Encompass Health Corp
Form 10-Q
August 02, 2018
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 June 30, 2018
OR

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

Commission File Number 001-10315

Encompass Health 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.)
9001 Liberty Parkway Birmingham, Alabama	35242
(Address of Principal Executive Offices)	(Zip Code)

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

3660 Grandview Parkway, Suite 200
Birmingham, Alabama 35243
(Former name or former address, if changed since last report)

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," "smaller reporting company," and "emerging growth company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer ý Accelerated filer o Smaller reporting company o
Non-Accelerated filer o (Do not check if a smaller reporting company) Emerging growth company o
If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act. 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 98,863,821 shares of common stock outstanding, net of treasury shares, as of July 25, 2018.

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NOTE TO READERS

As used in this report, the terms "Encompass Health," "we," "us," "our," and the "Company" refer to Encompass Health Corporation and its consolidated subsidiaries, unless otherwise stated or indicated by context. This drafting style is suggested by the Securities and Exchange Commission and is not meant to imply that Encompass Health 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 "Encompass Health Corporation" to refer to Encompass Health Corporation alone wherever a distinction between Encompass Health Corporation and its subsidiaries is required or aids in the understanding of this filing.

CAUTIONARY STATEMENT REGARDING FORWARD-LOOKING STATEMENTS

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

- each of the factors discussed in Item 1A, Risk Factors, of our Annual Report on Form 10-K for the year ended December 31, 2017, as well as uncertainties and factors, if any, discussed elsewhere in this Form 10-Q, including in the “Executive Overview—Key Challenges” section of Part I, Item 2, Management’s Discussion and Analysis of Financial Condition and Results of Operations, 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 re-basing of payment systems, the introduction of site neutral payments or case-mix weightings across post-acute settings, or other payment system reforms), affecting revenues 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;
- restrictive interpretations of the regulations governing the claims that are reimbursable by Medicare;
- delays in the administrative appeals process associated with denied Medicare reimbursement claims, including from various Medicare audit programs, and our exposure to the related delay or reduction in the receipt of the reimbursement amounts for services previously provided;
- the ongoing evolution of the healthcare delivery system, including alternative payment models and value-based purchasing initiatives, which may decrease our reimbursement rate or increase costs associated with our operations;
- our ability to comply with extensive and changing healthcare regulations as well as the increased costs of regulatory compliance and compliance monitoring in the healthcare industry, including the costs of investigating and defending asserted claims, whether meritorious or not;
- our ability to attract and retain nurses, therapists, and other healthcare professionals in a highly competitive environment with often severe staffing shortages and the impact on our labor expenses from potential union activity and staffing recruitment and retention;
- competitive pressures in the healthcare industry, including from other providers that may be participating in integrated delivery payment arrangements in which we do not participate, and our response to those pressures;
- changes in our payor mix or the acuity of our patients affecting reimbursement rates;
- 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, productivity improvements arising from the related operations and avoidance of unanticipated difficulties, costs or liabilities that could arise from acquisitions or integrations;
- any adverse outcome of various lawsuits, claims, and legal or regulatory proceedings, including the ongoing investigations initiated by the U.S. Departments of Justice and 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 claims;
- potential incidents affecting the proper operation, availability, or security of our information systems, including the patient information stored there;
- our ongoing rebranding and name change initiative and the impact on our existing operations, including our ability to attract patient referrals to our hospitals as well as the associated costs of rebranding;
- new or changing quality reporting requirements impacting operational costs or our Medicare reimbursement;
- the price of our common stock as it affects our willingness and ability to repurchase shares and the financial and accounting effects of any repurchases;
- our ability and willingness to continue to declare and pay dividends on our common stock;
- our ability to maintain proper local, state and federal licensing, including compliance with the Medicare conditions of participation, which is required to participate in the Medicare program;
- 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 armed conflict or an act of terrorism, governmental impasse over approval of the United States federal budget, an increase to the debt ceiling, or an international sovereign debt crisis.

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

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2018	2017	2018	2017
	(In Millions, Except Per Share Data)			
Net operating revenues	$1,067.7	$966.4	$2,113.7	$1,923.5
Operating expenses:				
Salaries and benefits	578.2	527.8	1,148.4	1,057.9
Other operating expenses	149.4	129.3	290.6	257.1
Occupancy costs	19.5	18.3	38.1	36.2
Supplies	39.3	37.1	79.2	74.1
General and administrative expenses	54.9	52.4	116.0	88.9
Depreciation and amortization	49.7	45.8	95.6	91.0
Total operating expenses	891.0	810.7	1,767.9	1,605.2
Loss on early extinguishment of debt	—	10.4	—	10.4
Interest expense and amortization of debt discounts and fees	37.7	40.4	73.3	81.7
Other income	(1.3)	(0.9)	(1.2)	(1.9)
Equity in net income of nonconsolidated affiliates	(2.0)	(2.0)	(4.3)	(4.1)
Income from continuing operations before income tax expense	142.3	107.8	278.0	232.2
Provision for income tax expense	29.3	28.6	59.3	68.3
Income from continuing operations	113.0	79.2	218.7	163.9
Income (loss) from discontinued operations, net of tax	0.2	0.2	(0.3)	(0.1)
Net income	113.2	79.4	218.4	163.8
Less: Net income attributable to noncontrolling interests	(21.4)	(16.4)	(42.8)	(34.0)
Net income attributable to Encompass Health	$91.8	$63.0	$175.6	$129.8
Weighted average common shares outstanding:				
Basic	97.9	90.3	97.9	89.5
Diluted	99.6	98.9	99.6	99.0
Earnings per common share:				
Basic earnings per share attributable to Encompass Health common shareholders:				
Continuing operations	$0.93	$0.70	$1.79	$1.45
Discontinued operations	—	—	—	—
Net income	$0.93	$0.70	$1.79	$1.45
Diluted earnings per share attributable to Encompass Health common shareholders:				
Continuing operations	$0.92	$0.70	$1.76	$1.42
Discontinued operations	—	—	—	—
Net income	$0.92	$0.70	$1.76	$1.42
Cash dividends per common share	$0.25	$0.24	$0.50	$0.48

Amounts attributable to Encompass Health common shareholders:

Income from continuing operations	$91.6	$62.8	$175.9	$129.9
Income (loss) from discontinued operations, net of tax	0.2	0.2	(0.3)	(0.1)
Net income attributable to Encompass Health	$91.8	$63.0	$175.6	$129.8

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

1

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2018	2017	2018	2017
	(In Millions)			
COMPREHENSIVE INCOME				
Net income	$113.2	$79.4	$218.4	$163.8
Other comprehensive income, net of tax:				
Net change in unrealized gain on available-for-sale securities:				
Unrealized net holding gain arising during the period	—	—	—	0.4
Other comprehensive income before income taxes	—	—	—	0.4
Provision for income tax expense related to other comprehensive income items	—	—	—	(0.1)
Other comprehensive income, net of tax	—	—	—	0.3
Comprehensive income	113.2	79.4	218.4	164.1
Comprehensive income attributable to noncontrolling interests	(21.4)	(16.4)	(42.8)	(34.0)
Comprehensive income attributable to Encompass Health	$91.8	$63.0	$175.6	$130.1

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

Encompass Health Corporation and Subsidiaries
Condensed Consolidated Balance Sheets
(Unaudited)

	June 30, 2018	December 31, 2017
	(In Millions)	
Assets		
Current assets:		
Cash and cash equivalents	$59.0	$ 54.4
Restricted cash	65.8	62.4
Accounts receivable	456.6	472.1
Other current assets	90.2	113.3
Total current assets	671.6	702.2
Property and equipment, net	1,565.8	1,517.1
Goodwill	2,074.7	1,972.6
Intangible assets, net	443.4	403.1
Deferred income tax assets	75.4	63.6
Other long-term assets	258.5	235.1
Total assets[(1)]	$5,089.4	$ 4,893.7
Liabilities and Shareholders' Equity		
Current liabilities:		
Current portion of long-term debt	$36.0	$ 32.3
Accounts payable	85.6	78.4
Accrued expenses and other current liabilities	452.3	406.8
Total current liabilities	573.9	517.5
Long-term debt, net of current portion	2,600.5	2,545.4
Other long-term liabilities	189.8	185.3
	3,364.2	3,248.2
Commitments and contingencies		
Redeemable noncontrolling interests	223.9	220.9
Shareholders' equity:		
Encompass Health shareholders' equity	1,254.9	1,181.7
Noncontrolling interests	246.4	242.9
Total shareholders' equity	1,501.3	1,424.6
Total liabilities[(1)] and shareholders' equity	$5,089.4	$ 4,893.7

(1) Our consolidated assets as of June 30, 2018 and December 31, 2017 include total assets of variable interest entities of $264.0 million and $264.1 million, respectively, which cannot be used by us to settle the obligations of other entities. Our consolidated liabilities as of June 30, 2018 and December 31, 2017 include total liabilities of the variable interest entities of $52.3 million and $52.5 million, respectively. See Note 3, Variable Interest Entities.

