

SECURITIES AND EXCHANGE COMMISSION

FORM 10-K/A

Annual report pursuant to section 13 and 15(d) [amend]

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FILER

HEALTHSOUTH CORP

CIK: **785161** | IRS No.: **630860407** | State of Incorporation: **DE** | Fiscal Year End: **1231**
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SIC: **8093** Specialty outpatient facilities, nec

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SECURITIES AND EXCHANGE COMMISSION
Washington, D. C. 20549
FORM 10-K/A

AMENDMENT NO. 2

(Mark One)

Annual Report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 [Fee Required] For the fiscal year ended December 31, 1994; or

Transition Report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 [No Fee Required] For the transition period from _____ to _____

Commission File Number 1-10315

HEALTHSOUTH Corporation

(Exact Name of Registrant as Specified in its Charter)

Delaware

63-0860407

(State or Other Jurisdiction of Incorporation or Organization)

(I.R.S. Employer Identification No.)

Two Perimeter Park South
Birmingham, Alabama

35243

(Address of Principal Executive Offices)

(Zip Code)

Registrant's Telephone Number, Including Area Code: (205) 967-7116

Securities Registered Pursuant to Section 12(b) of the Act:

Title of Each Class	Name of Each Exchange on which Registered
Common Stock, par value \$.01 per share	New York Stock Exchange
9.5% Senior Subordinated Notes due 2001	New York Stock Exchange
5% Convertible Subordinated Debentures due 2001	New York Stock Exchange

Securities Registered Pursuant to Section 12(g) of the Act: NONE

Indicate by check mark whether the Registrant (1) has filed all Reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the Registrant was required to file such Reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes No

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein and will not be contained, to the best of Registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

State the aggregate market value of the voting stock held by non-affiliates of the Registrant as of March 3, 1995:

Common Stock, par value \$.01 per share-\$1,383,817,854

Indicate the number of shares outstanding of each of the Registrant's classes of common stock, as of the latest practicable date.

Class	Outstanding at March 3, 1995
Common Stock, par value \$.01 per share	35,565,387 shares

DOCUMENTS INCORPORATED BY REFERENCE

No documents are incorporated by reference into this Annual Report on Form 10-K.

Index to Exhibits Page ____

Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations.

The following discussion is intended to facilitate the understanding and assessment of significant changes and trends related to the results of operations and financial condition of the Company, including certain factors related to the acquisition by the Company of 28 inpatient rehabilitation facilities and 45 associated outpatient rehabilitation locations from NME, effective December 31, 1993 (the "NME Selected Hospitals Acquisition"), as well as factors related to the acquisition transaction between the Company and ReLife, Inc., which was effective December 29, 1994 (the "ReLife Acquisition"). The ReLife Acquisition was accounted for as a pooling of interests, and, unless otherwise indicated, all amounts shown in the following discussion have been restated to reflect the effect of the ReLife Acquisition. This discussion and analysis should be read in conjunction with the Company's consolidated financial statements and notes thereto included elsewhere in this Annual Report on Form 10-K.

During the periods discussed below, governmental, commercial and private payors have increasingly recognized the need to contain their costs for healthcare services. These payors are turning to closer monitoring of services, prior authorization requirements, utilization review and increased utilization of outpatient services. The Company has experienced an increased effort by these payors to contain costs through negotiated discount pricing for health maintenance organizations and similar patient referral services. The Company views these efforts as an opportunity to demonstrate the effectiveness of its clinical programs and its ability to provide its rehabilitative healthcare services efficiently. The Company has entered into a number of contracts with payors to provide services and has realized an increased volume of patients as a result.

The Company provides rehabilitative healthcare services through its inpatient and outpatient rehabilitation facilities and medical centers. The Company has expanded its operations through the acquisition or opening of new facilities and satellite locations and by enhancing its existing operations. The Company's revenues increased from \$464,288,000 in 1992 to \$1,127,441,000 in 1994, an increase of 143%. As of December 31, 1994, the Company has 402 locations in 33 states, the District of Columbia and Ontario, Canada, including 238 outpatient rehabilitation locations (including 111 outpatient rehabilitation centers and 127 associated satellite clinics), 66 inpatient rehabilitation locations with 39 associated satellite outpatient clinics, five medical centers, and 54 locations providing other patient care services.

The Company's revenues include net patient service revenues and other operating revenues. Net patient service revenues are reported at estimated net realizable amounts from patients, insurance companies, third-party payors (primarily Medicare and Medicaid) and others for services rendered. Revenues from third-party payors also include estimated retroactive adjustments under reimbursement agreements which are subject to final review and settlement by appropriate authorities. Management determines allowances for doubtful accounts and contractual adjustments based on historical experience and the terms of payor contracts. Net accounts receivable include only those amounts estimated by management to be collectible.

The Company, in many cases, operates more than one site within a market. In such markets, there is customarily an outpatient center or inpatient facility with associated satellite outpatient locations. For purposes of the following discussion and analysis, same store operations are measured on locations within markets in which similar operations existed at the end of the period and include the operations of additional locations opened within the same market. New store operations are measured on locations within new markets.

Effective December 31, 1993, the Company acquired 28 inpatient rehabilitation facilities and 45 associated outpatient rehabilitation locations from NME. After giving effect to the NME Selected Hospitals Acquisition, the Company's pro forma revenues were \$979,456,000 and \$1,030,215,000 for the years ended December 31, 1992 and 1993, respectively.

Effective December 29, 1994, the Company consummated the ReLife Acquisition as a merger accounted for as a pooling of interests. In connection with the ReLife Acquisition, the Company acquired 31 inpatient rehabilitation facilities and 12 outpatient rehabilitation centers. The ReLife operations generated operating revenues of \$118,874,000 for the fiscal year ending September 30, 1994, compared to \$93,042,000 for the fiscal year ending September 30, 1993, an increase of 27.8%. The results for HEALTHSOUTH described below are based on a combination of HEALTHSOUTH's results for its December 31 fiscal year and ReLife's results for its September 30 fiscal year for all periods presented. All data set forth relating to revenues derived from Medicare and Medicaid do not take into account revenues of the ReLife facilities, because ReLife did not separately track such revenues prior to consummation of the ReLife Acquisition.

The Company determines the amortization period of the cost in excess of net asset value of purchased facilities based on an evaluation of the facts and

circumstances of each individual purchase transaction. The evaluation includes an analysis of historic and projected financial performance, an evaluation of the estimated useful life of the buildings and fixed assets acquired, the indefinite useful life of Certificates of Need and licenses acquired, the competition within local markets, lease terms where applicable, and the legal term of partnerships where applicable. The Company utilizes independent appraisers and relies on its own management expertise in evaluating each of the factors noted above. With respect to the carrying value of the excess of cost over net asset value of purchased facilities and other intangible assets, the Company determines on a quarterly basis whether an impairment event has occurred by considering factors such as the market value of the asset, a significant adverse change in legal factors or in the business climate, adverse action by a regulator, a history of operating losses or cash flow losses, or a projection of continuing losses associated with an operating entity. The carrying value of excess cost over net asset value of purchased facilities and other intangible assets will be evaluated if the facts and circumstances suggest that it has been impaired. If this evaluation indicates that the value of the asset will not be recoverable, as determined based on the undiscounted cash flows of the entity acquired over the remaining amortization period, the Company's carrying value of the asset will be reduced by the estimated shortfall of cash flows.

Results of Operations of the Company

Twelve-Month Periods Ended December 31, 1992 and 1993

The Company operated 171 outpatient rehabilitation locations at December 31, 1993, compared to 126 outpatient rehabilitation locations at December 31, 1992. In addition, the Company operated 39 inpatient facilities and four medical centers at December 31, 1993, compared to 22 inpatient facilities and four medical centers at December 31, 1992. In 1993, the Company opened the Vanderbilt Stallworth Rehabilitation Hospital in Nashville, Tennessee, and acquired 13 inpatient facilities from Rebound, Inc. The foregoing information does not give effect to the facilities acquired effective December 31, 1993 in the NME Selected Hospitals Acquisition.

The Company's operations generated revenues of \$575,346,000 in 1993, an increase of \$111,058,000, or 23.9%, as compared to 1992 revenues. Same store revenues for the twelve months ended December 31, 1993 were \$539,377,000 an increase of \$75,089,000, or 16.1%, as compared to the same period in 1992. New store revenues for 1993 were \$35,969,000. The increase in revenues is primarily attributable to increases in patient volume and the addition of 45 outpatient rehabilitation locations and 13 inpatient locations. Revenues generated from patients under Medicare and Medicaid plans respectively accounted for 30.6% and 1.0% of revenues for 1993, compared to 29.3% and 1.3% of revenues for 1992. Revenues from any other single third-party payor were not significant in relation to the Company's revenues. During 1993, same store outpatient visits and inpatient days increased 19.9% and 8.2%, respectively. Revenue per outpatient visit and revenue per inpatient day for same store operations increased by 0.6% and 6.3%, respectively.

