U.S. SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 6-K

REPORT OF FOREIGN PRIVATE ISSUER

PURSUANT TO RULE 13a-16 OR 15d-16 UNDER

THE SECURITIES EXCHANGE ACT OF 1934

Commission File Number: 333-10486

For the Month of August 2005

Trend Micro Incorporated

(Translation of registrant s name into English)

Shinjuku MAYNDS Tower, 1-1, Yoyogi 2-chome,

Shibuya-ku, Tokyo 151-0053, Japan

(Address of principal executive offices)

Indicate by check mark whether the registrant files or will file annual reports under cover Form 20-F or Form 40-F.

Form 20-F __X__ Form 40-F _____

Indicate by check mark if the registrant is submitting the Form 6-K in paper as permitted by Regulation S-T Rule 101(b)(1):__

Indicate by check mark if the registrant is submitting the Form 6-K in paper as permitted by Regulation S-T Rule 101(b)(7):__

Indicate by check mark whether by furnishing the information contained in this Form, the registrant is also thereby furnishing the information to the Commission pursuant to Rule 12g3-2(b) under the Securities Exchange Act of 1934.

Yes _____ No __X__

If Yes is marked, indicate below the file number assigned to the registrant in connection with Rule 12g3-2(b): 82-

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Information furnished on this form:

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SIGNATURE

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

		TREND MICRO INCORPORATED
Date: August 4, 2005	By:	/s/ MAHENDRA NEGI
		Mahendra Negi
		Representative Director, Chief Financial Officer and
		Executive Vice President

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Trend Micro Reports Second Quarter Results

Technology and service acquisitions and significant growth in networking

products highlight quarter

Tokyo, Japan August 03, 2005 Trend Micro, Inc. (TSE: 4704, NASDAQ: TMIC), a leader in network antivirus and Internet content security software and services, today announced earnings results for the second quarter 2005.

Trend Micro posted consolidated net sales of 17.19 billion Yen (or US $159.57 million, 107.72 JPY = 1USD), operating income of 5.47 billion Yen (or U.S. $50.78 million) and net income of 3.93 billion Yen (or U.S. $36.52 million) for the second quarter 2005. These figures reflect gains of nearly 16% in net sales compared with the same period in the previous year. Operating income was down 13% from the same quarter in the previous year, largely due to additional support costs incurred in Japan in April.

The company continued to enjoy steady growth around the world. Both the United States and the Asia-Pacific regions experienced a 29 percent year-over-year increase in revenue, and sales in Europe, the Middle East and Africa (EMEA) increased 19 percent over the same period. Much of the company s growth was buoyed by strong sales in networking security products. For example, in the second quarter, revenue for network products including Trend Micro Network VirusWall grew 232 percent year-over-year worldwide, with especially strong growth in the United States, EMEA and Japan compared to the previous year. Gateway Suite products also saw strong revenue growth compared to the same quarter in the previous year, highlighted by a 35 percent increase in Europe and a 63 percent increase in the Asia-Pacific region.

While growth remained steady, Trend Micro strengthened its position in the marketplace by announcing two major acquisitions that enhance the company s ability to protect customers from some of the most pressing threats. On May 10, 2005, the company announced its acquisition of InterMute, a leading developer of anti-spyware products. Shortly after the announcement, the company introduced Trend Micro Anti-Spyware 3.0 and Trend Micro Anti-Spyware for Small and Medium Businesses 3.0. On June 14, 2005, Trend Micro announced its acquisition of Kelkea Inc., a leading authority on IP filtering and reputation services. The acquisition enables Trend Micro to accelerate its development of network-level solutions against spam and other related threats.

The second quarter of this year has included some challenges and some significant triumphs for Trend Micro, but we continue to focus on service quality improvement, and continued growth and expansion, said Eva Chen, CEO of Trend Micro. The steady traction of our network-level solutions, partnerships and alliances, and new technology and service acquisitions are indicative of our strength and success as we further enhance our abilities to protect customers from even more complex threats.

Based on information currently available to the company, consolidated net sales for the third quarter ending September 30, 2005 is expected to be 17.2 billion Yen (or US $153.6 million, based on an exchange rate of 112JPY = 1USD). Operating income and net income are expected to be 6.2 billion Yen (or U.S. $55.4 million) and 3.75 billion Yen (or U.S. $33.5 million), respectively.

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Second Quarter Business Highlights

New Acquisitions

Trend Micro acquired InterMute, Inc., a leading developer of anti-spyware products, and quickly announced three new standalone products for the detection and removal of spyware and grayware for businesses and consumers. Trend Micro Anti-spyware products feature CWShredder, regarded as one of the most effective solutions for eliminating the CoolWebSearch Web browsing hijacker and its many variants some of which avoid detection and removal through ever-changing methods.

Trend Micro acquired Kelkea Inc., a leading authority on IP filtering and reputation services, and is offering Trend Micro Network Reputation Services to anti-spam customers. Trend Micro plans to further develop technologies to combat phishing attacks, zombies, and botnets; the company will also enhance current anti-spam solutions through the extensive knowledge base of more than 1.5 billion IP addresses.