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

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

Six Months Ended June 30, 2018
(In Millions)

	Encompass Health 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	98.3	$ 1.1	$2,791.4	$(1,191.0)	$ (1.3)	$(418.5)	$ 242.9	$1,424.6
Net income	—	—	—	175.6	—	—	36.3	211.9
Receipt of treasury stock	(0.2)	—	—	—	—	(8.3)	—	(8.3)
Dividends declared on common stock	—	—	(49.8)	—	—	—	—	(49.8)
Stock-based compensation	—	—	13.3	—	—	—	—	13.3
Distributions declared	—	—	—	—	—	—	(36.8)	(36.8)
Capital contributions from consolidated affiliates	—	—	—	—	—	—	4.0	4.0
Fair value adjustments to redeemable noncontrolling interests, net of tax	—	—	(58.2)	—	—	—	—	(58.2)
Other	0.8	—	1.3	(1.3)	1.3	(0.7)	—	0.6
Balance at end of period	98.9	$ 1.1	$2,698.0	$(1,016.7)	$ —	$(427.5)	$ 246.4	$1,501.3

Six Months Ended June 30, 2017
(In Millions)

	Encompass Health 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	88.9	$ 1.1	$2,799.1	$(1,448.4)	$ (1.2)	$(614.7)	$ 192.8	$928.7
Net income	—	—	—	129.8	—	—	28.3	158.1
Receipt of treasury stock	(0.9)	—	—	—	—	(19.8)	—	(19.8)
Dividends declared on common stock	—	—	(45.5)	—	—	—	—	(45.5)
Stock-based compensation	—	—	9.7	—	—	—	—	9.7
Stock options exercised	1.1	—	19.7	—	—	(19.3)	—	0.4
Stock warrants exercised	0.7	—	26.6	—	—	—	—	26.6
Distributions declared	—	—	—	—	—	—	(22.9)	(22.9)
Capital contributions from consolidated affiliates	—	—	—	—	—	—	21.1	21.1
Fair value adjustments to redeemable noncontrolling interests, net of tax	—	—	(45.1)	—	—	—	—	(45.1)

Repurchases of common stock in open market	(0.5)	—	—	—	—	(18.1)	—	(18.1)
Conversion of convertible debt, net of tax	8.9	—	53.7	—	—	274.5	—	328.2
Other	0.5	—	0.6	1.1	0.3	(0.4)	—	1.6
Balance at end of period	98.7	$ 1.1	$2,818.8	$(1,317.5)	$ (0.9)	$(397.8)	$ 219.3	$1,323.0

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

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

	Six Months Ended June 30, 2018	2017
	(In Millions)	
Cash flows from operating activities:		
Net income	$218.4	$163.8
Loss from discontinued operations, net of tax	0.3	0.1
Adjustments to reconcile net income to net cash provided by operating activities—		
Depreciation and amortization	95.6	91.0
Loss on early extinguishment of debt	—	10.4
Equity in net income of nonconsolidated affiliates	(4.3)	(4.1)
Distributions from nonconsolidated affiliates	3.5	4.4
Stock-based compensation	47.5	28.7
Deferred tax (benefit) expense	(3.6)	44.2
Other, net	6.4	6.4
Change in assets and liabilities, net of acquisitions—		
Accounts receivable	9.9	3.6
Other assets	11.4	(22.0)
Accounts payable	(0.4)	(0.4)
Accrued payroll	(10.6)	(0.5)
Other liabilities	12.0	7.0
Net cash used in operating activities of discontinued operations	(0.6)	(0.6)
Total adjustments	166.8	168.1
Net cash provided by operating activities	385.5	332.0

(Continued)

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

	Six Months Ended June 30,	
	2018	2017
	(In Millions)	
Cash flows from investing activities:		
Purchases of property and equipment	(108.8)	(99.9)
Additions to capitalized software costs	(9.7)	(9.7)
Acquisitions of businesses, net of cash acquired	(135.8)	(20.9)
Other, net	(6.7)	11.0
Net cash used in investing activities	(261.0)	(119.5)
Cash flows from financing activities:		
Principal payments on debt, including pre-payments	(9.1)	(13.4)
Borrowings on revolving credit facility	245.0	105.0
Payments on revolving credit facility	(190.0)	(187.0)
Repurchases of common stock, including fees and expenses	—	(18.1)
Dividends paid on common stock	(49.9)	(43.5)
Purchase of equity interests in consolidated affiliates	(65.1)	—
Proceeds from exercising stock warrants	—	26.6
Distributions paid to noncontrolling interests of consolidated affiliates	(35.2)	(24.1)
Taxes paid on behalf of employees for shares withheld	(8.3)	(19.8)
Other, net	(3.9)	4.5
Net cash used in financing activities	(116.5)	(169.8)
Increase in cash, cash equivalents, and restricted cash	8.0	42.7
Cash, cash equivalents, and restricted cash at beginning of period	116.8	101.4
Cash, cash equivalents, and restricted cash at end of period	$124.8	$144.1
Reconciliation of Cash, Cash Equivalents, and Restricted Cash		
Cash and cash equivalents at beginning of period	$54.4	$40.5
Restricted cash at beginning of period	62.4	60.9
Cash, cash equivalents, and restricted cash at beginning of period	$116.8	$101.4
Cash and cash equivalents at end of period	$59.0	$71.1
Restricted cash at end of period	65.8	73.0
Cash, cash equivalents, and restricted cash at end of period	$124.8	$144.1
Supplemental schedule of noncash financing activity:		
Conversion of convertible debt	$—	$319.4

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

Encompass Health Corporation and Subsidiaries
Notes to Condensed Consolidated Financial Statements

1. Basis of Presentation

Encompass Health Corporation, incorporated in Delaware in 1984, including its subsidiaries, is one of the nation's largest providers of post-acute healthcare services, offering both facility-based and home-based patient services in 36 states and Puerto Rico through its network of inpatient rehabilitation hospitals, home health agencies, and hospice agencies. Effective January 1, 2018, we changed our name from HealthSouth Corporation to Encompass Health Corporation. Our operations in both business segments will transition to the Encompass Health name on a rolling basis.

The accompanying unaudited condensed consolidated financial statements of Encompass Health Corporation and Subsidiaries should be read in conjunction with the consolidated financial statements and accompanying notes contained in Encompass Health's Annual Report on Form 10-K filed with the United States Securities and Exchange Commission on February 27, 2018 (the "2017 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, 2017 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 11, Segment Reporting.

Net Operating Revenues—

Our Net operating revenues disaggregated by payor source and segment are as follows (in millions):

	Inpatient Rehabilitation		Home Health and Hospice		Consolidated	
	Three Months Ended June 30,		Three Months Ended June 30,		Three Months Ended June 30,	
	2018	2017	2018	2017	2018	2017
Medicare	$607.1	$569.2	$199.2	$161.5	$806.3	$730.7
Medicare Advantage	78.7	67.1	21.8	19.1	100.5	86.2
Managed care	86.6	85.3	8.7	6.6	95.3	91.9
Medicaid	26.8	23.1	2.7	1.2	29.5	24.3
Other third-party payors	12.7	12.5	—	—	12.7	12.5
Workers' compensation	6.8	6.5	0.2	—	7.0	6.5
Patients	4.4	4.0	0.3	0.2	4.7	4.2
Other income	11.5	9.9	0.2	0.2	11.7	10.1
Total	$834.6	$777.6	$233.1	$188.8	$1,067.7	$966.4

Encompass Health Corporation and Subsidiaries
Notes to Condensed Consolidated Financial Statements

	Inpatient Rehabilitation		Home Health and Hospice		Consolidated	
	Six Months Ended June 30,		Six Months Ended June 30,		Six Months Ended June 30,	
	2018	2017	2018	2017	2018	2017
Medicare	$1,231.6	$1,142.9	$376.1	$313.8	$1,607.7	$1,456.7
Medicare Advantage	151.2	131.9	41.8	37.3	193.0	169.2
Managed care	171.6	170.2	16.3	13.7	187.9	183.9
Medicaid	51.5	44.7	3.2	2.4	54.7	47.1
Other third-party payors	24.7	23.9	—	—	24.7	23.9
Workers' compensation	14.2	13.9	0.3	0.1	14.5	14.0
Patients	8.8	8.4	0.7	0.4	9.5	8.8
Other income	21.3	19.5	0.4	0.4	21.7	19.9
Total	$1,674.9	$1,555.4	$438.8	$368.1	$2,113.7	$1,923.5

We record Net operating revenues on an accrual basis using our best estimate of the transaction price for the type of service provided to the patient. Our estimate of the transaction price includes estimates of price concessions for such items as contractual allowances, potential adjustments that may arise from payment and other reviews, and uncollectible amounts. Our accounting systems calculate contractual allowances on a patient-by-patient basis based on the rates in effect for each primary third-party payor. Adjustments related to payment reviews by third-party payors or their agents are based on our historical experience and success rates in the claims adjudication process. Estimates for uncollectible amounts are based on the aging of our accounts receivable, our historical collection experience for each type of payor, and other relevant factors.

Management continually reviews the revenue transaction price estimation process to consider and incorporate updates to laws and regulations and the frequent changes in managed care contractual terms that result from contract renegotiations and renewals. Due to complexities involved in determining amounts ultimately due under reimbursement arrangements with third-party payors, which are often subject to interpretation, we may receive reimbursement for healthcare services authorized and provided that is different from our estimates, and such differences could be material. In addition, laws and regulations governing the Medicare and Medicaid programs are complex, subject to interpretation, and are routinely modified for provider reimbursement. All healthcare providers participating in the Medicare and Medicaid programs are required to meet certain financial reporting requirements. Federal regulations require submission of annual cost reports covering medical costs and expenses associated with the services provided under each hospital, home health, and hospice provider number to program beneficiaries. Annual cost reports required under the Medicare and Medicaid programs are subject to routine audits, which may result in adjustments to the amounts ultimately determined to be due to Encompass Health under these reimbursement programs. These audits often require several years to reach the final determination of amounts earned under the programs. If actual results are not consistent with our assumptions and judgments, we may be exposed to gains or losses that could be material.