Operating expenses, at the operating unit level, were \$418,981,000, or 72.8% of revenues, for 1993, compared to 74.8% of revenues for 1992. Same store operating expenses for 1993 were \$391,409,000, or 72.6% of related revenues. New store operating expenses were \$27,572,000, or 76.7% of related revenues. The decrease in operating expenses as a percentage of revenues is primarily attributable to increased patient volume and controlled expenses. Corporate general and administrative expenses increased from \$14,418,000 in 1992 to \$20,018,000 in 1993. As a percentage of revenues, corporate general and administrative expenses increased from 3.1% in 1992 to 3.5% in 1993. Total operating expenses were \$438,999,000, or 76.3% of revenues, for 1993, compared to \$361,491,000, or 77.9% of revenues, for 1992. The provision for doubtful accounts was \$13,875,000, or 2.4% of revenues, for 1993, compared to \$11,842,000, or 2.6% of revenues, for 1992.

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Depreciation and amortization expense was \$39,376,000 for 1993, compared to \$26,737,000 for 1992. The increase represents the investment in additional assets by the Company. Interest expense increased to \$14,261,000 in 1993 compared to \$11,295,000 for 1992 primarily because of the increased borrowings during the year under the Company's revolving line of credit. For 1993, interest income was \$3,698,000, compared to \$5,121,000 for 1992. The reduction in interest income is primarily attributable to the reduction in rates received on invested funds and a decrease in the cash balance.

As a result of the NME Selected Hospitals Acquisition, the Company recognized an expense of approximately \$49,742,000 during the year ended December 31, 1993. By recognizing this expense, the Company accrued approximately \$3,000,000 for costs related to certain employee separations and relocations. The Company expects the plan of consolidation to take up to 24 months. The \$3,000,000 accrual, which is the only cash expense included in the acquisition-related expense, will be paid over that same period. In addition, the Company has provided approximately \$39,000,000 for the write-down of certain assets to net realizable value as the result of planned facility consolidations,

and approximately \$7,700,000 for the write-off of certain capitalized development projects. The consolidations are applicable in selected markets where the Company's services overlap with those of the acquired facilities. The costs of development projects in certain target markets that were previously capitalized were written off due to the acquisition of NME facilities in or near those markets. For further discussion, see Note 10 of "Notes to Consolidated Financial Statements".

Income before minority interests and income taxes for 1993 was \$22,791,000, compared to \$54,379,000 for 1992. The provision for income taxes for 1993 was \$9,009,000, compared to \$18,383,000 for 1992, resulting in effective tax rates of 39.9% for 1993 and 34.7% for 1992. Net income for 1993 was \$13,592,000.

Twelve-Month Periods Ended December 31, 1993 and 1994

The Company operated 238 outpatient rehabilitation locations (excluding outpatient satellites of inpatient facilities) at December 31, 1994, compared to 171 outpatient rehabilitation locations at December 31, 1993. In addition, the Company operated 66 inpatient facilities and five medical centers at December 31, 1994, compared to 39 inpatient facilities and four medical centers at December 31, 1993.

The Company's operations generated revenues of \$1,127,441,000 in 1994, an increase of \$552,095,000, or 96.0%, as compared to 1993 revenues. Same store revenues for the twelve months ended December 31, 1994 were \$660,973,000, an increase of \$85,627,000, or 14.9%, as compared to the same period in 1993. New store revenues for 1994 were \$466,468,000. New store revenues reflect (1) the 28 inpatient rehabilitation facilities and 45 associated outpatient rehabilitation locations associated with the NME Selected Hospitals Acquisition, (2) the acquisition of a specialty medial center in Dallas, Texas, (3) the opening of three new inpatient rehabilitation facilities, (4) the acquisition of outpatient locations in 28 new markets, (5) the acquisition of a contract therapist provider, and (6) the acquisition of a diagnostic imaging company. See Note 10 of "Notes to Consolidated Financial Statements". The increase in revenues is primarily attributable to the addition of these operations and increases in patient volume. Revenues generated from patients under Medicare and Medicaid plans respectively accounted for 41.0% and 3.2% of total revenues for 1994, compared to 30.6% and 1.0% of total revenues for 1993. Revenues from any other single third-party payor were not significant in relation to the Company's total revenues. The increase in Medicare revenues is primarily attributable to the NME Selected Hospitals Acquisition, since the acquired facilities had a greater proportion of Medicare patients than the Company's historical experience in its existing facilities. During 1994, same store outpatient visits and inpatient days increased 21.8% and 23.0%, respectively. Revenue per outpatient visit and revenue per inpatient day for the same store operations decreased by 7.8% and 8.4%, respectively. These decreases were offset by increased volume from managed care and national accounts and by control of expenses.

Operating expenses, at the operating unit level, were \$835,888,000, or 74.1% of revenues, for 1994, compared to 72.8% of revenues for 1993. This change was due to the decrease in revenue per visit and revenue per inpatient day described above. Same store operating expenses for 1994 were \$496,870,000, or 75.2% of related revenues. New store operating expenses were \$339,018,000, or 72.7% of related revenues. Corporate general and administrative expenses increased from \$20,018,000 in 1993 to \$37,139,000 in 1994. As a percentage of revenues, corporate general and administrative expenses decreased from 3.5% in 1993 to 3.3% in 1994. Total operating expenses were \$873,027,000, or 77.4% of revenues, for 1994, compared to \$438,999,000, or 76.3% of revenues, for 1993. The provision for doubtful accounts was \$20,583,000, or 1.8% of revenues, for 1994, compared to \$13,875,000, or 2.4% of revenues, for 1993.

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Depreciation and amortization expense was \$75,588,000 for 1994, compared to \$39,376,000 for 1993. The increase represents the investment in additional assets by the Company. Interest expense increased to \$57,255,000 in 1994, compared to \$14,261,000 for 1993, primarily because of the increased borrowings during the year under the Company's revolving line of credit, the issuance of \$250,000,000 principal amount of 9.5% Senior Subordinated Notes due 2001 and the issuance of \$115,000,000 principal amount of 5% Convertible Subordinated Debentures due 2001. See Note 7 of "Notes to Consolidated Financial Statements". For 1994, interest income was \$4,224,000 compared to \$3,698,000 for 1993. The increase in interest income is primarily attributable to the increase in the Company's cash position during the year.

During 1994, the Company began implementation of the plan of consolidation related to the NME Selected Hospitals Acquisition. The \$3,000,000 accrual for costs related to employee separations and relocations was reduced by approximately \$758,000. A total of 208 employees were affected during 1994. In addition, assets with a net book value \$17,911,000 were written off against the \$39,000,000 provided for the plan of consolidation. Finally, the Company wrote off all of the \$7,700,000 in capitalized development projects. The Company will

complete the plan of consolidation during 1995. It is management's opinion that the remaining accrual of \$23,669,000 is adequate to complete the plan. See Note 10 of "Notes to Consolidated Financial Statements".

As a result of the ReLife Acquisition in the fourth quarter of 1994, the Company has recognized \$2,949,000 in ReLife merger expenses during 1994. This amount represents costs and expenses incurred or accrued in connection with completing the ReLife Acquisition. See Note 2 of "Notes to Consolidated Financial Statements".

During 1994, the Company recognized a \$10,500,000 loss on impairment of assets. This amount relates to the termination of a ReLife management contract and a permanently damaged ReLife facility. The Company determined not to attempt to reopen such damaged facility because, under its existing licensure as a transitional living facility, the facility could not be operated on a basis which would allow it to cover the associated lease costs, and the Company did not believe it likely that any change in licensure could be obtained. This facility is leased under an operating lease as described in Note 12 through the year 2001. An impairment accrual has been established based on the projected undiscounted net cash flows related to this non-operating facility for the remainder of the lease term. The accrual totals \$5,900,000 and consists of \$4,700,000 in lease payments and \$1,200,000 in fixed costs and operating expenses, including property taxes, maintenance, security and other related costs. Also during 1994, the Company recognized a \$4,500,000 loss on abandonment of a ReLife computer project. See Note 16 of "Notes to Consolidated Financial Statements".

Income before minority interests and income taxes for 1994 was \$87,263,000, compared to \$22,791,000 for 1993. Minority interests reduced income before income taxes by \$203,000, compared to \$190,000 for 1993. The provision for income taxes for 1994 was \$33,835,000, compared to \$9,009,000 for 1993, resulting in effective tax rate of 38.9% for 1994 and 39.9% for 1993. Net income for 1994 was \$53,225,000.

Liquidity and Capital Resources

At December 31, 1994, the Company had working capital of \$218,681,000, including cash and marketable securities of \$82,577,000. Working capital at December 31, 1993 was \$198,352,000, including cash and marketable securities of \$77,299,000. For 1994, cash provided by operations was \$132,050,000, compared to \$59,787,000 for 1993. The Company used \$234,816,000 for investing activities during 1994, compared to \$570,916,000 for 1993. Additions to property, plant and equipment and acquisitions accounted for \$123,575,000 and \$85,967,000, respectively, during 1994. Those same investing activities accounted for \$113,161,000 and \$428,307,000, respectively, in 1993. Financing activities provided \$100,384,000 and \$493,095,000 during 1994 and 1993, respectively. Net borrowing proceeds (borrowings less principal reductions) for 1994 and 1993 were \$87,603,000 and \$494,979,000, respectively.

Net Accounts receivable were \$222,720,000 at December 31, 1994, compared to \$165,586,000 at December 31, 1993. The number of days of average revenues in average receivables was 69.9 at December 31, 1994, compared to 69.5 at December 31, 1993 (excluding the receivables acquired from NME at December 31, 1993). The concentration of net accounts receivable from patients, third-party payors, insurance companies and others at December 31, 1994 is consistent with the related concentration of revenues for the period then ended.