Anti-Spyware Solutions

Trend Micro introduced several new solutions for combating the growing spyware problem, including a multi-layered solutions strategy for coordinated security at the enterprise gateway, server, and client levels. The company also introduced standalone anti-spyware offerings designed for businesses and consumers.

During the quarter, Trend Micro was the first company in the security industry to achieve Checkmark Spyware certification for spyware detection performance. Two products Trend Micro OfficeScan and Trend Micro PC-cillin Internet Security Suite received the certification.

Products and Innovation

The following products were introduced in the second quarter 2005:

Trend Micro InterScan Web Security Suite 2.5 gateway security solution designed to block spyware, grayware, phishing attacks, viruses, and other malware entering corporate networks via the Internet gateway.

Trend Micro OfficeScan v7.0 an advanced, integrated client and server security solution that combines comprehensive threat protection with services and policy enforcement compatibility to help ensure enterprise uptime and productivity.

Trend Micro Anti-Spyware 3.0 and Trend Micro Anti-Spyware for Small and Medium Businesses 3.0 standalone options for detection and removal of evasive spyware and grayware.

Trend Micro Mobile Security 2.0 extends multiplatform protection to defend Microsoft Windows Mobile 5.0 operating system from viruses, worms, and other malicious threats.

Global Business Highlights

In May 2005, a U.S. International Trade Commission judge issued a final determination in Trend Micro s favor involving the unfair import proceeding Trend Micro brought against Fortinet. As a result, the judge has recommended that the ITC issue an order prohibiting Fortinet from importing FortiGate products into the United States.

New customers and new business in the Asia-Pacific region included: Guangzhou University of Traditional Chinese Medicine in China and Chung-Hwa Telecom in Taiwan.

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Notice Regarding Forward-looking Statements

Certain statements that we make in this release are forward-looking statements. These forward-looking statements are based upon management s current assumptions and beliefs in light of the information currently available to it, but involve known and unknown risks and uncertainties.

Many important factors could cause our actual results to differ materially from those expressed in our forward-looking statements. These factors include:

Difficulties in addressing new virus and other computer security problems

Timing of new product introductions and lack of market acceptance for our new products

The level of continuing demand for, and timing of sales of, our existing products

Rapid technological change within the antivirus software industry

Changes in customer needs for antivirus software

Existing products and new product introductions by our competitors and the pricing of those products

Declining prices for products and services

The effect of future acquisitions on our financial condition and results of operations

The effect of adverse economic trends on our principal markets

The effect of foreign exchange fluctuations on our results of operations

An increase in the incidence of product returns

The potential lack of attractive investment targets and

Difficulties in successfully executing our investment strategy

We assume no obligation to update any forward-looking statements.

For more details regarding risk factors relating to our future performance, please refer to our filings with the U.S. Securities and Exchange Commission.

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About Trend Micro, Inc.

Trend Micro, Inc. is a leader in network antivirus and Internet content security software and services. The Tokyo-based corporation has business units worldwide. Trend Micro products are sold through corporate and value-added resellers and managed service providers. For additional information and evaluation copies of all Trend Micro products, visit our Web site, www.trendmicro.com**.**

# # #

Trend Micro, the t-ball logo, OfficeScan, PC-cillin, and VirusWall are trademarks or registered trademarks of Trend Micro Incorporated. TrendLabs is a service mark of Trend Micro Incorporated. All other company or product names may be trademarks or registered trademarks of their owners.

For additional Information

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Supplementary Information

(1) CONSOLIDATED BALANCE SHEETS

(Thousands of yen)

Account	June 30, 2004 Amount	%	June 30, 2005 Amount	%	December 31, 2004 Amount	%
<Assets>						
Current assets:						
Cash and cash equivalents	40,462,189		55,797,854		52,908,357	
Time deposits	460,391		906,397		383,276	
Marketable securities	13,792,770		14,915,254		15,288,575	
Notes and accounts receivable, trade less allowance for doubtful accounts and sales returns of (Yen) 842,681 in the first half of FY2004, (Yen) 1,077,276 in the first half of FY2005 and (Yen) 864,938 in FY2004, respectively	12,323,100		13,742,453		15,245,213	
Inventories	189,226		280,722		201,243	
Deferred income taxes	5,955,785		6,272,727		6,224,972	
Prepaid expenses and other current assets	1,108,786		1,457,490		1,560,058	
Total current assets	74,292,247	86.1	93,372,897	83.7	91,811,694	86.0
Investments and other assets:						
Securities investments	6,867,926		9,321,151		9,831,913	
Investment in and advances to affiliate companies	138,183		206,944		175,281	
Software development costs	530,841		640,578		438,464	
Other intangibles	307,188		1,260,470		296,368	
Goodwill			2,442,109			
Deferred income taxes	1,774,102		1,543,222		1,695,771	
Other	652,561		662,846		636,009	
Total investments and other assets	10,270,801	11.9	16,077,320	14.4	13,073,806	12.3
Property and equipment:						
Office furniture and equipment	2,943,219		3,841,551		3,323,526	
Other properties	1,162,394		1,349,320		1,165,173	
	4,105,613		5,190,871		4,488,699	
Less: Accumulated depreciation	(2,389,676)		(3,094,701)		(2,640,288)	
Total property and equipment	1,715,937	2.0	2,096,170	1.9	1,848,411	1.7