The Centers for Medicare and Medicaid Services ("CMS") has been granted authority to suspend payments, in whole or in part, to Medicare providers if CMS possesses reliable information an overpayment, fraud, or willful misrepresentation exists. If CMS suspects payments are being made as the result of fraud or misrepresentation, CMS may suspend payment at any time without providing prior notice to us. The initial suspension period is limited to 180 days. However, the payment suspension period can be extended almost indefinitely if the matter is under investigation by the United States Department of Health and Human Services Office of Inspector General (the "HHS-OIG") or the United States Department of Justice. Therefore, we are unable to predict if or when we may be subject to a suspension of payments by the Medicare and/or Medicaid programs, the possible length of the suspension period, or the potential cash flow impact of a payment suspension. Any such suspension would adversely impact our financial position, results of operations, and cash flows.

Pursuant to legislative directives and authorizations from Congress, CMS has developed and instituted various Medicare audit programs under which CMS contracts with private companies to conduct claims and medical record audits. As a matter of course, we undertake significant efforts through training and education to ensure compliance with Medicare requirements. However, audits may lead to assertions we have been underpaid or overpaid by Medicare or submitted improper claims in some instances, require us to incur additional costs to respond to requests for records and defend the validity of payments and claims, and ultimately require us to refund any amounts determined to have been overpaid. In some circumstances auditors assert the authority to extrapolate denial rationales to large pools of claims not actually audited, which could increase the impact of the audit. We cannot predict when or how these audit programs will affect us.

Medicare Administrative Contractors ("MACs"), under programs known as "widespread probes," have conducted pre-payment claim reviews of our Medicare billings and in some cases denied payment for certain diagnosis codes. The majority of the denials we have encountered in these probes relate to determinations regarding medical necessity and provision of therapy services. We dispute, or "appeal," most of these denials, and for claims we choose to take to administrative law judge hearings, we have historically experienced a success rate of approximately 70%. This historical success rate is a component of our estimate of transaction price as discussed above. The resolution of these disputes can take in excess of three years, and we cannot provide assurance as to our ongoing and future success of these disputes. When the amount collected related to denied claims differs from the amount previously estimated, these collection differences are recorded as an adjustment to Net operating revenues.

In August 2017, CMS announced the Targeted Probe and Educate ("TPE") initiative. Under the TPE initiative, MACs use data analysis to identify healthcare providers with high claim error rates and items and services that have high national error rates. Once a MAC selects a provider for claims review, the initial volume of claims review is limited to 20 to 40 claims. The TPE initiative includes up to three rounds of claims review if necessary with corresponding provider education and a subsequent period to allow for improvement. If results do not improve sufficiently after three rounds, the MAC may refer the provider to CMS for further action, which may include extrapolation of error rates to a broader universe of claims or referral to a ZPIC or RAC (defined below). We cannot predict the impact of the TPE initiative on our ability to collect claims on a timely basis.

In connection with CMS approved and announced Recovery Audit Contractors ("RACs") audits related to inpatient rehabilitation facilities ("IRFs"), we received requests from 2013 to 2017 to review certain patient files for discharges occurring from 2010 to 2017. These RAC audits are focused on identifying Medicare claims that may contain improper payments. RAC contractors must have CMS approval before conducting these focused reviews which cover issues ranging from billing documentation to medical necessity. Medical necessity is an assessment by an independent physician of a patient's ability to tolerate and benefit from intensive multi-disciplinary therapy provided in an IRF setting.

CMS has also established contractors known as the Zone Program Integrity Contractors ("ZPICs"). These contractors conduct audits with a focus on potential fraud and abuse issues. Like the RACs, the ZPICs conduct audits and have the ability to refer matters to the HHS-OIG or the DOJ. Unlike RACs, however, ZPICs do not receive a specific financial incentive based on the amount of the error as a result of ZPIC audits. We have, from time to time, received ZPIC record requests which have resulted in claim denials on paid claims. We have appealed substantially all ZPIC denials arising from these audits using the same process we follow for appealing other denials by contractors.

To date, the Medicare claims that are subject to these post-payment audit requests represent less than 1% of our Medicare patient discharges from 2010 to 2017, and not all of these patient file requests have resulted in payment denial determinations by the audit contractor. Because we have confidence in the medical judgment of both the referring and admitting physicians who assess the treatment needs of their patients, we have appealed substantially all claim denials arising from these audits using the same process we follow for appealing denials of certain diagnosis codes by MACs. Due to the delays announced by CMS in the related adjudication process, we believe the resolution of any claims that are subsequently denied as a result of these claim audits could take in excess of three years. In addition, because we have limited experience with ZPICs and RACs in the context of claims reviews of this nature, we cannot provide assurance as to the timing or outcomes of these disputes. As such, we make estimates for these claims based on our historical experience and success rates in the claims adjudication process, which is the same process we follow for appealing denials of certain diagnosis codes by MACs. The impact on our estimates of amounts determined to be due to Encompass Health as a result of these audits during the three and six months ended June 30, 2018 and 2017 was not material.

Our performance obligations relate to contracts with a duration of less than one year. Therefore, we elected to apply the optional exemption to not disclose the aggregate amount of the transaction price allocated to performance obligations that are unsatisfied or partially unsatisfied at the end of the reporting period. These unsatisfied or partially unsatisfied performance obligations primarily relate to services provided at the end of the reporting period.

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We are subject to changes in government legislation that could impact Medicare payment levels and changes in payor patterns that may impact the level and timing of payments for services rendered.

Inpatient Rehabilitation Revenues

Inpatient rehabilitation segment revenues are recognized over time as the services are provided to the patient. The performance obligation is the rendering of services to the patient during the term of their inpatient stay. Revenues are recognized (or measured) using the input method as therapy, nursing and auxiliary services are provided based on our estimate of the respective transaction price. Revenues recognized by our inpatient rehabilitation segment are subject to a number of elements which impact both the overall amount of revenue realized as well as the timing of the collection of the related accounts receivable. Factors considered in determining the estimated transaction price include the patient's total length of stay for in-house patients, each patient's discharge destination, the proportion of patients with secondary insurance coverage and the level of reimbursement under that secondary coverage, and the amount of charges that will be disallowed by payors. Such additional factors are assumed to remain consistent with the experience for patients discharged in similar time periods for the same payor classes.

Home Health and Hospice Revenues

Home Health

Under the Medicare home health prospective payment system, we are paid by Medicare based on episodes of care. The performance obligation is the rendering of services to the patient during the term of the episode of care. An episode of care is defined as a length of stay up to 60 days, with multiple continuous episodes allowed. A base episode payment is established by the Medicare program through federal regulation. The base episode payment can be adjusted based on each patient's health including clinical condition, functional abilities, and service needs, as well as for the applicable geographic wage index, low utilization, patient transfers, and other factors. The services covered by the episode payment include all disciplines of care in addition to medical supplies.

We bill a portion of reimbursement from each Medicare episode near the start of each episode, and the resulting cash payment is typically received before all services are rendered. As we provide home health services to our patients on a scheduled basis over the episode of care in a manner that approximates a pro rata pattern, revenue for the episode of care is recorded over an average length of treatment period using a calendar day prorating method. The amount of revenue recognized for episodes of care which are incomplete at period end is based on the pro rata number of days in the episode which have been completed as of the period end date. As of June 30, 2018 and December 31, 2017, the difference between the cash received from Medicare for a request for anticipated payment on episodes in progress and the associated estimated revenue was not material and was recorded in Other current liabilities in our condensed consolidated balance sheets.

We are subject to certain Medicare regulations affecting outlier revenue if our patient's care was unusually costly. Regulations require a cap on all outlier revenue at 10% of total Medicare revenue received by each provider during a cost reporting year. Management has reviewed the potential cap. Adjustments to the transaction price for the outlier cap were not material as of June 30, 2018 and December 31, 2017.

For episodic-based rates that are paid by other insurance carriers, including Medicare Advantage, we recognize revenue in a similar manner as discussed above for Medicare revenues. However, these rates can vary based upon the negotiated terms. For non-episodic-based revenue, revenue is recorded on an accrual basis based upon the date of service at amounts equal to our estimated per-visit transaction price. Price concessions, including contractual allowances for the differences between our standard rates and the applicable contracted rates, as well as estimated uncollectible amounts from patients, are recorded as decreases to the transaction price.

Hospice

Medicare revenues for hospice are recognized and recorded on an accrual basis using the input method based on the number of days a patient has been on service at amounts equal to an estimated daily or hourly payment rate. The performance obligation is the rendering of services to the patient during each day that they are on hospice care. The payment rate is dependent on whether a patient is receiving routine home care, general inpatient care, continuous home care or respite care.

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Adjustments to Medicare revenues are recorded based on an inability to obtain appropriate billing documentation or authorizations acceptable to the payor or other reasons unrelated to credit risk. Hospice companies are subject to two specific payment limit caps under the Medicare program. One limit relates to inpatient care days that exceed 20% of the total days of hospice care provided for the year. The second limit relates to an aggregate Medicare reimbursement cap calculated by the MAC. Adjustments to the transaction price for these caps were not material as of June 30, 2018 and December 31, 2017.