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Beginning December 1, 1993, the Company became self-insured for professional liability and comprehensive general liability. The Company purchased coverage for all claims incurred prior to December 1, 1993. Additionally, the Company purchased underlying insurance which will cover all claims once established limits have been exceeded. The funding requirements for the self-insurance plan will be based on an independent actuarial determination. The funding requirements are not expected to have a material impact on the Company's liquidity and capital positions.

The Company has a \$550,000,000 revolving line of credit with NationsBank of North Carolina and 15 other participating banks. Interest is paid quarterly based on LIBOR plus a predetermined margin, prime, or competitively bid rates from the participating banks. This credit facility revolves until June 1, 1997, at which time the outstanding principal balance converts to a term loan to be repaid in 15 quarterly payments beginning June 30, 1997. The Company provided a negative pledge on all assets and granted the banks a first priority security interest in all shares of stock of its subsidiaries and rights and interests in its controlled partnerships. The effective interest rate on the average outstanding balance under the revolving line of credit was 5.94% for the year ended December 31, 1994, compared to the average prime rate of 7.15% during the same period. At December 31, 1994, the Company had drawn \$510,000,000 under its revolving line of credit. The Company has received a fully-underwritten commitment to amend and restate the credit agreement, which will increase the size of the facility to \$1,000,000,000.

The Company intends to pursue the acquisition or development of

additional healthcare operations, including comprehensive outpatient rehabilitation facilities, inpatient rehabilitation facilities and companies engaged in the provision of rehabilitation-related services, and to expand certain of its existing facilities. While it is not possible to estimate precisely the amounts which will actually be expended in the foregoing areas, the Company anticipates that over the next twelve months it will spend approximately \$50,000,000 for the acquisition and/or development of new comprehensive outpatient rehabilitation facilities and approximately \$70,000,000 for inpatient facility projects and the construction and equipping of additions to existing inpatient facilities.

As of January 22, 1995, the Company entered into an Amended and Restated Plan and Agreement of Merger with Surgical Health Corporation ("SHC"), pursuant to which the Company has agreed to acquire SHC through a stock-for-stock merger to be accounted for as a pooling of interests. SHC operates 36 outpatient surgery centers. Under the terms of the Plan and Agreement of Merger, the Company will issue shares of its Common Stock to all holders of SHC's Common Stock pursuant to an exchange ratio calculated to provide \$4.60 in value of HEALTHSOUTH Common Stock for each share of SHC's capital stock, subject to adjustment in certain circumstances. The transaction is subject to the satisfaction of various conditions, including the receipt of all required regulatory approvals and the termination or expiration of the waiting period under the HSR Act. The Company currently expects the transaction to be consummated during the second quarter of 1995 and is working toward the satisfaction of all such conditions and the obtaining of all regulatory approvals. Management expects the SHC acquisition to positively affect the Company's liquidity, capital resources and results of operations as a result of improved cash flow and leverage.

In addition, on February 3, 1995, the Company entered into a Stock Purchase Agreement with NovaCare, Inc. and NC Resources, Inc., pursuant to which the Company has agreed to acquire the operations of NovaCare, Inc.'s rehabilitation hospital division. NC Resources, Inc. is a wholly-owned subsidiary of NovaCare, Inc. NC Resources, Inc. in turn owns all of the capital stock of Rehab Systems Company ("RSC"), the holding company for the acquired division. In connection with that transaction, the Company will pay a cash purchase price of \$215,000,000, and will assume liabilities of approximately \$20,000,000. The transaction is subject to various conditions, including the expiration or termination of the waiting period under the HSR Act. The Company expects the transaction to be consummated early in the second quarter of 1995.

Although the Company is continually considering and evaluating acquisitions and opportunities for future growth, the Company has not entered into any agreements with respect to material future acquisitions other than the transactions with SHC and NovaCare. The Company believes that existing cash, cash flow from operations, and borrowings under the revolving line of credit, as increased pursuant to the new commitment, will be sufficient to satisfy the Company's estimated cash requirements for the next twelve months and thereafter.

Inflation in recent years has not had a significant effect on the Company's business, and is not expected to adversely affect the Company in the future unless it increases significantly.

Item 8. Financial Statements and Supplementary Data.

Consolidated financial statements of the Company meeting the requirements of Regulation S-X are filed on the succeeding pages of this Item 8 of this Annual Report on Form 10-K, as listed below:

Page

Report of Independent Auditors

Consolidated Balance Sheets as of December 31, 1993 and 1994

Consolidated Statements of Income for the Years Ended
December 31, 1992, 1993 and 1994

Consolidated Statements of Stockholders' Equity for the
Years Ended December 31, 1992, 1993 and 1994

Consolidated Statements of Cash Flows for the Years Ended
December 31, 1992, 1993 and 1994

Notes to Consolidated Financial Statements

Other financial statements and schedules required under Regulation S-X are listed in Item 14(a)2, and filed under Item 14(d), of this Annual Report on Form 10-K.

Item 14. Exhibits, Financial Statement Schedules,
and Reports on Form 8-K

Report of Independent Auditors

The Board of Directors
HEALTHSOUTH Corporation

We have audited the accompanying consolidated balance sheets of HEALTHSOUTH Corporation and Subsidiaries as of December 31, 1993 and 1994, and the related consolidated statements of income, stockholders' equity and cash flows for each of the three years in the period ended December 31, 1994. Our audits also included the financial statement schedule listed in the Index at Item 14 (a). These financial statements and schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of HEALTHSOUTH Corporation and Subsidiaries at December 31, 1993 and 1994, and the consolidated results of their operations and their cash flows for each of the three years in the period ended December 31, 1994, in conformity with generally accepted accounting principles. Also, in our opinion, the related financial statement schedule, when considered in relation to the basic financial statements taken as a whole, presents fairly in all material respects the information set forth therein.

ERNST & YOUNG LLP

Birmingham, Alabama
February 24, 1995

HEALTHSOUTH Corporation and Subsidiaries

Consolidated Balance Sheets

<TABLE>
<CAPTION>

December 31

	1993	1994
	(In thousands)	
<S>	<C>	<C>
Assets		
Current assets:		
Cash and cash equivalents (Note 3)	\$ 68,331	\$ 65,949
Other marketable securities (Note 3)	8,968	16,628
Accounts receivable, net of allowances for doubtful accounts and contractual adjustments of \$118,746,000 in 1993 and \$141,859,000 in 1994	165,586	222,720
Inventories	21,139	22,262
Prepaid expenses and other current assets	41,814	68,401
Total current assets	305,838	395,960
Other assets:		
Loans to officers	1,488	1,240
Other (Note 4)	21,950	40,692
	23,438	41,932
Property, plant and equipment, net (Note 5)	744,084	789,538
Intangible assets, net (Note 6)	208,162	324,904
Total assets	\$1,281,522	\$1,552,334

</TABLE>

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<TABLE>
<CAPTION>

	December 31	
	1993	1994
<S>	<C>	<C>
Liabilities and stockholders' equity		
Current liabilities:		
Accounts payable	\$ 45,737	\$ 83,180
Salaries and wages payable	26,877	32,672
Accrued interest payable and other liabilities	29,857	46,714
Current portion of long-term debt and leases (Note 7)	5,015	14,713
Total current liabilities	107,486	177,279
Long-term debt (Note 7)	813,334	930,061
Deferred income taxes (Note 11)	9,647	7,882
Deferred revenue (Note 15)	-	7,526
Other long-term liabilities (Note 16)	458	5,655
Minority interests--limited partnerships (Note 9)	(1,799)	(2,203)
Commitments and contingent liabilities (Notes 12 and 17)		
Stockholders' equity:		
Preferred Stock, \$.10 par value--1,500,000 shares authorized; issued and outstanding--none	-	-
Common Stock, \$.01 par value--100,000,000 shares authorized; issued--33,195,000 in 1993 and 34,230,000 in 1994	332	342
Additional paid-in capital	285,679	306,565

Retained earnings	85,640	137,027
Treasury stock, at cost (91,000 shares)	(323)	(323)
Receivable from Employee Stock Ownership Plan (Note 13)	(18,932)	(17,477)
	-----	-----
Total stockholders' equity	352,396	426,134
	-----	-----
Total liabilities and stockholders' equity	\$ 1,281,522	\$ 1,552,334
	-----	-----

</TABLE>

See accompanying notes.