Total assets	86,278,985	100.0	111,546,387	100.0	106,733,911	100.0

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(Thousands of yen)

Account	June 30, 2004 Amount	%	June 30, 2005 Amount	%	December 31, 2004 Amount	%
<Liabilities, minority interest and shareholders equity>						
Current liabilities:						
Notes payable, trade	63,044		139,895		88,087	
Accounts payable, trade	1,824,187		744,285		1,271,067	
Accounts payable, other	1,987,842		2,970,364		2,699,762	
Withholding income taxes	572,839		839,157		882,693	
Accrued expenses	2,185,496		2,886,400		2,143,694	
Accrued income and other taxes	4,638,402		4,133,554		7,192,085	
Deferred revenue	20,409,178		26,240,519		24,634,662	
Other	796,297		781,518		651,503	
Total current liabilities	32,477,285	37.6	38,735,692	34.7	39,563,553	37.1
Long-term liabilities:						
Deferred revenue	3,187,325		3,425,101		3,268,892	
Accrued pension and severance costs	588,430		767,945		656,041	
Other	160,329		64,108		70,665	
Total long-term liabilities	3,936,084	4.6	4,257,154	3.8	3,995,598	3.7
Minority interest			4,613	0.0		
Shareholders equity:						
Common stock						
Authorized						
-June 30, 2004 250,000,000 shares						
-June 30, 2005 250,000,000 shares						
-December 31, 2004 250,000,000 shares (no par value)						
Issued						
-June 30, 2004 133,997,891 shares	9,144,983					
-June 30, 2005 136,051,155 shares			11,803,201			
-December 31, 2004 135,755,872 shares					11,426,977	
Additional paid-in capital	14,756,997		18,035,675		17,359,335	
Retained earnings	33,355,669		45,829,022		42,165,026	
Accumulated other comprehensive income (loss)						
Net unrealized gain (loss) on debt and equity securities	(91,832)		(2,654)		284,348	
Cumulative translation adjustments	(565,491)		230,810		(606,463)	
	(657,323)		228,156		(322,115)	
Treasury stock, at cost						
-June 30, 2004 2,504,854 shares	(6,734,710)		(7,347,126)		(7,454,463)	

-June 30, 2005 2,545,688 shares

-December 31, 2004 2,588,439 shares

Total shareholders equity	49,865,616	57.8	68,548,928	61.5	63,174,760	59.2
Total liabilities, minority interest and shareholders equity	86,278,985	100.0	111,546,387	100.0	106,733,911	100.0

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(2) CONSOLIDATED STATEMENTS OF INCOME

(Thousands of yen)

	For the six months ended June 30, 2004		For the six months ended June 30, 2005		For the year ended December 31, 2004	
Account	**Amount**	**%**	**Amount**	**%**	**Amount**	**%**
Net sales	28,464,157	100.0	34,489,740	100.0	62,049,254	100.0
Cost of sales	1,926,769		1,191,244		3,236,499	
Gross profit	26,537,388	93.2	33,298,496	96.5	58,812,755	94.8
Operating expenses:						
Selling	7,457,213		10,338,819		16,009,409	
Research and development and maintenance	2,278,974		2,891,775		4,858,259	
Customer support	2,717,490		3,190,146		5,723,426	
General and administrative	2,705,635		4,106,616		6,143,985	
Total operating expenses	15,159,312	53.2	20,527,356	59.5	32,735,079	52.8
Operating income	11,378,076	40.0	12,771,140	37.0	26,077,676	42.0
Other incomes (expenses):						
Interest income	160,957		326,282		451,217	
Interest expense	(44,644)		(2,241)		(87,464)	
Gain (loss) on sales of marketable securities	82,857		20,534		101,199	
Foreign exchange gain (loss), net	(29,075)		197,132		(183,292)	
Other income (expense), net	(21,451)		2,897		(34,350)	
Total other income (expenses)	148,644	0.5	544,604	1.6	247,310	0.4
Net income before tax	11,526,720	40.5	13,315,744	38.6	26,324,986	42.4
Income taxes:						
Current	5,498,022		4,698,548		11,893,659	
Deferred	(922,416)		158,283		(1,390,387)	
	4,575,606	16.1	4,856,831	14.1	10,503,272	16.9
Income before minority interest and equity in earnings of affiliated companies	6,951,114	24.4	8,458,913	24.5	15,821,714	25.5
Minority interest in income of consolidated subsidiaries			(420)	0.0		
Equity in earnings of affiliated companies	17,893	0.1	31,663	0.1	53,122	0.1
Net income	6,969,007	24.5	8,490,156	24.6	15,874,836	25.6

Per share data:			
Net income	Yen	Yen	Yen
-Basic	52.41	63.67	120.64
-Diluted	51.47	62.71	118.59
Cash dividends	14.00	36.00	14.00

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(3) CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME

(Thousands of yen)