For non-Medicare hospice revenues, we record gross revenue on an accrual basis based upon the date of service at amounts equal to our estimated per day transaction price. Price concessions, including contractual adjustments for the difference between our standard rates and the amounts estimated to be realizable from patients and third parties for services provided, are recorded as decreases to the transaction price and thus reduce our Net operating revenues.

Marketable Securities—

Effective January 1, 2018, in connection with the adoption of ASU 2016-01, we record all equity securities with readily determinable fair values and for which we do not exercise significant influence at fair value and record the change in fair value for the reporting period in our condensed consolidated statements of operations.

Prior to January 1, 2018, we recorded all equity securities with readily determinable fair values and for which we did not exercise significant influence as available-for-sale securities. We carried the available-for-sale securities at fair value and reported unrealized holding gains or losses, net of income taxes, in Accumulated other comprehensive loss, which is a separate component of shareholders' equity. We recognized realized gains and losses in our consolidated statements of operations using the specific identification method. Unrealized losses were charged against earnings when a decline in fair value was determined to be other than temporary. Management reviewed several factors to determine whether a loss was other than temporary, such as the length of time a security is in an unrealized loss position, the extent to which fair value is less than cost, the financial condition and near term prospects of the issuer, industry, or geographic area and our ability and intent to hold the security for a period of time sufficient to allow for any anticipated recovery in fair value.

Accounts Receivable—

We report accounts receivable from services rendered at their estimated transaction price which takes into account price concessions from federal and state agencies (under the Medicare and Medicaid programs), managed care health plans, commercial insurance companies, workers' compensation programs, employers, and patients. Our accounts receivable are concentrated by type of payor. The concentration of patient service accounts receivable by payor class, as a percentage of total patient service accounts receivable, is as follows:

	June 30, 2018		December 31, 2017	
Medicare	72.9	%	75.1	%
Managed care and other discount plans, including Medicare Advantage	19.2	%	17.4	%
Medicaid	2.9	%	2.4	%
Other third-party payors	2.9	%	2.9	%
Workers' compensation	1.2	%	1.3	%
Patients	0.9	%	0.9	%
Total	100.0	%	100.0	%

While revenues and accounts receivable from the Medicare program are significant to our operations, we do not believe there are significant credit risks associated with this government agency. We do not believe there are any other significant concentrations of revenues from any particular payor that would subject us to any significant credit risks in the collection of our accounts receivable.

Accounts requiring collection efforts are reviewed via system-generated work queues that automatically stage (based on age and size of outstanding balance) accounts requiring collection efforts for patient account representatives. Collection efforts include contacting the applicable party (both in writing and by telephone), providing information (both financial and

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clinical) to allow for payment or to overturn payor decisions to deny payment, and arranging payment plans with self-pay patients, among other techniques. When we determine all in-house efforts have been exhausted or it is a more prudent use of resources, accounts may be turned over to a collection agency.

The collection of outstanding receivables from Medicare, managed care payors, other third-party payors, and patients is our primary source of cash and is critical to our operating performance. While it is our policy to verify insurance prior to a patient being admitted, there are various exceptions that can occur. Such exceptions include instances where we are (1) unable to obtain verification because the patient's insurance company was unable to be reached or contacted, (2) a determination is made that a patient may be eligible for benefits under various government programs, such as Medicaid, and it takes several days, weeks, or months before qualification for such benefits is confirmed or denied, and (3) the patient is transferred to our hospital from an acute care hospital without having access to a credit card, cash, or check to pay the applicable patient responsibility amounts (i.e., deductibles and co-payments).

Our primary collection risks relate to patient responsibility amounts and claims reviews conducted by MACs or other contractors. Patient responsibility amounts include accounts for which the patient was the primary payor or the primary insurance carrier has paid the amounts covered by the applicable agreement, but patient co-payment amounts remain outstanding. Changes in the economy, such as increased unemployment rates or periods of recession, can further exacerbate our ability to collect patient responsibility amounts.

If actual results are not consistent with our assumptions and judgments, we may be exposed to gains or losses that could be material. Changes in general economic conditions, business office operations, payor mix, or trends in federal or state governmental and private employer healthcare coverage could affect our collection of accounts receivable, financial position, results of operations, and cash flows.

Recently Adopted Accounting Pronouncements—

In May 2014, the FASB issued ASU 2014-09, "Revenue from Contracts with Customers" and has subsequently issued supplemental and/or clarifying ASUs (collectively "ASC 606"). ASC 606 outlines a five-step framework that supersedes the principles for recognizing revenue and eliminates industry-specific guidance. In addition, ASC 606 revises current disclosure requirements in an effort to help financial statement users better understand the nature, amount, timing, and uncertainty of revenue that is recognized. We adopted ASC 606 on January 1, 2018 using the full retrospective model. The primary impact of adopting under ASC 606 is that all amounts we previously presented as Provision for doubtful accounts are now considered an implicit price concession in determining Net operating revenues. Such concessions reduce the transaction price and therefore Net operating revenues, as shown below. Adopting ASC 606 on January 1, 2018 using the full retrospective transition method had the following impact to our previously reported condensed consolidated statements of operations (in millions):

	For the Three Months Ended June 30, 2017			For the Six Months Ended June 30, 2017		
	As Previously Reported	Adjustment for ASC 606	Restated	As Previously Reported	Adjustment for ASC 606	Restated
Net operating revenues	$981.3	$ (14.9)	$ 966.4	$1,956.1	$ (32.6)	$1,923.5
Provision for doubtful accounts	$13.7	$ (13.7)	$ —	$30.1	$ (30.1)	$—
Other operating expenses	$130.5	$ (1.2)	$ 129.3	$259.6	$ (2.5)	$257.1
Net income attributable to Encompass Health	$63.0	$ —	$ 63.0	$129.8	$ —	$129.8

In addition, the adoption of ASC 606 resulted in increased disclosure, including qualitative and quantitative disclosures about the nature, amount, timing and uncertainty of revenue and cash flows arising from contracts with customers. See the "Net Operating Revenues" and "Accounts Receivable" sections of this note. Except for the adjustments discussed above, the adoption of ASC 606 did not have a material impact on our condensed consolidated financial statements.

In January 2016, the FASB issued ASU No. 2016-01, "Financial Instruments - Overall (Topic 825): Recognition and Measurement of Financial Assets and Financial Liabilities." This standard revises the classification and measurement of

investments in certain equity investments and the presentation of certain fair value changes for certain financial liabilities measured at fair value. This revised standard requires the change in fair value of many equity investments to be recognized in Net income. This revised standard requires a modified retrospective application with a cumulative effect adjustment recognized in retained earnings as of the date of adoption and was effective for our interim and annual periods beginning January 1, 2018. During the first quarter of 2018, we recognized mark-to-market gains and losses associated with our available-for-sale equity securities through Net income instead of Accumulated other comprehensive income. The adoption of this guidance resulted in an immaterial impact to our condensed consolidated financial statements. See the "Marketable Securities" section of this note.

In August 2016, the FASB issued ASU 2016-15, "Statement of Cash Flows (Topic 230), Classification of Certain Cash Receipts and Cash Payments," to reduce diversity in practice in how certain transactions are classified in the statement of cash flows. In addition, the standard clarifies when cash receipts and cash payments have aspects of more than one class of cash flows and cannot be separated, classification will depend on the predominant source or use. The new guidance requires retrospective application and was effective for our annual reporting period beginning January 1, 2018, including interim periods within that reporting period. The adoption of this standard did not have any effect on our previously presented statement of cash flows for the six months ended June 30, 2017. The clarification that debt prepayment premiums should be classified as financing activities will result in an immaterial increase in operating cash inflows and a corresponding increase in financing cash outflows for the nine months and year ended September 30, 2017 and December 31, 2017, respectively, when presented.

In November 2016, the FASB issued ASU 2016-18, "Statement of Cash Flows (Topic 230), Restricted Cash," to clarify how entities should present restricted cash and restricted cash equivalents in the statement of cash flows. The new guidance requires amounts generally described as restricted cash and restricted cash equivalents be included with Cash and cash equivalents when reconciling the total beginning and ending amounts for the periods shown on the statement of cash flows. The new guidance requires retrospective application and is effective for our annual reporting period beginning January 1, 2018, including interim periods within that reporting period. The adoption of this guidance resulted in an immaterial decrease to previously reported Net cash used in investing activities for the six months ended June 30, 2017 and a corresponding increase to previously reported Increase in cash and cash equivalents (which is now captioned Increase in cash, cash equivalents, and restricted cash, pursuant to the adoption of this guidance). In addition, as noted above, we added a reconciliation of cash, cash equivalents, and restricted cash to the condensed consolidated statements of cash flows.