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HEALTHSOUTH Corporation and Subsidiaries

Consolidated Statements of Income

<TABLE>

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	Year ended December 31		
	1992	1993	1994

	(In thousands, except for per share amounts)		
<S>	<C>	<C>	<C>
Revenues	\$ 464,288	\$ 575,346	\$ 1,127,441
Operating expenses:			
Operating units	347,073	418,981	835,888
Corporate general and administrative	14,418	20,018	37,139
Provision for doubtful accounts	11,842	13,875	20,583
Depreciation and amortization	26,737	39,376	75,588
Interest expense	11,295	14,261	57,255
Interest income	(5,121)	(3,698)	(4,224)
ReLife merger expense (Note 2)	-	-	2,949
Loss on impairment of assets (Note 16)	-	-	10,500
Loss on abandonment of computer project (Note 16)	-	-	4,500
NME Selected Hospitals Acquisition related expense (Note 10)	-	49,742	-
Terminated merger expense (Note 14)	3,665	-	-
	-----	-----	-----
	409,909	552,555	1,040,178
	-----	-----	-----
Income before income taxes and minority interests	54,379	22,791	87,263
Provision for income taxes (Note 11)	18,383	9,009	33,835
	-----	-----	-----
Minority interests	35,996	13,782	53,428
	1,402	190	203
	-----	-----	-----
Net income	\$ 34,594	\$ 13,592	\$ 53,225
	-----	-----	-----
Weighted average common and common equivalent shares outstanding	34,418	34,717	37,938
	-----	-----	-----
Net income per common and common equivalent share	\$ 1.01	\$.39	\$ 1.40
	-----	-----	-----
Net income per common share--assuming full dilution	\$ N/A	\$ N/A	\$ 1.39
	-----	-----	-----

</TABLE>
See accompanying notes.

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HEALTHSOUTH Corporation and Subsidiaries							
Consolidated Statements of Stockholders' Equity							
	Common Shares	Common Stock	Additional Paid-In Capital	Retained Earnings	Treasury Stock	Receivable from ESOP	Total Stockholders' Equity
(In thousands)							
<S>	<C>	<C>	<C>	<C>	<C>	<C>	<C>
Balance at December 31, 1991	30,978	\$ 310.4	\$246,105.4	\$52,079.0	\$ (60.0)	\$ (10,000.0)	\$288,434.8
Proceeds from issuance of common shares	949	9.5	24,341.5	--	--	--	24,351.0
Proceeds from exercise of options	956	9.6	6,873.6	--	--	--	6,883.2
Income tax benefits related to Incentive Stock Options	--	--	5,634.7	--	--	--	5,634.7
Common shares exchanged in the exercise of options	(4)	--	(95.6)	--	--	--	(95.6)
Loan to Employee Stock Ownership Plan	--	--	--	--	--	(10,000.0)	(10,000.0)
Reduction in Receivable from Employee Stock Ownership Plan	--	--	--	--	--	358.0	358.0
Purchase of limited partnership units	21	.2	499.8	(10,193.4)	--	--	(9,693.4)
Net income	--	--	--	34,594.0	--	--	34,594.0
Balance at December 31, 1992	32,900	329.7	283,359.4	76,479.6	(60.0)	(19,642.0)	340,466.7
Proceeds from exercise of options	224	2.2	1,734.4	--	--	--	1,736.6
Income tax benefits related to Incentive Stock Options	--	--	584.7	--	--	--	584.7
Reduction in Receivable from Employee Stock Ownership Plan	--	--	--	--	--	710.1	710.1
Purchase of limited partnership units	--	--	--	(4,431.7)	--	--	(4,431.7)
Purchase of treasury stock	(20)	--	--	--	(263.0)	--	(263.0)
Net income	--	--	--	13,592.1	--	--	13,592.1
Balance at December 31, 1993	33,104	331.9	285,678.5	85,640.0	(323.0)	(18,931.9)	352,395.5

</TABLE>

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<TABLE>
<CAPTION>

HEALTHSOUTH Corporation and Subsidiaries	
Consolidated Statements of Stockholders' Equity (continued)	
Additional	Total

	Common Shares	Common Stock	Paid-In Capital	Retained Earnings	Treasury Stock	Receivable from ESOP	Stockholders' Equity
	(In thousands)						
<S>	<C>	<C>	<C>	<C>	<C>	<C>	<C>
Proceeds from issuance of common shares at \$27.17 per share	19	\$.2	\$ 532.8	\$ --	\$ --	\$ --	\$ 533.0
Proceeds from exercise of options	1,027	10.3	14,205.4	--	--	--	14,215.7
Income tax benefits related to Incentive Stock Options	--	--	6,469.6	--	--	--	6,469.6
Common shares exchanged in the exercise of options	(11)	(.1)	(321.3)	--	--	--	(321.4)
Reduction in receivable from Employee Stock Ownership Plan	--	--	--	--	--	1,455.0	1,455.0
Purchase of limited partnership units	--	--	--	(1,838.0)	--	--	(1,838.0)
Net income	--	--	--	53,225.0	--	--	53,225.0
Balance at December 31, 1994	34,139	\$342.3	\$306,565.0	\$137,027.0	\$ (323.0)	\$ (17,476.9)	\$426,134.4

</TABLE>
See accompanying notes.

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<TABLE>
<CAPTION>

HEALTHSOUTH Corporation and Subsidiaries

Consolidated Statements of Cash Flows

	Year ended December 31		
	1992	1993	1994
	(In thousands)		
<S>	<C>	<C>	<C>
Operating activities			
Net income	\$ 34,594	\$ 13,592	\$ 53,225
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	26,737	39,376	75,588
Provision for doubtful accounts	11,842	13,875	20,583
Provision for losses on impairment of assets	-	-	10,500
Provision for losses on abandonment of computer project	-	-	4,500
NME Selected Hospitals Acquisition related expense	-	49,742	-
Income applicable to minority interests of limited partnerships	1,402	190	203
Provision (benefit) for deferred income taxes	4,501	(6,554)	(1,199)
Provision for deferred revenue	(279)	(49)	(164)
Gain on sale of property, plant and equipment	-	-	(627)
Changes in operating assets and liabilities, net of effects of acquisitions:			

Accounts receivable	(32,894)	(24,195)	(66,781)
Inventories, prepaid expenses and other current assets	(12,956)	(15,639)	(21,166)
Accounts payable and accrued expenses	6,245	(10,551)	57,388

Net cash provided by operating activities	39,192	59,787	132,050
Investing activities			
Purchases of property, plant and equipment	(88,503)	(113,161)	(123,575)
Proceeds from sale of property, plant and equipment	-	-	59,025
Additions to intangible assets, net of effects of acquisitions	(25,206)	(39,156)	(59,307)
Assets obtained through acquisitions, net of liabilities assumed	(53,961)	(428,307)	(85,434)
Changes in other assets	1,834	(4,846)	(17,526)
Proceeds received on sale of other marketable securities	14,041	20,554	1,660
Investments in other marketable securities	(13,000)	(6,000)	(9,126)

Net cash used in investing activities	(164,795)	(570,916)	(234,283)

</TABLE>

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<TABLE>
<CAPTION>

HEALTHSOUTH Corporation and Subsidiaries
Consolidated Statements of Cash Flows (continued)

	Year ended December 31		
	1992	1993	1994
	(In thousands)		
<S>	<C>	<C>	<C>
Financing activities			
Proceeds from borrowings	\$ 169,800	\$ 512,710	\$ 940,084
Principal payments on long-term debt and leases	(61,313)	(17,731)	(852,481)
Proceeds from exercise of options	6,788	1,736	13,895
Proceeds from issuance of common stock	19,004	--	--
Purchase of treasury stock	--	(263)	--
Loans to Employee Stock Ownership Plan	(10,000)	--	--
Reduction in Receivable from Employee Stock Ownership Plan	358	710	1,455
Proceeds from investment by minority interests	971	614	44
Purchase of limited partnership interests	(11,495)	(3,784)	(1,090)
Payment of cash distributions to limited partners	(2,833)	(897)	(2,056)

Net cash provided by financing activities	111,280	493,095	99,851

Decrease in cash and cash equivalents	(14,323)	(18,034)	(2,382)
Cash and cash equivalents at beginning of year	100,688	86,365	68,331

Cash and cash equivalents at end of year	\$ 86,365	\$ 68,331	\$ 65,949

Supplemental disclosures of cash flow information			
Cash paid during the year for:			
Interest	\$ 12,899	\$ 12,344	\$ 48,668
Income taxes	10,466	20,326	28,029

</TABLE>

Non-cash investing activities:

The Company assumed liabilities of \$57,091,000, \$88,566,000 and \$24,659,000 during the years ended December 31, 1992, 1993 and 1994, respectively, in conjunction with its acquisitions. During the year ended December 31, 1994, the Company issued 19,000 common shares, with a market value of

\$533,000, as consideration for an acquisition.

Non-cash financing activities:

The Company received a tax benefit from the disqualifying disposition of incentive stock options of \$5,635,000, \$585,000 and \$6,470,000 for the years ended December 31, 1992, 1993 and 1994, respectively.

During the years ended December 31, 1992 and 1994, respectively, 4,000 and 11,000 common shares were exchanged in the exercise of options. The shares exchanged had market values on the date of exchange of \$95,600 and \$321,400, respectively.

See accompanying notes.

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HEALTHSOUTH Corporation and Subsidiaries

Notes to Consolidated Financial Statements

December 31, 1994

1. Significant Accounting Policies

The significant accounting policies followed by HEALTHSOUTH Corporation (formerly HEALTHSOUTH Rehabilitation Corporation) and its subsidiaries (the Company) are presented as an integral part of the consolidated financial statements.

Principles of Consolidation

The consolidated financial statements include the accounts of HEALTHSOUTH Corporation (HEALTHSOUTH) and its wholly-owned subsidiaries, as well as its limited partnerships (see Note 9). All significant intercompany accounts and transactions have been eliminated in consolidation.