Account	For the six months ended June 30, 2004	For the six months ended June 30, 2005	For the year ended December 31, 2004
Net income	6,969,007	8,490,156	15,874,836
Other comprehensive income (loss), before tax:			
Unrealized gains (losses) on debt and equity securities:			
Unrealized holding gains (losses) arising during period	(198,675)	(279,612)	514,117
Less reclassification adjustment for (gains) losses included in net income	(67,303)	(186,353)	(143,702)
	(265,978)	(465,965)	370,415
Foreign currency translation adjustments	(64,545)	837,273	(105,517)
Total	(330,523)	371,308	264,898
Income tax expense related to unrealized gains (losses) on debt and equity securities	103,181	178,963	(157,032)
Other comprehensive income (loss), net of tax	(227,342)	550,271	107,866
Comprehensive income	6,741,665	9,040,427	15,982,702

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(4) CONSOLIDATED STATEMENT OF SHAREHOLDERS EQUITY

(Thousands of yen)

Account	For the six months ended June 30, 2004	For the six months ended June 30, 2005	For the year ended December 31, 2004
<Common stock>			
Balance at beginning of period	7,396,194	11,426,977	7,396,194
Exercise of stock purchase warrants and stock acquisition rights	1,748,789	376,224	4,030,783
Balance at end of period	9,144,983	11,803,201	11,426,977
<Additional paid-in capital>			
Balance at beginning of period	13,165,881	17,359,335	13,165,881
Tax benefit from exercise of non-qualified stock warrants	115,383	300,271	498,905
Tax recognition derived from elimination of reversed warrant related with stock option plan	(249,978)		(312,708)
Loss on sales of treasury stock, net of tax	(22,941)		(22,941)
Exercise of stock purchase warrants and stock acquisition rights	1,748,652	376,069	4,030,198
Balance at end of period	14,756,997	18,035,675	17,359,335
<Retained earnings>			
Balance at beginning of period	28,236,466	42,165,026	28,236,466
Net income	6,969,007	8,490,156	15,874,836
Stock issue costs, net of tax	(3,735)	(1,829)	(11,977)
Cash dividends	(1,829,260)	(4,794,028)	(1,829,260)
Loss on sales of treasury stock, net of tax	(16,809)	(30,303)	(105,039)
Balance at end of period	33,355,669	45,829,022	42,165,026
<Net unrealized gain (loss) on debt and equity securities>			
Balance at beginning of period	70,965	284,348	70,965
Net change during the period	(162,797)	(287,002)	213,383
Balance at end of period	(91,832)	(2,654)	284,348
<Cumulative translation adjustments>			
Balance at beginning of period	(500,946)	(606,463)	(500,946)
Aggregate translation adjustments for the period	(64,545)	837,273	(105,517)
Balance at end of period	(565,491)	230,810	(606,463)
<Treasury stock, at cost>			
Balance at beginning of period	(4,416,763)	(7,454,463)	(4,416,763)
Purchase of treasury stock	(2,616,694)	(42,631)	(3,759,507)
Sales of treasury stock	298,747	149,968	721,807

Balance at end of period	(6,734,710)	(7,347,126)	(7,454,463)
Total shareholders equity	49,865,616	68,548,928	63,174,760

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(5) CONSOLIDATED STATEMENTS OF CASH FLOWS

(Thousands of yen)

Account	For the six months ended June 30, 2004	For the six months ended June 30, 2005	For the year ended December 31, 2004
Cash flows from operating activities:			
Net income	6,969,007	8,490,156	15,874,836
Adjustments to reconcile net income to net cash provided by operating activities			
Depreciation and amortization	785,396	942,777	1,590,743
Pension and severance costs, less payments	99,262	91,650	166,649
Deferred income taxes	(922,416)	158,283	(1,390,387)
(Gain) loss on sales of marketable securities	(82,857)	(20,534)	(101,199)
Equity in earnings of affiliated companies	(17,893)	(31,663)	(53,122)
Minority interest		420	
Changes in assets and liabilities:			
Increase (decrease) in deferred revenue	3,201,387	1,424,155	7,293,488
(Increase) decrease in accounts receivable, net of allowances	(719,133)	1,552,014	(3,421,729)
(Increase) decrease in inventories	(112,030)	(53,076)	(124,093)
Increase (decrease) in notes and accounts payable, trade	896,839	(510,190)	379,882
Increase (decrease) in accrued income and other taxes	358,248	(3,219,572)	2,912,481
(Increase) decrease in other current assets	16,948	133,075	(90,479)
Increase (decrease) in accounts payable, other	279,029	250,129	823,199
Increase (decrease) in other current liabilities	908,479	321,916	1,107,855
(Increase) decrease in other assets	390,684	5,754	110,628
Other	117,191	113,694	(178,744)
Net cash provided by operating activities	12,168,141	9,648,988	24,900,008
Cash flows from investing activities:			
Payments for purchases of property and equipment	(226,434)	(507,160)	(801,935)
Software development cost	(402,096)	(475,129)	(645,166)
Payments for purchases of other intangibles	(200,253)	(83,946)	(229,167)
Proceeds from sales of marketable securities	954,474	8,545,586	4,986,012
(Payments for) / Proceeds from marketable securities maturing within three months or less (net)		784,865	(2,156,191)
Payments for purchases of marketable securities and security investments	(11,062,351)	(8,241,925)	(17,240,100)
Payment for business acquisition		(2,716,702)	
(Payments for) / Proceeds from time deposits	(20,068)	(523,121)	57,047
Net cash used in investing activities	(10,956,728)	(3,217,532)	(16,029,500)
Cash flows from financing activities:			
Issuance of common stock pursuant to exercise of stock purchase warrants and stock acquisition rights	3,493,706	750,464	8,049,004
Redemption of bonds	(6,500,000)		(6,500,000)
Proceeds from/(Purchase of) treasury stock (net)	(2,357,697)	77,034	(3,165,679)
Tax benefit from exercise of non-qualified stock warrants	115,383	300,271	498,905
Tax recognition derived from elimination of reversed warrant related with stock option plan	(249,978)		(312,708)