Recent Accounting Pronouncements Not Yet Adopted—

In February 2016, the FASB issued ASU 2016-02, "Leases (Topic 842)" and has subsequently issued supplemental and/or clarifying ASUs (collectively "ASC 842"), in order to increase transparency and comparability by recognizing lease assets and liabilities on the balance sheet and disclosing key information about leasing arrangements. Under ASC 842, lessees will recognize a right-of-use asset and a corresponding lease liability for all leases other than leases that meet the definition of a short-term lease. The liability will be equal to the present value of future minimum lease payments. The asset will be based on the liability, subject to adjustment, such as for initial direct costs. For income statement purposes, the FASB retained a dual model, requiring leases to be classified as either operating or finance. Operating leases will result in straight-line expense while finance leases will result in an expense pattern similar to current capital leases. Classification will be based on criteria that are similar to those applied in current lease accounting. ASC 842 will be effective for our annual reporting period beginning on January 1, 2019. Early adoption is permitted. In transition, we will be required to recognize and measure leases beginning in the earliest period presented using a modified retrospective approach; therefore, we anticipate restating our condensed consolidated financial statements for the two fiscal years prior to the year of adoption. While we are currently assessing the impact this guidance may have on our condensed consolidated financial statements, we expect that virtually all of our existing operating leases will be reflected as right-of-use assets and liabilities on our condensed consolidated balance sheets under the new standard. We have received the necessary updates to our leasing software and are preparing for implementation. See Note 6, Property and Equipment, to the consolidated financial statements accompanying the 2017 Form 10-K for disclosure related to our operating leases.

In June 2016, the FASB issued ASU 2016-13, “Financial Instruments – Credit Losses (Topic 326),” which provides guidance for accounting for credit losses on financial instruments. The new guidance introduces an approach based on expected losses to estimate credit losses on certain types of financial instruments and modifies the impairment model for available-for-sale debt securities. The new guidance is effective for our annual reporting period beginning January 1, 2020, including interim periods within that reporting period. Early adoption is permitted beginning January 1, 2019. We continue to review the requirements of this standard and any potential impact it may have on our condensed consolidated financial statements.

We do not believe any other recently issued, but not yet effective, accounting standards will have a material effect on our condensed consolidated financial position, results of operations, or cash flows.

2. Business Combinations

Home Health and Hospice

Camellia Acquisition

On May 1, 2018, we completed the previously announced acquisition of privately owned Camellia Healthcare and affiliated entities (“Camellia”). The Camellia portfolio consists of hospice, home health and private duty locations in Mississippi, Alabama, Louisiana and Tennessee. The acquisition leverages our home health and hospice operating platform across key certificate of need states and strengthens our geographic presence in the Southeastern United States. We funded the cash purchase price of the acquisition with cash on hand and borrowings under our revolving credit facility.

We accounted for this transaction under the acquisition method of accounting and reported the results of operations of Camellia from its date of acquisition. Assets acquired and liabilities assumed were recorded at their estimated fair values as of the acquisition date. Estimated fair values were based on various valuation methodologies including: replacement cost and continued use methods for property and equipment; an income approach using primarily discounted cash flow techniques for the noncompete and certain license intangible assets; an income approach utilizing the relief-from-royalty method for the trade name intangible asset; and an income approach utilizing the excess earnings method for the certificate of need and certain license intangible assets. The aforementioned income methods utilize management’s estimates of future operating results and cash flows discounted using a weighted-average cost of capital that reflects market participant assumptions. For all other assets and liabilities, the fair value was assumed to represent carrying value due to their short maturities. The excess of the fair value of the consideration conveyed over the fair value of the net assets acquired was recorded as goodwill. All goodwill recorded as a result from this transaction is deductible for federal income tax purposes. The goodwill reflects our expectations of favorable growth opportunities in the home health and hospice markets based on positive demographic trends.

The fair values recorded were based upon a preliminary valuation. Estimates and assumptions used in such valuation are subject to change, which could be significant, within the measurement period (up to one year from the acquisition date). The primary areas of the preliminary valuation that are not yet finalized relate to the fair values of amounts for income taxes, adjustments to working capital, and the final amount of residual goodwill. We expect to continue to obtain information to assist us in determining the fair values of the net assets acquired at the acquisition date during the measurement period.

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

Cash and cash equivalents	$1.3
Prepaid expenses and other current assets	0.3
Property and equipment, net	0.6
Identifiable intangible assets:	
Noncompete agreements (useful lives of 5 years)	0.5
Trade name (useful life of 1 year)	1.4
Certificates of need (useful lives of 10 years)	16.6
Licenses (useful lives of 10 years)	21.6
Goodwill	97.0
Total assets acquired	139.3
Liabilities assumed:	
Accounts payable	4.3
Accrued payroll	4.0
Total liabilities assumed	8.3
Net assets acquired	$131.0

Information regarding the net cash paid for Camellia is as follows (in millions):

Fair value of assets acquired, net of $1.3 million of cash acquired	$41.0
Goodwill	97.0
Fair value of liabilities assumed	(8.3)
Net cash paid for acquisition	$129.7

Other Home Health and Hospice Acquisitions

During the six months ended June 30, 2018, we completed the following home health and hospice acquisitions, none of which were individually material to our financial position, results of operations, or cash flows. Each acquisition was made to enhance our position and ability to provide post-acute healthcare services to patients in the applicable geographic areas. Each acquisition was funded using cash on hand.

- In January 2018, we acquired the assets of one hospice location from Golden Age Hospice, Inc. in Oklahoma City, Oklahoma.
- In June 2018, we acquired the assets of one hospice location from Medical Services of America in Las Vegas, Nevada.

We accounted for these transactions under the acquisition method of accounting and reported the results of operations of the acquired locations from their respective dates of acquisition. Assets acquired were recorded at their estimated fair values as of the respective acquisition dates. The fair values of identifiable intangible assets were based on valuations using an income approach. The income approach is based on management's estimates of future operating results and cash flows discounted using a weighted-average cost of capital that reflects market participant assumptions. The excess of the fair value of the consideration conveyed over the fair value of the net assets acquired was recorded as goodwill. The goodwill reflects our expectations of our ability to utilize the acquired locations' mobile workforce and established relationships within each community and the benefits of being able to leverage operational efficiencies with favorable growth opportunities based on positive demographic trends in these markets. All goodwill recorded as a result of these transactions is deductible for federal income tax purposes.

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

Identifiable intangible assets:	
Noncompete agreements (useful lives of 5 years)	$0.2
Licenses (useful lives of 10 years)	0.8
Goodwill	5.1
Total assets acquired	$6.1

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2018	2017	2018	2017
Fair value of assets acquired	$0.9	$1.4	$1.0	$2.7
Goodwill	4.6	3.2	5.1	7.4
Fair value of liabilities assumed	—	(0.1)	—	(0.1)
Net cash paid for acquisitions	$5.5	$4.5	$6.1	$10.0

Pro Forma Results of Operations

The following table summarizes the results of operations of the above mentioned acquisitions from their respective dates of acquisition included in our consolidated results of operations and the unaudited pro forma results of operations of the combined entity had the date of the acquisitions been January 1, 2017 (in millions):

	Net Operating Revenues	Net Income Attributable to Encompass Health
Acquired entities only: Actual from acquisition date to June 30, 2018		
Camellia	$ 13.7	$ 0.1
All Other Home Health and Hospice	0.7	(0.1)
Combined entity: Supplemental pro forma from 04/01/2018-06/30/2018	1,075.0	93.7
Combined entity: Supplemental pro forma from 04/01/2017-06/30/2017	986.7	66.5
Combined entity: Supplemental pro forma from 01/01/2018-06/30/2018	2,141.9	179.8
Combined entity: Supplemental pro forma from 01/01/2017-06/30/2017	1,963.1	135.7

The information presented above is for illustrative purposes only and is not necessarily indicative of results that would have been achieved if the acquisitions had occurred as of the beginning of our 2017 reporting period.

See Note 2, Business Combinations, to the consolidated financial statements accompanying the 2017 Form 10-K for information regarding acquisitions completed in 2017.

3. Variable Interest Entities

As of June 30, 2018 and December 31, 2017, we consolidated ten limited partnership-like entities that are variable interest entities ("VIEs") and of which we are the primary beneficiary. Our ownership percentages in these entities range from 6.8% to 99.5%. Through partnership and management agreements with or governing each of these entities, we manage all of these entities and handle all day-to-day operating decisions. Accordingly, we have the decision making power over the activities that most significantly impact the economic performance of our VIEs and an obligation to absorb losses or receive benefits from the VIE that could potentially be significant to the VIE. These decisions and significant activities include, but are not limited to, marketing efforts, oversight of patient admissions, medical training, nurse and therapist scheduling, provision of healthcare services, billing, collections, and creation and maintenance of medical records. The terms of the agreements governing each of our VIEs prohibit us from using the assets of each VIE to satisfy the obligations of other entities.

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

	June 30, 2018	December 31, 2017
Assets		
Current assets:		
Cash and cash equivalents	$1.2	$ 1.2
Accounts receivable	35.4	32.6
Other current assets	5.4	5.6
Total current assets	42.0	39.4
Property and equipment, net	140.9	142.8
Goodwill	73.5	73.5
Intangible assets, net	7.0	7.7
Other long-term assets	0.6	0.7
Total assets	$264.0	$ 264.1
Liabilities		
Current liabilities:		
Current portion of long-term debt	$1.8	$ 1.8
Accounts payable	5.9	6.5
Accrued expenses and other current liabilities	17.3	15.9
Total current liabilities	25.0	24.2
Long-term debt, net of current portion	27.3	28.3
Total liabilities	$52.3	$ 52.5

4. Investments in and Advances to Nonconsolidated Affiliates

As of June 30, 2018 and December 31, 2017, we had $12.6 million and $11.9 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 six partially owned subsidiaries, of which five are general or limited partnerships, limited liability companies, or joint ventures in which Encompass Health or one of its subsidiaries is a general or limited partner, managing member, member, or venturer, as applicable. We do not control these affiliates but have the ability to exercise significant influence over the operating and financial policies of certain of these affiliates. Our ownership percentages in these affiliates range from approximately 1% to 60%. We account for these investments using the cost and equity methods of accounting.