HEALTHSOUTH Corporation is engaged in the business of providing comprehensive rehabilitative and clinical healthcare services on an inpatient and outpatient basis.

Marketable Securities

Marketable equity securities and debt securities are classified as available-for-sale. Available-for-sale securities are carried at fair value, with the unrealized gains and losses, if material, reported as a separate component of stockholders' equity, net of tax. The adjusted cost of the specific security sold method is used to compute gain or loss on the sale of securities. Interest and dividends on securities classified as available-for-sale are included in investment income. Marketable equity securities and debt securities of the Company have maturities of less than one year.

Accounts Receivable and Third-Party Reimbursement Activities

Receivables from patients, insurance companies and third-party contractual insured accounts (Medicare and Medicaid) are based on payment agreements which generally result in the Company collecting an amount different from the established rates. Final determination of the settlement is subject to review by appropriate authorities. Adequate allowances are provided for doubtful accounts and contractual adjustments. Uncollectible accounts are written off against the allowance for doubtful accounts after adequate collection efforts are made. Net accounts receivable include only those amounts estimated by management to be collectible.

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HEALTHSOUTH Corporation and Subsidiaries

Notes to Consolidated Financial Statements (continued)

1. Significant Accounting Policies (continued)

The concentration of net accounts receivable from third-party contractual payors and others, as a percentage of total net accounts receivable, was as follows:

	December 31	
	1993	1994
Medicare	33%	36%
Medicaid	4%	6%
Other	63%	58%

Inventories

Inventories are stated at the lower of cost or market using the specific identification method.

Property, Plant and Equipment

Property, plant and equipment are recorded at cost. Upon sale or retirement of property, plant or equipment, the cost and related accumulated depreciation are eliminated from the respective account and the resulting gain or loss is included in the results of operations.

Interest cost incurred during the construction of a facility is capitalized. The Company incurred interest of \$13,274,000, \$16,645,000 and \$59,014,000 of which \$1,979,000, \$2,384,000 and \$1,759,000 was capitalized during 1992, 1993 and 1994, respectively.

Depreciation and amortization is computed using the straight-line method over the estimated useful lives of the assets or the term of the lease, as appropriate. The estimated useful life of buildings is 30-40 years and the general range of useful lives for leasehold improvements, furniture, fixtures and equipment is 10-15 years.

Intangible Assets

Cost in excess of net asset value of purchased facilities is amortized over 20 to 40 years using the straight-line method. Organization and start-up costs incurred prior to opening a new facility and partnership formation costs are deferred and amortized on a straight-line basis over a period of 36 months. Organization, partnership formation and start-up costs for a project that is subsequently abandoned are charged to operations in that period. Debt issue costs are amortized over the term of the debt. Noncompete agreements are amortized using the straight-line method over the term of the agreements.

Minority Interests

The equity of minority investors in limited partnerships of the Company is reported on the balance sheet as minority interests. Minority interests reported in the income statement reflect the respective shares of income or loss of the limited partnerships attributable to the minority investors, the effect of which is removed from the results of operations of the Company.

Revenues

Revenues include net patient service revenues and other operating revenues. Net patient service revenues are reported at the estimated net realizable amounts from patients, third-party payors and others for services rendered, including estimated retroactive adjustments under reimbursement agreements with third-party payors.

Income Per Common and Common Equivalent Share

Income per common and common equivalent share is computed based on the weighted average number of common shares and common equivalent shares outstanding during the periods. Common equivalent shares include dilutive employees' stock options, less the number of treasury shares assumed to be purchased from the proceeds using the average market price of the Company's common stock. Fully diluted earnings per share (based on 40,299,000 shares in 1994) assumes conversion of the 5% Convertible Subordinated Debentures due 2001 (see Note 7).

1. Significant Accounting Policies (continued)

Impairment of Assets

Long-lived assets, such as property, plant and equipment and identifiable intangible assets are reviewed for impairment losses when certain impairment indicators exist. If an impairment exists, the related asset is adjusted to the lower of book value or estimated future undiscounted cash flows from the use and eventual disposal of the asset.

With respect to the carrying value of the excess of cost over net asset value of purchased facilities and other intangible assets, the Company determines on a quarterly basis whether an impairment event has occurred by considering factors such as: the market value of the asset; a significant adverse change in legal factors or in the business climate; adverse action by a regulator; a history of operating or cash flow losses or a projection of continuing losses associated with an operating entity. The carrying value of net asset value of purchased facilities and other intangible assets will be evaluated if the facts and

circumstances suggest that it has been impaired. If this evaluation indicates that the value of the asset will not be recoverable, as determined based on the undiscounted cash flows of the entity acquired over the remaining amortization period, the Company's carrying value of the asset will be reduced by the estimated shortfall of cash flows.

2. Merger

Effective December 29, 1994, the Company merged with ReLife, Inc. (ReLife) and in connection therewith issued 5,512,645 shares of its Common Stock for all of ReLife's outstanding common stock. ReLife provides a system of rehabilitation services and operates 31 inpatient facilities with an aggregate of approximately 1,100 licensed beds, including nine free-standing rehabilitation hospitals, nine acute rehabilitation units, five sub-acute rehabilitation units, seven transitional living units and one residential facility and provides outpatient rehabilitation services at twelve outpatient centers.

The merger was accounted for as a pooling of interests and, accordingly, the Company's financial statements have been restated to include the results of ReLife for all periods presented. Prior to the merger, ReLife reported on a fiscal year ending on September 30. The accompanying financial statements are based on a combination of the Company's results for its December 31 fiscal year and ReLife's results for its September 30 fiscal year for all periods presented. Costs and expenses of \$2.9 million incurred by HEALTHSOUTH in connection with the merger have been recorded in operations in 1994 and reported as ReLife merger expenses in the accompanying consolidated statements of income.

Combined and separate results of the Company and ReLife are as follows (in thousands):

	HEALTHSOUTH	ReLife	Combined
	<C>	<C>	<C>
Year ended December 31, 1992			
Revenues	\$ 406,968	\$ 57,320	\$ 464,288
Net income	29,738	4,856	34,594
Year ended December 31, 1993			
Revenues	482,304	93,042	575,346
Net income	6,687	6,905	13,592
Year ended December 31, 1994			
Revenues	1,008,567	118,874	1,127,441
Net income (loss)	54,047	(822)	53,225

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There were no transactions between the Company and ReLife prior to the merger. The effects of conforming the accounting policies of the two companies are not material.

3. Cash, Cash Equivalents and Other Marketable Securities

Cash, cash equivalents and other marketable securities consisted of the following:

	December 31	
	1993	1994
	(In thousands)	
	<C>	<C>
Cash	\$ 39,916	\$ 56,849
Municipal put bonds	9,800	2,100
Tax advantaged auction preferred stocks	4,000	7,000
Municipal put bond mutual funds	2,000	-
Money market funds	8,410	-
United States Treasury bills	4,205	-
Total cash and cash equivalents	68,331	65,949
United States Treasury notes	-	1,004
Certificates of deposit	1,108	2,135
Municipal put bonds	1,860	3,975
Municipal put bond mutual funds	5,000	8,514
Collateralized mortgage obligations	1,000	1,000
Total other marketable securities	8,968	16,628
Total cash, cash equivalents and other marketable securities (approximates market value)	\$ 77,299	\$ 82,577

</TABLE>

For purposes of the consolidated balance sheets and statements of cash flows, marketable securities purchased with an original maturity of ninety days or less are considered cash equivalents.

4. Other Assets

Other assets consisted of the following:

<TABLE>

<CAPTION>

	December 31	
	1993	1994
	(In thousands)	
<S>	<C>	<C>
Notes and accounts receivable	\$ 3,280	\$ 15,104
Investment in Caretenders Health Corp.	7,382	7,370
Investments in other unconsolidated subsidiaries	3,991	6,007
Real estate investments	3,023	10,022
Escrow funds	394	-
Other	3,880	2,189
	\$ 21,950	\$ 40,692

</TABLE>

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The Company has a 24% ownership interest in Caretenders Health Corp. (Caretenders). Accordingly, the Company's investment is being accounted for using the equity method of accounting. The investment was initially valued at \$7,250,000. The Company's equity in earnings of Caretenders for the years ended December 31, 1992, 1993 and 1994 was not material to the Company's results of operations.

It was not practicable to estimate the fair value of the Company's various investments in other unconsolidated subsidiaries (involved in operations similar to those of the Company) because of the lack of a quoted market price and the inability to estimate fair value without incurring excessive costs. The carrying amount at December 31, 1994 represents the original cost of the investments, which management believes is not impaired.