Capital contribution from minority interest		4,193	
Dividend paid	(1,814,984)	(4,766,610)	(1,819,607)
Net cash used in financing activities	(7,313,570)	(3,634,648)	(3,250,085)
Effect of exchange rate changes on cash and cash equivalents	(154,594)	92,689	568,994
Net increase (decrease) in cash and cash equivalents	(6,256,751)	2,889,497	6,189,417
Cash and cash equivalents at beginning of period	46,718,940	52,908,357	46,718,940
Cash and cash equivalents at end of period	40,462,189	55,797,854	52,908,357
Supplementary information of cash flow:			
Payment for interest expense	19,424	2,241	114,121
Payment for income taxes	5,754,866	7,350,227	8,990,398

August 3, 2005

Trend Micro Incorporated

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August 3, 2005

Report of First Half Results (Consolidated)

For Fiscal Year Ending December 31, 2005

[Prepared in accordance with US GAAP]

Company:	Trend Micro Incorporated	Tokyo Stock Exchange 1st Section
Code:	4704	Location : Tokyo
(URL http://www.trendmicro.co.jp/)		
Representative:	Title	Representative Director and Chief Executive Officer
	Name	Eva Chen
Contact:	Title	Director, Corporate Affairs Department
	Name	Hideki Minamibayashi (Phone: 81-3-5334-3600)
Date of the board of directors meeting authorizing the first-half results:		August 3, 2005

1. Financial Highlights for the first half of FY 2005 (January 1, 2005 through June 30, 2005)

(1) Consolidated Results of Operations

(All figures except for per share information are rounded to millions of yen.)

	Net sales	Growth rate	Operating income	Growth rate	Net income before tax	Growth rate
	Millions of yen	%	Millions of yen	%	Millions of yen	%
The first half of FY 2005	34,490	21.2	12,771	12.2	13,316	15.5
The first half of FY 2004	28,464	27.6	11,378	95.4	11,527	96.1
FY 2004 (annual)	62,049		26,078		26,325	

	Net income	Growth rate	Net income per share (basic)	Net income per share (diluted)
	Millions of yen	%	Yen	Yen
The first half of FY 2005	8,490	21.8	63.67	62.71

The first half of FY 2004	6,969	110.7	52.41	51.47
FY 2004 (annual)	15,875		120.64	118.59

(Note)

1. Equity in earnings (losses) of affiliated companies: 32 million yen (18 million yen in the first half of FY 2004, 53 million yen in FY 2004)

2. The company made no changes in accounting principle that had material effects on the financial position, results of operations, and cash flow position, during the current period.

3. Weighted average number of shares outstanding: 133,341,012 shares (132,974,192 shares in the first half of FY 2004, 131,588,738 shares in FY 2004)

4. The percentage of net sales, operating income, net income before tax and net income represent comparison to the corresponding financial figures for the first half of prior fiscal year.

(2) Consolidated Financial Position

	Total assets	Shareholders equity	Shareholders equity ratio	Shareholders equity per share
As of	**Millions of yen**	**Millions of yen**	**%**	**Yen**
June 30, 2005	111,546	68,549	61.5	513.45
June 30, 2004	86,279	49,866	57.8	379.23
December 31, 2004	106,734	63,175	59.2	474.40

(Note)

Number of shares outstanding : 133,505,467 shares (131,493,037 shares as of June 30, 2004, 133,167,433 shares as of December 31, 2004)

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(3) Consolidated Cash Flow Position

As of	Cash flows from operating activities	Cash flows from investing activities	Cash flows from financing activities	Ending balance of cash and cash equivalents
	Millions of yen	Millions of yen	Millions of yen	Millions of yen
June 30, 2005	9,649	(3,218)	(3,635)	55,798
June 30, 2004	12,168	(10,957)	(7,314)	40,462
December 31, 2004	24,900	(16,030)	(3,250)	52,908

(4) Basis of consolidation and application of equity method:

The number of consolidated subsidiaries: 21

The number of unconsolidated subsidiaries accounted by equity method: 0

The number of affiliated companies: 2

(5) Changes in the basis of consolidation and application of equity method:

The number of additional consolidated subsidiaries: 3

The number of excluded consolidated subsidiaries: 1

The number of additional consolidated affiliated companies: 0

The number of excluded consolidated affiliated companies: 0

2. Projected consolidated earnings

Projected earnings for the next quarter (July 1, 2005 through September 30, 2005)

	Net sales	Operating income	Net income
	Millions of yen	Millions of yen	Millions of yen
3rd Qtr	17,200	6,200	3,750

(Note) Since the business environment surrounding Trend Micro Group tends to fluctuate in the short run, it is difficult to make the highly reliable projection figures on a yearly basis. We, therefore, decided to announce the earnings on a quarterly basis in the fiscal year ending in December 2005 as well as earnings projection of the succeeding quarter.