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2018	2017	2018	2017
Net operating revenues	$10.5	$10.4	$21.5	$21.2
Operating expenses	(5.6)	(6.0)	(13.2)	(12.1)
Income from continuing operations, net of tax	4.9	4.4	8.3	9.0
Net income	4.9	4.4	8.3	9.0

5. Redeemable Noncontrolling Interests

The following is a summary of the activity related to our Redeemable noncontrolling interests during the six months ended June 30, 2018 and 2017 (in millions):

	Six Months Ended June 30,	
	2018	2017
Balance at beginning of period	$220.9	$138.3
Net income attributable to noncontrolling interests	6.5	5.7
Distributions declared	(4.6)	(3.1)
Purchase of redeemable noncontrolling interests	(65.1)	—
Change in fair value	66.2	75.1
Balance at end of period	$223.9	$216.0

The following table reconciles the net income attributable to nonredeemable Noncontrolling interests, as recorded in the shareholders' equity section of the condensed consolidated balance sheets, and the net income attributable to Redeemable noncontrolling interests, as recorded in the mezzanine section of the condensed consolidated balance sheets, to the Net income attributable to noncontrolling interests presented in the condensed consolidated statements of operations for the three and six months ended June 30, 2018 and 2017 (in millions):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2018	2017	2018	2017
Net income attributable to nonredeemable noncontrolling interests	$17.7	$13.8	$36.3	$28.3
Net income attributable to redeemable noncontrolling interests	3.7	2.6	6.5	5.7
Net income attributable to noncontrolling interests	$21.4	$16.4	$42.8	$34.0

On December 31, 2014, we acquired 83.3% of our home health and hospice business when we purchased EHHI Holdings, Inc. ("EHHI"). In the acquisition, we acquired all of the issued and outstanding equity interests of EHHI, other than equity interests contributed to Encompass Health Home Health Holdings, Inc. ("Holdings"), a subsidiary of Encompass Health and an indirect parent of EHHI, by certain sellers in exchange for shares of common stock of Holdings. Those sellers were members of EHHI management, and they contributed a portion of their shares of common stock of EHHI, valued at approximately $64 million on the acquisition date, in exchange for approximately 16.7% of the outstanding shares of common stock of Holdings. At any time after December 31, 2017, each management investor has the right (but not the obligation) to have his or her shares of Holdings stock repurchased by Encompass Health for a cash purchase price per share equal to the fair value. Specifically, up to one-third of each management investor's shares of Holdings stock may be sold prior to December 31, 2018; two-thirds of each management investor's shares of Holdings stock may be sold prior to December 31, 2019; and all of

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each management investor's shares of Holdings stock may be sold thereafter. At any time after December 31, 2019, Encompass Health will have the right (but not the obligation) to repurchase all or any portion of the shares of Holdings stock owned by one or more management investors for a cash purchase price per share equal to the fair value. In February 2018, each management investor exercised the right to sell one-third of his or her shares of Holdings stock to Encompass Health, representing approximately 5.6% of the outstanding shares of the common stock of Holdings. On February 21, 2018, Encompass Health settled the acquisition of those shares upon payment of approximately $65 million in cash. As of June 30, 2018, the value of the outstanding shares of Holdings owned by management investors was approximately $195 million. See also Note 6, Fair Value Measurements.

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 June 30, 2018	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	$ 9.1	$ —	$ 9.1	$ —	M
Other long-term assets:					
Restricted marketable securities	51.9	—	51.9	—	M
Redeemable noncontrolling interests	223.9	—	—	223.9	I
As of December 31, 2017					
Other current assets:					
Current portion of restricted marketable securities	$ 17.8	$ —	$ 17.8	$ —	M
Other long-term assets:					
Restricted marketable securities	44.2	—	44.2	—	M
Redeemable noncontrolling interests	220.9	—	—	220.9	I

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

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

- Restricted marketable securities - The fair values of our restricted marketable securities are determined based on quoted market prices in active markets or quoted prices, dealer quotations, or alternative pricing sources supported by observable inputs in markets that are not considered to be active.
- Redeemable noncontrolling interests - The fair value of the Redeemable noncontrolling interests related to our home health segment is determined using the product of a twelve-month adjusted EBITDA measure and a specified median market price multiple based on a basket of public home health companies and transactions, after adding cash and deducting indebtedness that includes the outstanding principal balance under any intercompany notes. To determine the fair value of the Redeemable noncontrolling interests in our joint venture hospitals, we use the applicable hospitals' projected operating results and cash flows discounted using a rate that reflects market participant assumptions for the applicable facilities. The projected operating results use management's best estimates of economic and market conditions over the forecasted periods including assumptions for pricing and volume, operating expenses, and capital expenditures. See also Note 5, Redeemable Noncontrolling Interests.

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In addition to assets and liabilities recorded at fair value on a recurring basis, we are also required to record assets and liabilities at fair value on a nonrecurring basis. Generally, assets are recorded at fair value on a nonrecurring basis as a result of impairment charges or similar adjustments made to the carrying value of the applicable assets. During the three and six months ended June 30, 2018 and June 30, 2017, we did not record any gains or losses related to our nonfinancial assets and liabilities that are recognized or disclosed at fair value in the financial statements on a nonrecurring basis as part of our continuing operations.

As discussed in Note 1, Summary of Significant Accounting Policies, "Fair Value Measurements," to the consolidated financial statements accompanying the 2017 Form 10-K, the carrying value equals fair value for our financial instruments that are not included in the table below and are classified as current in our condensed consolidated balance sheets. The carrying amounts and estimated fair values for all of our other financial instruments are presented in the following table (in millions):

	As of June 30, 2018		As of December 31, 2017	
	Carrying Amount	Estimated Fair Value	Carrying Amount	Estimated Fair Value
Long-term debt:				
Advances under revolving credit facility	$150.0	$ 150.0	$95.0	$ 95.0
Term loan facilities	287.4	288.8	294.7	296.3
5.125% Senior Notes due 2023	296.3	303.0	295.9	306.8
5.75% Senior Notes due 2024	1,194.3	1,212.0	1,193.9	1,228.5
5.75% Senior Notes due 2025	344.7	354.9	344.4	364.9
Other notes payable	96.3	96.3	82.3	82.3
Financial commitments:				
Letters of credit	—	38.1	—	35.4

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 2017 Form 10-K.

7. Share-Based Payments

In February and May 2018, we issued a total of 0.5 million restricted stock awards to members of our management team and our board of directors. Approximately 0.2 million of these awards contain only a service condition, while the remainder contain both a service and a performance condition. For the awards that include a performance condition, the number of shares that will ultimately be granted to employees may vary based on the Company's performance during the applicable two-year performance measurement period. Additionally, in February 2018, 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 2017 Form 10-K.

8. Income Taxes

Our Provision for income tax expense of $29.3 million and $59.3 million for the three and six months ended June 30, 2018, respectively, primarily resulted from the application of our estimated effective blended federal and state income tax rate. Our Provision for income tax expense of $28.6 million and $68.3 million for the three and six months ended June 30, 2017, respectively, primarily resulted from the application of our estimated effective blended federal and state income tax rate and tax benefits resulting from exercises and vesting of share-based compensation.

We have state net operating losses ("NOLs") of $73.7 million that expire in various amounts at varying times through 2031. The $75.4 million of net deferred tax assets included in the accompanying condensed consolidated balance sheet as of June 30, 2018 reflects management's assessment it is more likely than not we will be able to generate sufficient future taxable

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income to utilize those deferred tax assets based on our current estimates and assumptions. As of June 30, 2018, we maintained a valuation allowance of $36.7 million due to uncertainties regarding our ability to utilize a portion of our state NOLs and other credits before they expire. The amount of the valuation allowance has been determined for each tax jurisdiction based on the weight of all available evidence including management's estimates of taxable income for each jurisdiction in which we operate over the periods in which the related deferred tax assets will be recoverable. It is possible we may be required to increase or decrease our valuation allowance at some future time if our forecast of future earnings varies from actual results on a consolidated basis or in the applicable state tax jurisdictions, if the timing of future tax deductions differs from our expectations, or pursuant to changes in state tax laws and rates.

During the third quarter of 2016, we filed a non-automatic tax accounting method change related to billings denied under pre-payment claims reviews conducted by certain of our MACs. In March 2017, the IRS approved our request resulting in additional tax benefits of approximately $51.3 million through December 31, 2017. These benefits are expected to reverse as pre-payment claims denials are settled and collected. This change did not have a material impact on our effective tax rate. The 2017 Tax Cuts and Jobs Act (the "Tax Act") included revisions to Internal Revenue Code §451 that may eliminate this deferral of revenue for tax purposes and require us to pay tax on such denied claims. We are currently evaluating this provision of the Tax Act and its future impact on the method change we received in March 2017.

Total remaining gross unrecognized tax benefits were $1.1 million and $0.3 million as of June 30, 2018 and December 31, 2017, respectively, all of which would affect our effective tax rate if recognized. A reconciliation of the beginning and ending liability for unrecognized tax benefits is as follows (in millions):

	Gross Unrecognized Income Tax Benefits		Accrued Interest and Penalties	
Balance at December 31, 2017	$	0.3	$	—
Gross amount of increases in unrecognized tax benefits related to prior periods	0.8		0.1	
Balance at June 30, 2018	$	1.1	$	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 six months ended June 30, 2018 and 2017 was not material. Accrued interest income related to income taxes as of June 30, 2018 and December 31, 2017 was not material.