5. Property, Plant and Equipment

Property, plant and equipment consisted of the following:

<TABLE>

<CAPTION>

	December 31	
	1993	1994
	(In thousands)	
<S>	<C>	<C>
Land	\$ 61,822	\$ 52,250
Buildings	470,181	476,620
Leasehold improvements	17,616	28,352
Furniture, fixtures and equipment	223,271	288,067
Construction in progress	29,274	43,374
	802,164	888,663
Less accumulated depreciation and amortization	58,080	99,125
	\$ 744,084	\$ 789,538

</TABLE>

6. Intangible Assets

Intangible assets consisted of the following:

<TABLE>

<CAPTION>

	December 31	
	1993	1994
	(In thousands)	
<S>	<C>	<C>
Organization, partnership formation and start-up costs	\$ 42,919	\$ 77,882
Debt issue costs	1,653	18,848
Noncompete agreements	24,862	35,253
Cost in excess of net asset value of purchased facilities	169,106	245,008

	238,540	376,991
Less accumulated amortization	30,378	52,087
	\$ 208,162	\$ 324,904

</TABLE>

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7. Long-Term Debt

Long-term debt consisted of the following:

<TABLE>

<CAPTION>

	December 31	
	1993	1994
	(In thousands)	
<S>	<C>	<C>
Notes and bonds payable:		
Advances under a \$390,000,000 credit agreement with a bank	\$ 370,000	\$ -
Advances under a \$550,000,000 credit agreement with a bank	-	510,000
9.5% Senior Subordinated Notes due 2001	-	250,000
5% Convertible Subordinated Debentures due 2001	-	115,000
Due to National Medical Enterprises, Inc.	361,164	-
Notes payable to banks and various other notes payable, at interest rates from 5.5% to 9.0%	37,572	25,680
Noncompete agreements payable with payments due at varying intervals through December 2004	12,050	17,610
Hospital revenue bonds payable	24,862	24,763
Other	12,701	1,721
	818,349	944,774
Less amounts due within one year	5,015	14,713
	\$ 813,334	\$ 930,061

</TABLE>

The fair value of total long-term debt approximates book value at December 31, 1994 and 1993. The fair values of the Company's long-term debt are estimated using discounted cash flow analyses, based on the Company's current incremental borrowing rates for similar types of borrowing arrangements.

During 1994, the Company entered into a Credit Agreement with NationsBank of North Carolina, N.A. and other participating banks (the 1994 Credit Agreement) which consists of a \$550,000,000 revolving facility and term loan. The 1994 Credit Agreement replaced a previous \$390,000,000 Credit Agreement with NationsBank. Interest is paid quarterly based on LIBOR rates plus a predetermined margin, a base rate, or competitively bid rates from the participating banks. The Company is required to pay a fee on the unused portion of the 1994 revolving credit facility ranging from 0.25% to 0.5%, depending on certain defined ratios. The principal amount is payable in 15 equal quarterly installments beginning on June 30, 1997. The Company has provided a negative pledge of all its assets and has granted a first priority security interest in and lien on all shares of stock of its subsidiaries and rights and interests in its partnerships. At December 31, 1994, the effective interest rate associated with the 1994 Credit Agreement was approximately 6.75%.

The amount shown as Due to National Medical Enterprises, Inc. at December 31, 1993 was subsequently repaid from proceeds of other notes and bonds.

On March 24, 1994, the Company issued \$250,000,000 principal amount of 9.5% Senior Subordinated Notes due 2001 (the Notes). Interest is payable on April 1 and October 1. The Notes are senior subordinated obligations of the Company and as such will be subordinated to all existing and future senior indebtedness of the Company, and also will be effectively subordinated to all existing and future liabilities of the Company's subsidiaries and partnerships. The Notes rank senior to all subordinated indebtedness of the Company, including the 5% Convertible Subordinated Debentures due 2001 described below. The Notes mature on April 1, 2001.

Also on March 24, 1994, the Company issued \$100,000,000 principal amount of 5% Convertible Subordinated Debentures due 2001 (the Convertible Debentures). An additional \$15,000,000 principal amount of Convertible Debentures was issued in April 1994 to cover underwriters' over allotments. Interest is payable on April 1 and October 1. The Convertible Debentures are convertible into Common Stock of the Company at the option of the holder at a conversion price of \$37.625 per share, subject to adjustment in the occurrence of certain events.

The net proceeds from the issuance of the Notes and Convertible Debentures were used by the Company to pay down indebtedness outstanding under its other existing credit facilities.

Principal maturities of long-term debt are as follows:

Year ending December 31	(In thousands)
1995	\$ 14,713
1996	12,246
1997	112,233
1998	143,334
1999	140,605
After 1999	521,643
	\$ 944,774

8. Stock Options

The Company has various stockholder-approved stock option plans which provide for the grant of options to Directors, officers and other key employees to purchase common stock at 100% of the fair market value as of the date of grant. The Board of Directors administers the stock option plans. Options may be granted as incentive stock options or as non-qualified stock options. Incentive stock options vest 25% annually, commencing upon completion of one year of employment subsequent to the date of grant. Non-qualified stock options generally are not subject to any vesting provisions. The options expire at dates ranging from five to ten years from the date of grant.

The following table summarizes activity in the stock option plans:

	1992	1993	1994
Options outstanding January 1:	3,368,571	5,339,742	6,875,786
Granted	2,762,000	1,770,000	330,000
Exercised	765,328	180,455	981,286
Cancelled	25,501	53,501	202,563
Options outstanding at December 31	5,339,742	6,875,786	6,021,937

<TABLE>
<CAPTION>

	1992	1993	1994
<S>	<C>	<C>	<C>
Option price range for options granted during the period	\$15.25-\$19.88	\$13.50-\$16.88	\$28.38-\$36.50
Option price range for options exercised during the period	\$5.67-\$21.41	\$5.91-\$19.17	\$8.67-\$16.88
Options exercisable at December 31	4,155,817	5,332,940	5,186,809
Options available for grant at December 31	546,050	324,550	550,204

</TABLE>

9. Limited Partnerships

HEALTHSOUTH operates a number of rehabilitation centers as limited partnerships. HEALTHSOUTH serves as the general partner and operates the partnerships as comprehensive outpatient rehabilitation facilities or inpatient rehabilitation facilities. These limited partnerships are included in the consolidated financial statements (as more fully described in Note 1 under "Minority Interests"). The limited partners share in the profit or loss of the partnerships based on their respective ownership percentage (ranging from 1% to 50% at December 31, 1994) during their ownership period.

Beginning in 1992, due to federal and state regulatory requirements, the Company began the process of buying back the partnership interests of its physician limited partners. The buyback prices for the interests were in general based on a predetermined multiple of projected cash flows of the partnerships. The excess of the buyback price over the book value of the limited partners' capital amounts was charged to the Company's retained earnings.

10. Acquisitions

At various dates during 1994, the Company acquired 53 separate outpatient operations located throughout the United States. The combined purchase price of these acquired outpatient operations was approximately \$53,947,000. The Company also acquired a specialty medical center in Dallas, Texas, a contract therapist provider and a diagnostic imaging company. The combined purchase price of these three operations was approximately \$25,861,000. The form of consideration comprising the total purchase prices of \$79,808,000 was approximately \$68,359,000 in cash, \$10,916,000 in notes payable and approximately 19,000 shares of Common Stock valued at \$533,000. In connection with the acquisition of the contract therapist provider, there is additional contingent consideration payable of up to \$9,000,000 if the acquired company achieves certain levels of future earnings. Such contingency payments will be paid to the former owners each fiscal year in which the acquired company's annual pretax income exceeds a certain threshold. The contingent payments will cease upon the earlier of the payment of the maximum amount of contingent payments allowed or ten years. The Company accrues, as an operating expense, for this contingency in accordance with Statement of Financial Accounting Standards No. 5, "Accounting for Contingencies." As of December 31, 1994, the Company has accrued \$99,000 in contingent consideration.

In connection with these transactions, the Company entered into non-compete agreements with former owners totaling \$10,814,000. In general these non-compete agreements are payable in monthly or quarterly installments over periods ranging from five to ten years.

The fair value of the total net assets relating to the 1994 acquisitions described above was approximately \$11,087,000. The total cost for 1994 acquisitions exceeded the fair value of the net assets acquired by approximately \$68,721,000. The Company evaluated each acquisition, independently, to determine the appropriate amortization period for the cost in excess of net asset value of purchased facilities. Each evaluation included an analysis of historic and projected financial performance, evaluation of the estimated useful life of buildings and fixed assets acquired, the indefinite life of Certificates of Need and licenses acquired, the competition within local markets, lease terms where applicable, and the legal term of partnerships where applicable. Based on these evaluations, the Company determined that the cost in excess of net asset value of purchased facilities relating to the 1994 acquisitions should be amortized over periods ranging from twenty-five to forty years on a straight line basis. No other identifiable intangible assets were recorded in the acquisitions described above.

All of the 1994 acquisitions described above were accounted for as purchases and, accordingly, the results of operations of the acquired businesses (not material individually or in the aggregate) are included in the accompanying consolidated financial statements from their respective dates of acquisition.

Effective December 31, 1993, the Company completed an acquisition from National Medical Enterprises, Inc. (NME) of 28 inpatient rehabilitation facilities and 45 outpatient rehabilitation centers, which constituted substantially all of NME's rehabilitation services division (the NME Selected Hospitals Acquisition). The purchase price was approximately \$296,661,000 cash, plus net working capital of \$64,503,000, subject to certain adjustments, the assumption of approximately \$16,313,000 of current liabilities and the assumption of approximately \$17,111,000 in long-term debt.

The pro forma effect of this acquisition on 1993 operations and net income per common and common equivalent share is reflected in the pro forma summary in Note 17.