If we found through our calculation conducted from time to time that the net sales fluctuate from the most recent quarterly projection by more than 10%, or operating income or net income fluctuates by more than 30%, we will announce the revision of the earnings projection.

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Attachment to the Report

1. Condition of corporate group

Trend Micro Group consists of Trend Micro Inc. (Japan), and its subsidiaries which develop and sell anti-virus products and offer other related services. Affiliated companies are Soft Trend Capital Corporation which manages capital funds to be invested into Internet-related ventures and NetSTAR Inc. which develops and offers the products of URL filtering.

The business related to anti-virus are described below.

Products related to anti-virus:

PC client products LAN server products Internet server products Other products	Trend Micro Inc. (Japan) develops and sells the products. Some parts of the research and development activities are entrusted to Trend Micro Incorporated (Taiwan), Trend Micro Inc. (U.S.A.), Trend Micro Deutschland GmbH (Germany), Trend Micro(UK)Limited (UK), and Trend Micro (China) Incorporated. (China). Trend Micro Incorporated (Taiwan) also operates manufacturing and sales of the products too, part of which are purchased by Trend Micro Inc. (Japan), Trend Micro Inc. (U.S.A.), Trend Micro Korea Inc. (Korea), Trend Micro Deutschland GmbH (Germany), Trend Micro Italy S.r.l. (Italy), Trend Micro Australia Pty. Ltd. (Australia), Trend Micro do Brasil Ltda. (Brazil), Trend Micro France (France), Trend Micro Hong Kong Limited (China), Trend Micro (UK) Limited (UK), Trend Micro Latinoamerica S.A.de C.V (Mexico) and Trend Micro (China) Incorporated (China). Besides below indicated chart, Trend Micro (EMEA) Limited (Ireland) provides the back office functions for our business in Europe. In addition, Trend Micro Inc. (Japan) owns software copyrights and receives from its overseas subsidiaries royalties based on the respective sales of products to such subsidiaries.

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2. Management Policy and Business Performance

MANAGEMENT POLICY

(1). BASIC POLICY OF MANAGEMENT

Our Vision:	To create a world safe for exchanging digital information.
Our Mission:	We ensure digital operational continuity against unpredictable threats.

The computer network systems mainly among the Internet have already become a global infrastructure as lifelines of the information society regardless of individual, business or national border. In the information society which is flooded with vast amount of information, the computer network systems are used as communication methods comparable to telephones and faxes and as means to improve and rationalize business flows at companies in recent years and the systems play a roll in improving productivity and efficiency. Today many companies and individuals are being connected via the internet and it has produced various working styles, such as small offices and home offices, which enables employees to work at remote locations and business forms which establish data management operation and customer support operation, etc. in areas where labor cost is relatively low beyond the confines of country, industry, business form. The diffusion of networks on a global scale has already become the foundation for the global economy with eliminating the geological restrictions of business activities.

In typical homes there are many devices with internet functions and fusion of home appliance and IT is emerging as a result of the diffusions technologies such as IP telephone, broadband high-speed communication technology and wireless communication technology. In-home networks become prevalent and several internet devices are introduced into a house, and our daily life is evolving influenced by the advance information society.

In this way today s computer network systems has much impact on the whole society to bring about changes in business forms and individual lifestyles around the world. When we think about the changes of our life from the viewpoint of information, the benefit of worldwide networking cannot be overestimated. Non- standardized manufactures as the obstacle digital information exchanges in the past have gradually disappeared, and as a consequence, improvements in compatibility and convenience are achieved. On the other hand, with the disappearance of diversity, the possibility to use the vulnerabilities for attacking the whole network system by computer viruses is acknowledged as a problem. With the standardization of the global infrastructure for networks, significant impact on daily life and economical production activities due occurrence of viruses and incidents caused by them is inextricably linked to the convenience of them. Today the threats on the network such as computer viruses, spywares and spam are not the nature that can be predicted beforehand and treated with all possible measures. It seems requirement for enterprises and individuals to deploy security measure against new threats on the networks which could make the networks flattened around the world. For such a great responsibility to protect the global infrastructure, we will provide products and services promptly beyond national boundaries which strongly support a series of operations which could be experienced in the event of an attack such as preventive measures, risk management, outbreak prevention, timely update of virus pattern files, minimization of damage and system restoration. We are not only protecting each enterprise and individual users from the threats over the networks without interrupting economic activities but also would like to contribute to the further development of the information society by improving the safety of the whole network system.

(2). BASIC POLICY OF PROFIT SHARING

We intend to continue to return profits to shareholders based on the net profit on the consolidated basis while striving to enhance financial strength and secure inner reserve in order to deal with significantly changing business environment and maintain competitive edge against competitors. As our basic policy about dividend, we plan to pay a year-end dividend on the basis of the dividend ratio of 30%.