In December 2014, we signed an agreement with the IRS to begin participating in their Compliance Assurance Process, a program in which we and the IRS endeavor to agree on the treatment of significant tax positions prior to the filing of our federal income tax return. We renewed this agreement in December 2015 for the 2016 tax year, in December 2016 for the 2017 tax year, and in January 2018 for the 2018 tax year. As a result of these agreements, the IRS surveyed our 2013, 2012, and 2011 federal income tax returns and is currently examining the 2017 and 2018 tax years. Our 2014 federal income tax return has been filed, and the IRS has not indicated its intent to examine or survey this return. The IRS has issued no-change Revenue Agent's Reports effectively closing our 2015 and 2016 tax year audits. As a result, we have settled federal income tax examinations with the IRS for all tax years through 2013 as well as 2015 and 2016. Our state income tax returns are also periodically examined by various regulatory taxing authorities. We are currently under audit by one state for tax years ranging from 2013 through 2015.

For the tax years that remain open under the applicable statutes of limitation, amounts related to unrecognized tax benefits have been considered by management in its estimate of our potential net recovery of prior years' income taxes. Based on discussions with taxing authorities, we anticipate that approximately $0.5 million of our unrecognized tax benefits will be released within the next 12 months.

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2018	2017	2018	2017
Basic:				
Numerator:				
Income from continuing operations	$113.0	$79.2	$218.7	$163.9
Less: Net income attributable to noncontrolling interests included in continuing operations	(21.4)	(16.4)	(42.8)	(34.0)
Less: Income allocated to participating securities	(0.3)	(0.2)	(0.6)	(0.4)
Income from continuing operations attributable to Encompass Health common shareholders	91.3	62.6	175.3	129.5
Income (loss) from discontinued operations, net of tax, attributable to Encompass Health common shareholders	0.2	0.2	(0.3)	(0.1)
Net income attributable to Encompass Health common shareholders	$91.5	$62.8	$175.0	$129.4
Denominator:				
Basic weighted average common shares outstanding	97.9	90.3	97.9	89.5
Basic earnings per share attributable to Encompass Health common shareholders:				
Continuing operations	$0.93	$0.70	$1.79	$1.45
Discontinued operations	—	—	—	—
Net income	$0.93	$0.70	$1.79	$1.45
Diluted:				
Numerator:				
Income from continuing operations	$113.0	$79.2	$218.7	$163.9
Less: Net income attributable to noncontrolling interests included in continuing operations	(21.4)	(16.4)	(42.8)	(34.0)
Add: Interest on convertible debt, net of tax	—	2.1	—	4.6
Add: Loss on extinguishment of convertible debt, net of tax	—	6.2	—	6.2
Income from continuing operations attributable to Encompass Health common shareholders	91.6	71.1	175.9	140.7
Income (loss) from discontinued operations, net of tax, attributable to Encompass Health common shareholders	0.2	0.2	(0.3)	(0.1)
Net income attributable to Encompass Health common shareholders	$91.8	$71.3	$175.6	$140.6
Denominator:				
Diluted weighted average common shares outstanding	99.6	98.9	99.6	99.0
Diluted earnings per share attributable to Encompass Health common shareholders:				
Continuing operations	$0.92	$0.70	$1.76	$1.42
Discontinued operations	—	—	—	—
Net income	$0.92	$0.70	$1.76	$1.42

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2018	2017	2018	2017
Basic weighted average common shares outstanding	97.9	90.3	97.9	89.5
Convertible senior subordinated notes	—	7.5	—	8.1
Restricted stock awards, dilutive stock options, and restricted stock units	1.7	1.1	1.7	1.4
Diluted weighted average common shares outstanding	99.6	98.9	99.6	99.0

For the second quarter of 2017, adding back the loss on extinguishment of convertible debt, net of tax to our Income from continuing operations attributable to Encompass Health common shareholders causes a per share increase when calculating diluted earnings per common share resulting in an antidilutive per share amount.

In October 2017, February 2018, and May 2018, our board of directors declared cash dividends of $0.25 per share that were paid in January 2018, April 2018, and July 2018, respectively. On July 24, 2018, our board of directors approved an increase in our quarterly dividend and declared a cash dividend of $0.27 per share, payable on October 15, 2018 to stockholders of record on October 1, 2018. As of June 30, 2018 and December 31, 2017, accrued common stock dividends of $26.0 million and $25.4 million, respectively, were included in Accrued expenses and other current liabilities in our condensed consolidated balance sheets. Future dividend payments are subject to declaration by our board of directors.

On September 30, 2009, we issued 5.0 million shares of common stock and 8.2 million common stock warrants in full satisfaction of our obligation to do so under the January 2007 comprehensive settlement of the consolidated securities action brought against us by our stockholders and bondholders. Under the terms of the related warrant agreement, the warrants were exercisable at a price of $41.40 per share by means of a cash or a cashless exercise at the option of the holder. The warrants were not assumed exercised for dilutive shares outstanding because they were antidilutive in the periods presented. The warrants expired on January 17, 2017.

The following table summarizes information relating to these warrants and their activity through their expiration date (number of warrants in millions):

	Number of Warrants	Weighted-Average Exercise Price
Common stock warrants outstanding as of December 31, 2016	8.2	$ 41.40
Cashless exercise	(6.5)	41.40
Cash exercise	(0.6)	41.40
Expired	(1.1)	41.40
Common stock warrants outstanding as of January 17, 2017	—	

The above exercises resulted in the issuance of 0.7 million shares of common stock. Cash exercises resulted in gross proceeds of approximately $27 million.

See Note 9, Long-term Debt and Note 16, Earnings per Common Share, to the consolidated financial statements accompanying the 2017 Form 10-K for additional information related to our convertible senior subordinated notes, common stock and common stock warrants.

10. Contingencies and Other Commitments

We operate in a highly regulated and litigious industry. As a result, various lawsuits, claims, and legal and regulatory proceedings have been and can be expected to be instituted or asserted against us. The resolution of any such lawsuits, claims,

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or legal and regulatory proceedings could materially and adversely affect our financial position, results of operations, and cash flows in a given period.

Nichols Litigation—

We were named as a defendant in a lawsuit filed March 28, 2003 by several individual stockholders in the Circuit Court of Jefferson County, Alabama, captioned Nichols v. HealthSouth Corp. The plaintiffs allege that we, some of our former officers, and our former investment bank engaged in a scheme to overstate and misrepresent our earnings and financial position. The plaintiffs are seeking compensatory and punitive damages. This case was stayed in the circuit court on August 8, 2005. 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 Encompass Health 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 the former officers named as a defendant has repeatedly attempted to remove the case to federal district court, most recently on December 11, 2012. We filed our latest motion to remand the case back to state court on January 10, 2013. On September 27, 2013, the federal court remanded the case back to state court. On November 25, 2014, the plaintiffs filed another amended complaint to assert new allegations relating to the time period of 1997 to 2002. On December 10, 2014, we filed a motion to dismiss on the grounds the plaintiffs lack standing because their claims were derivative in nature, and the claims were time-barred by the statute of limitations. On May 26, 2016, the court granted our motion to dismiss. The plaintiffs appealed the dismissal of the case to the Supreme Court of Alabama on June 28, 2016. On March 23, 2018, the Alabama Supreme Court reversed the trial court's dismissal, holding that the plaintiffs' claims were not derivative or time-barred, and remanded the case for further proceedings. On April 6, 2018, we filed an application for rehearing with the Alabama Supreme 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 an amount of loss, if any, or range of possible loss that might result from an adverse judgment or settlement of this case.

Other Litigation—

One of our hospital subsidiaries was named as a defendant in a lawsuit filed August 12, 2013 by an individual in the Circuit Court of Etowah County, Alabama, captioned Honts v. HealthSouth Rehabilitation Hospital of Gadsden, LLC. The plaintiff alleged that her mother, who died more than three months after being discharged from our hospital, received an unprescribed opiate medication at the hospital. We deny the patient received any such medication, accounted for all the opiates at the hospital and argued the plaintiff established no causal liability between the actions of our staff and her mother's death. The plaintiff sought recovery for punitive damages. On May 18, 2016, the jury in this case returned a verdict in favor of the plaintiff for $20.0 million. On June 17, 2016, we filed a renewed motion for judgment as a matter of law or, in the alternative, a motion for new trial or, in the further alternative, a motion seeking reduction of the damages awarded (collectively, the "post-judgment motions"). The trial court denied the post-judgment motions. We appealed the verdict as well as the rulings on the post-judgment motions to the Supreme Court of Alabama on October 12, 2016. On November 8, 2017, the Alabama Supreme Court heard the oral hearing of the appeal but has not yet rendered a decision.

We posted a bond in the amount of the judgment pending resolution of our appeal. We intend to vigorously defend ourselves in this case. Although we continue to believe in the merit of our defenses and counterarguments, we recorded a net charge of $5.7 million to Other operating expenses in our consolidated statements of operations for the year ended December 31, 2016. As of June 30, 2018, we maintained a liability of $20.1 million in Accrued expenses and other liabilities in our condensed consolidated balance sheet with a corresponding receivable of $15.5 million in Other current assets for the portion of the liability we would expect to be covered through our excess insurance coverages. The portion of this liability that would be a covered claim through our captive insurance subsidiary, HCS, Ltd. is $6.0 million.