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As a result of the NME Selected Hospitals Acquisition, HEALTHSOUTH recognized an expense of approximately \$49,742,000 during the year ended December 31, 1993. This expense represents management's estimate of the cost to consolidate operations of thirteen existing HEALTHSOUTH facilities (three inpatient facilities and ten outpatient facilities) into the operations of certain facilities acquired from NME. This plan was formulated by HEALTHSOUTH management in order to more efficiently provide services in markets where multiple locations now exist as a result of the acquisition. The plan of consolidation calls for the affected operations to be merged into the operations of the acquired facilities over a period of twelve to twenty-four months from the date of the NME Selected Hospitals Acquisition. Due to the single-use nature of these properties, the consolidation plan does not provide for the sale of these facilities.

The total expense of \$49,742,000 consists of several components. First, approximately \$39,000,000 relates to the writedown of the assets of the affected HEALTHSOUTH facilities to their estimated net realizable value. Of this \$39,000,000, approximately \$31,500,000 relates to the assets of the three inpatient facilities and approximately \$7,500,000 relates to the assets of the ten outpatient facilities. The \$39,000,000 is broken down into the following asset categories (net of any related accumulated depreciation or amortization):

<TABLE>
<CAPTION>

	Inpatient Facilities	Outpatient Facilities	Total
	(In thousands)		
<S>	<C>	<C>	<C>
Land	\$ 2,898	\$ -	\$ 2,898
Buildings	16,168	-	16,168
Equipment	4,326	2,920	7,246
Intangible assets	6,111	3,455	9,566
Other assets	1,997	1,125	3,122
	\$ 31,500	\$ 7,500	\$ 39,000

</TABLE>

During the year ended December 31, 1994, management discontinued operations in two of the inpatient facilities and three of the outpatient facilities affected by the plan and merged them into the operations of the acquired facilities. Accordingly, assets with a net book value of approximately \$17,911,000 were written off in 1994 against the reserves established at December 31, 1993. The two inpatient facilities and three outpatient facilities affected by the plan in 1994 had revenues of approximately \$11,441,000, \$8,640,000 and \$9,125,000 for the years ended December 31, 1992, 1993 and 1994, respectively. These same facilities had net operating income (loss) before income taxes of \$(489,000), \$(844,000) and \$67,000 for the years ended December 31, 1992, 1993 and 1994, respectively. Operations at the remaining inpatient facility and the remaining seven outpatient facilities identified in the plan will be discontinued during 1995.

Second, \$7,700,000 relates to the write-off of certain capitalized development projects. These projects relate to planned facilities that, if completed, would be in direct competition with certain of the acquired NME facilities. These development projects were written off in 1994 against the reserves established at December 31, 1993.

Finally, approximately \$3,000,000 was accrued for costs of employee separations, relocations and other direct costs related to the planned consolidation of the affected operations. During the second quarter of 1994, management revised its estimate of the cost of the employee separations and relocations. The revised estimate calls for approximately 150 employees to be affected by separations and approximately 400 to be affected by relocations. Separation benefits under the revised plan range from one month's to one year's compensation and total approximately \$2,188,000. Relocation benefits are estimated to be \$2,000 per employee and total \$800,000. An additional \$350,000 has been provided for additional direct administrative costs associated with the implementation of the plan, including outplacement services, travel and legal fees. Accordingly, the total revised estimated cost of employee separations and relocations is \$3,338,000. The difference between the initial estimate and the revised estimate was treated as a change in accounting estimate and charged to operations in the second quarter of 1994.

During the year ended 1994, a total of 208 employees were affected by terminations and relocations at a cost of approximately \$758,000. This cost is the only cash expense included in the acquisition-related expense.

It is management's opinion that remaining accrual at December 31, 1994 of \$23,669,000 is adequate to complete the plan of consolidation of the affected operations.

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Also at various dates during 1993, the Company acquired 27 separate outpatient operations located throughout the United States. The total consideration paid for these acquired outpatient operations was approximately \$23,943,000, consisting of \$21,634,000 in cash and \$2,309,000 in notes payable. The fair value of the net assets acquired was approximately \$5,196,000. The total cost of the 1993 outpatient acquisitions exceeded the fair value of the net assets acquired by approximately \$18,747,000. Based on the evaluation of each acquisition, utilizing the criteria described above, the Company determined that the cost in excess of net asset value of purchased facilities relating to the 1993 acquisitions should be amortized over a forty-year period on a straight line basis. No other identifiable intangible assets were recorded in the acquisitions described above.

Also during 1993, the Company acquired 100% of the stock of Rebound, Inc. (Rebound) for net consideration of approximately \$14,000,000 in cash. Rebound operates 293 beds in thirteen facilities. The purchase price exceeded the fair value of the net assets acquired by approximately \$11,200,000, which was allocated to excess of cost over net asset value of purchased facilities.

Effective February 1, 1992, the Company acquired substantially all of the assets

and/or stock of Dr. John T. Macdonald Health Systems, Inc. and Subsidiaries (collectively, JTM Health Systems). JTM Health Systems includes two general acute-care hospitals and other healthcare-related entities located in the Miami, Florida metropolitan area. The total purchase price paid was approximately \$16,893,000 in cash.

Also in 1992 the Company acquired 100% of the stock of Renaissance America, Inc. (Renaissance) for net consideration of approximately \$5,996,000 consisting of \$649,000 cash and \$5,347,000 in the Company's Common Stock (214,885 shares).

Also at various dates during 1992, the Company acquired 28 separate outpatient operations located throughout the United States. The combined purchase price of these acquired outpatient operations was approximately \$25,964,000.

The fair value of the net assets acquired in 1992 was approximately \$21,956,000. The total cost of the 1992 acquisitions exceeded the fair value of the assets acquired by approximately \$26,897,000, which is being amortized over a forty-year period on a straight-line basis.

All of the 1993 and 1992 acquisitions described above were accounted for as purchases and, accordingly, the results of operations of the acquired businesses are included in the accompanying consolidated financial statements from their respective dates of acquisition.

11. Income Taxes

HEALTHSOUTH and its subsidiaries file a consolidated federal income tax return. The limited partnerships file separate income tax returns. HEALTHSOUTH's allocable portion of each partnership's income or loss is included in the taxable income of the Company. The remaining income or loss of each partnership is allocated to the limited partners.

Effective January 1, 1993, the Company changed its method of accounting for income taxes to the liability method required by Financial Accounting Standards Board (FASB) Statement No. 109, "Accounting for Income Taxes". The cumulative effect of adopting Statement No. 109 was not material. Previously, the Company had used the liability method as prescribed by FASB Statement No. 96.

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Deferred income taxes reflect the net effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes. Significant components of the Company's deferred tax liabilities and assets as of December 31, 1993 are as follows:

<TABLE>
<CAPTION>

	Current	Noncurrent	Total
	(In thousands)		
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Deferred tax liabilities:			
Depreciation and amortization	--	\$31,117	\$31,117
Other	340	-	340
Total deferred tax liabilities	340	31,117	31,457
Deferred tax assets:			
NME Selected Hospitals			
Acquisition related expense	--	19,399	19,399
Other	3,549	2,071	5,620
Total deferred tax assets	3,549	21,470	25,019
Net deferred tax (assets) liabilities	\$ (3,209)	\$ 9,647	\$ 6,438

</TABLE>
Significant components of the Company's deferred tax liabilities and assets as of December 31, 1994 are as follows:

<TABLE>
<CAPTION>

	Current	Noncurrent	Total
	(In thousands)		
<S>	<C>	<C>	<C>
Deferred tax liabilities:			
Depreciation and amortization	--	\$24,068	\$24,068
Total deferred tax liabilities	--	24,068	24,068

Deferred tax assets:

NME Selected Hospitals Acquisition related expense	--	15,241	15,241
Other	2,643	945	3,588

Total deferred tax assets	2,643	16,186	18,829

Net deferred tax (assets) liabilities	\$ (2,643)	\$ 7,882	\$ 5,239

</TABLE>

The current portion of the Company's deferred tax asset is included with prepaid expenses and other current assets on the accompanying balance sheet.

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The provision for income taxes was as follows:

<TABLE>

<CAPTION>

	Year ended December 31		
	1992	1993	1994
	(In thousands)		
<S>	<C>	<C>	<C>
Currently payable:			
Federal	\$ 12,255	\$ 13,876	\$ 30,593
State	1,627	1,687	4,441

	13,882	15,563	35,034
Deferred expense (benefit):			
Federal	4,010	(5,884)	(983)
State	491	(670)	(216)

	4,501	(6,554)	(1,199)

Total provision	\$ 18,383	\$ 9,009	\$ 33,835

</TABLE>

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11. Income Taxes (continued)

The components of the provision for deferred income taxes for the year ended December 31, 1992 are as follows:

	(In thousands)

Depreciation and amortization	\$ 5,599
Bad debts	(1,119)
Other	21

	\$ 4,501

The difference between the provision for income taxes and the amount computed by applying the statutory federal income tax rate to income before taxes was as follows:

	Year ended December 31		
	1992	1993	1994
	(In thousands)		
Federal taxes at statutory rates	\$ 18,013	\$ 7,910	\$ 30,471
Add (deduct):			
State income taxes, net of federal tax benefit	1,054	1,121	\$2,671
Tax-exempt interest income	(1,076)	(454)	(276)
Other	392	432	969

	\$ 18,383	\$ 9,009	\$ 33,835

12. Commitments and Contingencies

At December 31, 1994, anticipated capital expenditures for the next twelve months approximate \$120,000,000. This amount includes expenditures for the construction and equipping of additions to existing facilities, the construction of two inpatient rehabilitation facilities for which regulatory approval is being obtained and the acquisition or development of comprehensive outpatient rehabilitation facilities.