(3). VIEWS AND POLICIES FOR INVESTMENT UNIT

While we recognize that securing liquidity of our shares is an important issue, we consider the current liquidity is at a satisfactory level. With that background, we conclude that reducing investment unit which will incur considerable expense is not necessarily profitable to all shareholders.

We intend to review in the future the investment unit as needed taking into consideration the shareholders interest and influences to the liquidity of our shares.

(4). TARGET MANAGEMENT INDEX

According to a research institute, the anti-virus industry, which we belongs to, is estimated to expand at an annual growth rate of around 20% from 2003 to 2004 and is also expected two-digit annual growth rate for a medium-term forecast (August 2004, IDC, USA). Making the growth rate of our consolidated net sales to exceed the industry average without fail is an important index for us weather we can grow up to a leading company which can contribute to customers in the global market as well as Japanese market or not.

In view of the fact that we have relatively small amount of investment in physical fixed assets such as manufacturing equipment and have no significant time-lag between accounting profit and loss and cash flow as a characteristics of software companies, have uncertainty about the long-term forecast of the whole industry which, including our company, has a relatively short history, we set target as operating income margin rate of 35 40% at this time.

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(5). ISSUES TO DEAL WITH

In the anti-virus industry which we belong to, there has been two competitors having higher market share than ours in the U.S. In such a situation, it is expected that the competition of anti-virus products in the consumer market will become more intense by the anticipated entry of Microsoft into the security market. For such intensification of competition, we are enhancing our wide range of technologies to realize multifaceted security measures against new threats evolving day by day by acquiring InterMute Inc. which provides anti-spyware technologies and Kelkea Inc. which provides IP filtering and reputation services.

At the same time, we had an incident related to the virus pattern file which we had distributed in this April. Though its impact was slight in foreign countries, the impact was significant in Japan as reported via some media. The social responsibility of security vendors become much larger as the infrastructurization of the networks and our responsibility also becomes enormous, so we have lost our credibility and trustworthiness significantly as a result of the incident. Now, we are promoting a fundamental reform to restore customer s credibility and our bland image and will set up further efforts to improve quality management.

We would like to continue to develop original solutions faster than the competitors by concentrating our business resources and improve our superiority in products and services by improving the specifications and performance of our products from the viewpoint of customers. We also would like to aim for the future growth by strengthening customers loyalty with our marketing development that is conscious of the customer attribute characterized by the difference in purchasing behavior.

We, specialized in the anti-virus field, have formed several business alliances with dominant vendors in the field other than the anti-virus field until now. As for the alliance with Cisco Systems Inc., the world s biggest vendor in the U.S, announced last year, a part of our anti-virus functions is planed to be installed on the company s router, switch and security appliance products and they are planed to be sold after this second half. We believe this kind of alliance has important roll in our products and sales strategies, because it has potential effects from the fusion of competitive products in each other s fields and the supplement of sales channels between affiliated vendors.

(6). CORPORATE GOVERNANCE

Our management system is administering business operations under the recognition that quickly corresponding to changes in the environment of our company group and securing transparency and soundness of management as well as keeping reliability of disclosures are of prime importance.

The Board of Directors is composed of four directors and holding the Board meetings according to circumstances so that it can quickly make decisions. One of the four directors is appointed from outside of our company to enhance supervisory function for appropriate operation of the Board.

An executive is appointed for each business unit to take responsibility for executing respective operation so that our management policy decided by the Board of Directors is reflected in actual operation in the business area extending into over 20 countries in the world.

We have appointed four corporate auditors all from outside of our company so that the Board of Auditors can audit without bias the operation of the Board of Directors and business execution by the directors. The Board of Auditors has formulated a guideline for the relationship with the external auditor in order to ensure independence of the external auditor which takes charge of audit of our consolidated financial statements. The guideline prohibits commissioning the external auditor any affair which may impair independence of the said auditor. The guideline has also established a system in which the Board of Auditors is to make advance approval according to the guideline for audit and non-audit services we receive from the said auditor.

As for the internal control functions of our whole group, we have established an effective internal control functions by considering our business model and the business environment surrounding our group. We have also appointed a full-time person for supervision at corporate affairs department and are developing this system in communication with the external auditor and legal advisors as well as the board of corporate auditors and the board of directors. In fiscal year 2004, we have implemented our Code of Conduct focusing on ethical behavior , compliance with laws and full and fair disclosure and clarified internal reporting channel and executed a survey of business process by physical inspections at major department both domestically and abroad. We will continually aim to establish internal control in the direction of strengthening our unique and global business operation which is not restricted by time, space and culture, and will also respond to the Sarbanes-Oxley Act of 2002 which is applicable to us because we are listed on the Nasdaq exchange.