Governmental Inquiries and Investigations—

On March 4, 2013, we received document subpoenas from an office of the United States Department of Health and Human Services Office of Inspector General ("HHS-OIG") addressed to four of our hospitals. Those subpoenas also requested complete copies of medical records for 100 patients treated at each of those hospitals between September 2008 and June 2012. The investigation is being conducted by the United States Department of Justice (the "DOJ"). On April 24, 2014, we received document subpoenas relating to an additional seven of our hospitals. The new subpoenas reference substantially similar investigation subject matter as the original subpoenas and request materials from the period January 2008 through December 2013. Two of the four hospitals addressed in the original set of subpoenas have received supplemental subpoenas to cover this new time period. The most recent subpoenas do not include requests for specific patient files. However, in February 2015, the DOJ requested the voluntary production of the medical records of an additional 70 patients, some of whom were treated in hospitals not subject to the subpoenas, and we provided these records. We have not received any subsequent requests for medical records from the DOJ.

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 this investigation and are currently unable to predict the timing or outcome of it. We intend to vigorously defend ourselves in this matter. Based on discussions with the DOJ, review of the current facts and circumstances as we understand them, and the nature of the investigation, it is not possible to estimate an amount of loss, if any, or range of possible loss that might result from it.

Other Matters—

The False Claims Act allows private citizens, called "relators," to institute civil proceedings on behalf of the United States alleging violations of the False Claims Act. These lawsuits, also known as "whistleblower" or "qui tam" actions, can involve significant monetary damages, fines, attorneys' fees and the award of bounties to the relators who successfully prosecute or bring these suits to the government. Qui tam cases are sealed at the time of filing, which means knowledge of the information contained in the complaint typically is limited to the relator, the federal government, and the presiding court. The defendant in a qui tam action may remain unaware of the existence of a sealed complaint for years. While the complaint is under seal, the government reviews the merits of the case and may conduct a broad investigation and seek discovery from the defendant and other parties before deciding whether to intervene in the case and take the lead on litigating the claims. The court lifts the seal when the government makes its decision on whether to intervene. If the government decides not to intervene, the relator may elect to continue to pursue the lawsuit individually on behalf of the government. It is possible that qui tam lawsuits have been filed against us, which suits remain under seal, or that we are unaware of such filings or precluded 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 CMS relating to amounts we suspect represent over-payments from these programs, whether due to inaccurate billing or otherwise. Some of these disclosures have resulted in, or may result in, Encompass Health refunding amounts to Medicare or other federal healthcare programs.

11. Segment Reporting

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

(1) inpatient rehabilitation and (2) home health and hospice. These reportable operating segments are consistent with

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information used by our chief executive officer, who is our chief operating decision maker, to assess performance and allocate resources. The following is a brief description of our reportable segments:

- Inpatient Rehabilitation - Our national network of inpatient rehabilitation hospitals stretches across 31 states and Puerto Rico, with a concentration of hospitals in the eastern half of the United States and Texas. As of June 30, 2018, we operate 128 inpatient rehabilitation hospitals, including one hospital that operates as a joint venture that we account for using the equity method of accounting. In addition, we manage five inpatient rehabilitation units through management contracts. We provide specialized rehabilitative treatment on both an inpatient and outpatient basis. Our inpatient rehabilitation hospitals provide a higher level of rehabilitative care to patients who are recovering from conditions such as stroke and other neurological disorders, cardiac and pulmonary conditions, brain and spinal cord injuries, complex orthopedic conditions, and amputations.
- Home Health and Hospice - As of June 30, 2018, we provide home health and hospice services across 272 locations and 30 states with concentrations in the Southeast and Texas. In addition, two of these agencies operate as joint ventures that we account for using the equity method of accounting. Our home health services include a comprehensive range of Medicare-certified home nursing services to adult patients in need of care. These services include, among others, skilled nursing, physical, occupational, and speech therapy, medical social work, home health aide, and private duty services. Our hospice services primarily include in-home services to terminally ill patients and their families to address patients' physical needs, including pain control and symptom management, and to provide emotional and spiritual support.

The accounting policies of our reportable segments are the same as those described in Note 1, Basis of Presentation, "Net Operating Revenues" and "Accounts Receivable" to these condensed consolidated financial statements and Note 1, Summary of Significant Accounting Policies, to the consolidated financial statements accompanying the 2017 Form 10-K. All revenues for our services are generated through external customers. See Note 1, Basis of Presentation, "Net Operating Revenues," for the payor composition of our revenues. No corporate overhead is allocated to either of our reportable segments. Our chief operating decision maker evaluates the performance of our segments and allocates resources to them based on adjusted earnings before interest, taxes, depreciation, and amortization ("Segment Adjusted EBITDA").

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

	Inpatient Rehabilitation				Home Health and Hospice			
	Three Months Ended June 30,		Six Months Ended June 30,		Three Months Ended June 30,		Six Months Ended June 30,	
	2018	2017	2018	2017	2018	2017	2018	2017
Net operating revenues	$834.6	$777.6	$1,674.9	$1,555.4	$233.1	$188.8	$438.8	$368.1
Operating expenses:								
Inpatient rehabilitation:								
Salaries and benefits	416.5	394.3	840.7	792.5	—	—	—	—
Other operating expenses	126.9	112.9	249.8	224.7	—	—	—	—
Supplies	34.7	33.8	70.6	67.5	—	—	—	—
Occupancy costs	16.0	15.5	31.5	30.6	—	—	—	—
Home health and hospice:								
Cost of services sold (excluding depreciation and amortization)	—	—	—	—	109.1	87.5	207.7	175.2
Support and overhead costs	—	—	—	—	80.8	67.7	152.8	134.5
	594.1	556.5	1,192.6	1,115.3	189.9	155.2	360.5	309.7
Other income	(1.2)	(0.9)	(1.7)	(1.9)	(0.5)	—	(0.5)	—
Equity in net income of nonconsolidated affiliates	(1.6)	(1.8)	(3.6)	(3.7)	(0.4)	(0.2)	(0.7)	(0.4)
Noncontrolling interests	19.8	15.4	40.3	31.9	2.5	1.0	4.4	2.1
Segment Adjusted EBITDA	$223.5	$208.4	$447.3	$413.8	$41.6	$32.8	$75.1	$56.7
Capital expenditures	$54.4	$62.6	$116.6	$105.8	$4.3	$2.2	$6.0	$3.9

	Inpatient Rehabilitation	Home Health and Hospice	Encompass Health Consolidated
As of June 30, 2018			
Total assets	$ 3,818.7	$1,311.2	$ 5,089.4
Investments in and advances to nonconsolidated affiliates	9.8	2.8	12.6
As of December 31, 2017			
Total assets	$ 3,789.1	$1,150.5	$ 4,893.7
Investments in and advances to nonconsolidated affiliates	9.3	2.6	11.9

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Segment reconciliations (in millions):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2018	2017	2018	2017
Total segment Adjusted EBITDA	$265.1	$241.2	$522.4	$470.5
General and administrative expenses	(54.9)	(52.4)	(116.0)	(88.9)
Depreciation and amortization	(49.7)	(45.8)	(95.6)	(91.0)
Loss on disposal of assets	(2.4)	(0.8)	(3.2)	(0.3)
Loss on early extinguishment of debt	—	(10.4)	—	(10.4)
Interest expense and amortization of debt discounts and fees	(37.7)	(40.4)	(73.3)	(81.7)
Net income attributable to noncontrolling interests	21.4	16.4	42.8	34.0
SARs mark-to-market impact on noncontrolling interests	0.9	—	1.9	—
Change in fair market value of equity securities	(0.4)	—	(1.0)	—
Income from continuing operations before income tax expense	$142.3	$107.8	$278.0	$232.2

	June 30, 2018	December 31, 2017
Total assets for reportable segments	$5,129.9	$ 4,939.6
Reclassification of deferred income tax liabilities to net deferred income tax assets	(40.5)	(45.9)
Total consolidated assets	$5,089.4	$ 4,893.7

Additional detail regarding the revenues of our operating segments by service line follows (in millions):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2018	2017	2018	2017
Inpatient rehabilitation:				
Inpatient	$809.6	$751.5	$1,626.7	$1,504.2
Outpatient and other	25.0	26.1	48.2	51.2
Total inpatient rehabilitation	834.6	777.6	1,674.9	1,555.4
Home health and hospice:				
Home health	204.8	171.9	390.1	335.8
Hospice	28.3	16.9	48.7	32.3
Total home health and hospice	233.1	188.8	438.8	368.1
Total net operating revenues	$1,067.7	$966.4	$2,113.7	$1,923.5

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 Encompass Health, and all guarantees are full and unconditional and joint and several, subject to certain customary conditions for release. Encompass Health’s investments in its consolidated subsidiaries, as well as guarantor subsidiaries’ investments in nonguarantor subsidiaries and nonguarantor subsidiaries’ investments in guarantor subsidiaries, are presented under the equity method of accounting with the related investment presented within the line items Intercompany receivable and investments in consolidated affiliates and Intercompany payable in the accompanying condensed consolidating balance sheets.

The terms of our credit agreement allow us to declare and pay cash dividends on our common stock so long as: (1) we are not in default under our credit agreement and (2) our senior secured leverage ratio (as defined in our credit agreement) remains less than or equal to 2x. 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 9, Long-term Debt, to the consolidated financial statements accompanying the 2017 Form 10-K.

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