead plaintiffs in the Stockholder Securities Action, the Bondholder Securities Action, and the derivative litigation (as defined in Note 24, *Securities Litigation Settlement*, to the consolidated financial statements accompanying our March 2007 Form 8-K), as well as with our insurance carriers to settle claims filed in those actions against us and many of our former directors and officers. In September 2006, the plaintiffs in the Stockholder Securities Action and the Bondholder Securities Action, HealthSouth, and certain individual former HealthSouth employees and board members entered into and filed a stipulation of partial settlement of this litigation. We also entered into definitive agreements with the lead plaintiffs in these actions and the derivative actions, as well as certain of our insurance carriers, to settle the litigation. In September 2006, the U.S. District Court entered an order preliminarily approving the stipulation and settlement. Following a period to allow class members to opt out of the settlement and for objections to the settlement to be lodged, the U.S. District Court held a hearing in January 2007 and determined that the proposed settlement is fair, reasonable, and adequate to the class members and that it should receive final approval. Individual class members representing approximately 205,000 shares of common stock and one bondholder whose bonds have a face value of $1.5 million elected to be excluded from the settlement. The order approving the settlement bars claims by the non-settling defendants arising out of or relating to the Stockholder Securities Action, the Bondholders Securities Action, and the derivative litigation but does not prevent other security holders excluded from the settlement from asserting claims directly against HealthSouth.

Under the terms of our securities litigation settlement, which is described in more detail in Note 24, *Securities Litigation Settlement*, to the consolidated financial statements accompanying our March 2007 Form 8-K, federal securities and fraud claims brought in the Consolidated Securities Action (as defined in our March 2007 Form 8-K) against us and certain of our former directors and officers were settled in exchange for aggregate consideration of $445 million, consisting of HealthSouth common stock and warrants valued at $215 million and cash payments by HealthSouth s insurance carriers of $230 million. In addition, the settlement agreements provided that the plaintiffs in the Stockholder Securities Action and the Bondholder Securities Action will receive 25% of any net recoveries from future judgments obtained by us or on our behalf with respect to certain claims against

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Richard M. Scrushy, our former chairman and chief executive officer (excluding the $48 million judgment against Mr. Scrushy on January 3, 2006, as discussed in Note 25, *Contingencies and Other Commitments*, to the consolidated financial statements accompanying our March 2007 Form 8-K), Ernst & Young LLP, our former auditor, and UBS, our former primary investment bank, each of which remains a defendant in the derivative actions as well as the Consolidated Securities Action. Mr. Scrushy has appealed one provision of the bar order, which is a component of the settlement. The settlement is subject to the satisfaction of a number of conditions, including a favorable resolution of any appeal. The settlement was also conditioned upon the approval of bar orders in the derivative litigation by the Alabama Circuit Court that would, among other things, preclude certain claims by the non-settling co-defendants against HealthSouth and the insurance carriers relating to matters covered by the settlement. As more fully described in Note 10, *Contingencies*