12. Commitments and Contingencies (continued)

Beginning December 1, 1993, the Company became self-insured for professional liability and comprehensive general liability. The Company purchased coverage for all claims incurred prior to December 1, 1993. In addition, the Company purchased underlying insurance which would cover all claims once established limits have been exceeded. It is the opinion of management that at December 31, 1994 the Company has adequate reserves to cover losses on asserted and unasserted claims.

Operating leases

Operating leases generally consist of short-term lease agreements for buildings where facilities are located. These leases generally have 5-year terms, with one or more renewal options, with terms to be negotiated at the time of renewal. Total rental expense for all operating leases was \$15,902,000, \$23,417,000 and \$58,529,000 for the years ended December 31, 1992, 1993 and 1994, respectively.

The following is a schedule of future minimum lease payments under all operating leases having initial or remaining non-cancelable lease terms in excess of one year:

Year ending December 31	(In thousands)
-----	-----
1995	\$ 50,173
1996	46,383
1997	42,493
1998	38,554
1999	33,618
After 1999	96,667

Total minimum payments required	\$ 307,888

13. Employee Benefit Plans

The Company has a 401(k) savings plan which matches 15% of the first 4% of earnings that an employee contributes. All contributions are in the form of cash. All employees who have completed one year of service with a minimum of 1,000 hours worked are eligible to participate in the plan. Company contributions are gradually vested over a seven-year service period. Contributions to the plan by the Company were approximately \$521,000, \$490,000 and \$1,094,000 in 1992, 1993 and 1994, respectively.

In 1991, the Company established an Employee Stock Ownership Plan (ESOP) for the purpose of providing substantially all employees of the Company the opportunity to save for their retirement and acquire a proprietary interest in the Company. The ESOP currently owns approximately 830,000 shares of the Company's Common Stock, which were purchased with funds borrowed from the Company, \$10,000,000 in 1991 (the 1991 ESOP Loan) and \$10,000,000 in 1992 (the 1992 ESOP Loan). At December 31, 1994, the combined ESOP Loans had a balance of \$17,477,000. The 1991 ESOP Loan, which bears an interest rate of 10%, is payable in annual installments covering interest and principal over a ten-year period beginning in 1992. The 1992 ESOP Loan, which bears an interest rate of 8.5%, is payable in annual installments covering interest and principal over a ten-year period beginning in 1993. Company contributions to the ESOP began in 1992 and shall at least equal the amount required to make all ESOP Loan amortization payments for each plan year. The Company recognizes compensation expense based on the shares allocated method. The total compensation expense related to the ESOP recognized by the Company was \$1,701,000, \$3,198,000 and \$3,673,000 in 1992, 1993 and 1994, respectively. Interest incurred on the ESOP Loans was approximately \$964,000, \$1,743,000 and \$1,608,000 in 1992, 1993 and 1994, respectively. Approximately 213,000 shares owned by the ESOP have been allocated to participants at December 31, 1994.

During 1993 the American Institute of Certified Public Accountants issued Statement of Position ("SOP") 93-6, "Employers Accounting for Employee Stock Ownership Plans." Among other provisions, SOP 93-6 requires that compensation expense relating to employee stock ownership plans be measured based on the fair market value of the shares when allocated to the employees. The provisions of SOP 93-6 apply only to leveraged ESOPs formed after December 31, 1992, or shares newly acquired by an existing leveraged ESOP after December 31, 1992. Because all shares owned by the Company's ESOP were acquired prior to December 31, 1992, the Company's accounting policies for the shares currently owned by the ESOP are not affected by SOP 93-6.

14. Terminated Merger

On January 2, 1992, the Company and Continental Medical System, Inc. (CMS) jointly announced an agreement to combine their business operations as provided in an Agreement and Plan of Reorganization (the Plan). On May 6, 1992, the Company and CMS jointly announced the termination of the Plan. Accordingly, all costs and expenses incurred in connection with the Plan were charged to operations in 1992 and reported as terminated merger expense in the accompanying statements of income.

15. Sale of Assets

During the second quarter of 1994, the Company consummated the sale of selected properties to Capstone Capital Corporation (Capstone), a real estate investment trust. These properties include six ancillary hospital facilities, three outpatient rehabilitation facilities, and one research facility. The net proceeds to the Company as a result of this transaction were approximately \$49,025,000. The net book value of the properties was approximately \$41,335,000. Because the Company is leasing back substantially all of the properties from Capstone, payments which aggregate \$5.7 million annually, the resulting gain on sale of approximately \$7,690,000 has been recorded on the accompanying consolidated balance sheet as deferred revenue and will be amortized into income over the initial lease terms of the properties. The Company is accounting for each of the new leases as an operating lease with an initial lease term of 15 years. The Company and certain Company officers own approximately 3.9% of the outstanding common stock of Capstone.

16. Impairment of Long-Term Assets

During 1994, certain events have occurred impairing the value of specific long-term assets of ReLife (see Note 2). A hospital in Missouri with a distinct part unit which ReLife was managing was purchased in 1994 by an acute care provider which terminated the contract with ReLife. Remaining goodwill of \$1,700,000 and costs allocated to the management contract of \$1,300,000 were written off as there is no value remaining for the terminated contract.

A ReLife facility in central Florida incurred tornado damage and has not been operating since September 1993. During 1994, management of ReLife has determined that it is probable that this facility will not reopen. Start-up costs of \$1,600,000 were written off. This facility is leased under an operating lease as described in Note 12 through the year 2001. An impairment accrual has been established based on the projected undiscounted net cash flows related to this non-operating facility for the remainder of the lease term. The accrual totals \$5,900,000 and consists of \$4,700,000 in lease payments and \$1,200,000 in fixed costs and operating expenses, including property taxes, maintenance, security and other related costs. The current portion of the accrual approximates \$600,000 and is included with accrued interest payable and other liabilities in the accompanying December 31, 1994 balance sheet. The remaining long-term portion of the accrual is included with other long-term liabilities in the accompanying December 31, 1994 balance sheet.

During 1994, ReLife entered into a contract for a new information system. During the period ended September 30, 1994, ReLife's expenditures related to this contract totalled approximately \$4,363,000. The system was not operational during this period, thus those expenditures are considered non-recurring. The Company will retain certain equipment, with an approximate cost of \$750,000, which was included in the expenditures noted above. The remainder of the expenditures, \$3,613,000, is included in the loss on abandonment of the computer project. The Company has also established a reserve of approximately \$887,000 for settlement of the contract. The contract contains a provision for cancellation by ReLife, without cause, upon at least 180 days' prior written notice. The application of this termination provision could result in a settlement of up to \$6,500,000. The Company is currently in negotiations to settle the contract and believes that it is probable that the settlement will be for an amount approximately equal to the reserve established.

The above amounts are shown as operating expenses in the consolidated statement of income.

17. Subsequent Events

On January 24, 1995, the Company signed an agreement to merge with Surgical Health Corporation (SHC). SHC operates 36 outpatient surgery centers in eleven states. Under the terms of the agreement, all shares of common and preferred stock of SHC will be exchanged for shares of the Company's Common Stock pursuant to an exchange ratio that will yield an aggregate value of approximately \$155,000,000 to SHC shareholders. The transaction will be accounted for as a pooling of interests and is subject to certain regulatory and governmental reviews, and to approval by the shareholders of both companies. The transaction is expected to be completed early in the second quarter of 1995. The effects of conforming the accounting policies of the two companies is not expected to be

material.

The following table summarizes the unaudited consolidated pro forma results of operations, assuming the SHC acquisition described above had occurred at the beginning of each of the following periods. This pro forma summary does not necessarily reflect the results of operations as they would have been had the Company and the acquired entities constituted a single entity during such periods. The 1993 amounts reflect the pro forma effect of the NME Selected Hospital Acquisition (see Note 10).

	Year ended December 31		
	1992	1993	1994

	(In thousands, except for per share amounts)		
Revenues	\$ 501,046	\$1,111,198	\$1,236,190
Net income	34,929	25,076	49,961
Net income per common and common equivalent share	0.95	0.65	1.19

On February 3, 1995, the Company entered into a definitive agreement to purchase the operations of the rehabilitation hospital division of NovaCare, Inc., consisting of 11 rehabilitation hospitals in seven states, 12 other facilities and certificates of need to build two additional facilities. The purchase price will be approximately \$215,000,000 in cash and the assumption of \$20,000,000 in liabilities for a total consideration of \$235,000,000. The transaction is expected to be completed in the second quarter of 1995.

Subsequent to December 31, 1994, the Company received a fully underwritten commitment to amend and restate the 1994 Credit Agreement (see Note 7) which will increase the size of the facility to \$1 billion.

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SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Registrant has duly caused this Amendment No. 2 to be signed on its behalf by the undersigned, thereunto duly authorized.

HEALTHSOUTH Corporation

By RICHARD M. SCRUSHY

Richard M. Scrushy,
Chairman of the Board
and Chief Executive Officer

Date: May 10, 1995

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