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OPERATING RESULTS AND FINANCIAL CONDITION

I. OPERATING RESULTS

(1). REVIEW OF CURRENT PERIOD

(Unit: million yen)

	Net Sales	Gross Profit	Operating income	Net income before tax	Net income
The first half of FY2005	**34,490**	**33,298**	**12,771**	**13,316**	**8,490**
The first half of FY2004	28,464	26,537	11,378	11,527	6,969
Rate of Change (%)	21%	25%	12%	16%	22%

(Unit: million yen)

	Net Sales		
	The first half of FY2005	The first half of FY2004	Rate of Change (%)
Japan	**14,248**	12,067	18%
North America	**6,885**	5,342	29%
Europe	**8,829**	7,375	20%
Asia Pacific	**3,766**	2,821	33%
Latin America	**763**	860	-11%

[Overview of Current Business Performance]

Japanese economy in this mid term, though it showed some signs of a partial recovery such as improvement in the diffusion index of the Short-term Economic Survey of Enterprise in Japan (Tankan) announced this July and visible signs of consumer spending recovery, the future of the situation is still unstable to optimistic because of remaining uncertainty in the surge of oil price and the trend of IT-related demand.

In the network security industry, though a new type of viruses for mobile phones were emerged, this year again the large volume mail sending type virus still top the list of virus damages for a long time in terms of actual damages, as represented by TROJ_NETSKY.P, in Japan and overseas. However, the number of damages is on a declining trend on a global basis and the number of infection damages in this first half is bellow that of the same period last year both in Japan and overseas.

The number of virus infections in this first half in Japan was about a half of the same period last year (16,083 infections: from our data) and there was a few incidents of large-scale virus infection like last year, at the same time, new threats for computer networks which emerged one after another were only going to get worse in their nature. In recent days, malicious programs which steal data in a PC or remotely control other person s PC through file exchanging soft wares or webpage defacing via hacking affected businesses and individuals and many information leak incidents which might caused by viruses were occurred. These devious programs are clearly divided into two extreme cases. In one case many targets are attacked randomly by criminals for pleasure, and in the other case a specific target is attacked by criminals with purpose of money etc. Therefore the multifaceted security measures for new threats remain to be urgent.

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Under such environment our group s business conditions are as follows.

First of all, in Japan it was thought that the demand for security products from medium and small companies as well as large companies would increase and the introduction of anti-virus products and contents security products by corporations especially due to the personal information protection law fully enforced from this April. However, since the incident related to the virus pattern file of our product was occurred in April, it resulted in significant adverse effect especially on the domestic sales trend in consumer market. Though the sales of personal products including Virus Buster , called PC-Cillin for out of Japan, which was released in the fourth quarter of last year, was strong in early part of the first half of this year, the sales for new customers was decreased due to the effect of voluntary refrain from the sales at stores after the incident and the incident also affected contract renewals and new contracts from corporate customers as a result. Despite such influence, the amount of sales for this period was 14,248 million yen (18% increase from the same period in previous year). On the other hand, the influences of the incident are minor overseas.

In the North American region there remain concerns on the slowdown of U.S economy due to high oil prices, the pace of economic expansion is steady and the improvement of employment continues gradually, so the business environment of the area remains strong. In such situations the interests on anti-virus measures from enterprises are increasing rapidly focusing on spyware measures in the region market. The demand from the medium and small business market remains strong, and especially, the demand from the consumer market increases significantly as a result of expansion of sales channels. As a result, the amount of sales for this period in the region was 6,885 million yen (29% increase from the same period in previous year).

In Europe economy was weak including Germany where unemployment rate remained at high level. The sense of political uncertainty is also strongly rooted triggered by the rejection of the European Union (EU) Constitution ratification and there remain some concerns on the recovery of macro economy of the Europe region in the future. In spite of such conditions the demand mainly from medium and small businesses shows strong increase continually especially for Italy and France. Among the EU counties the sales of Germany and Italy were increased and the amount of sales for this period in the region was 8,829 million yen (20% increase from the same period in previous year).

In Asia Pacific region Australia and Taiwan were greatly expanded and the amount of sales for this period in the region was 3,766 million yen (33% increase from the same period in previous year).

In Latin America region the amount of sales for this period in the region was 763 million yen (11% decrease from the same period in previous year) due to the influences of the review of business with government and other public offices etc. As a result, the consolidated sales amount of the first half of this year became 34,490 million yen, 21% increase compared with the same period in previous year.

As for expenses, the total expense of sales expense, R&D expense and general administrative expense was 20,527 million yen (35% increase from the same period in previous year) due to the additional expense to deal with the pattern file incident. Despite these expenses, the consolidated operating income for this period was 12,771 million yen (12% increase from the same period in previous year) and the consolidated net income for this period was 8,490 million yen (22% increase from the same period in previous year).

(2). Projection for the First Quarter of the fiscal year 2005 (from July 1, 2005 to September 30, 2005)

The business environment tends to drastically change over a short term. Consequently, it is difficult to calculate highly reliable values about the projection for the whole financial year. Instead, we make it a rule to announce a business forecast for the coming quarter term at the time of reporting quarterly results.

In the event forecast numbers are revised by more than 10% for net sales or 30% for operating income and net income from the last forecast, we will announce revision of the earnings forecast.

Business Forecast for the Third Quarter of FY2005 (July 1 2005 September 30 2005)

Consolidated Net Sales	17,200 million yen
Consolidated Operating income	6,200 million yen
Consolidated Current Net income	3,750 million yen

In development of the business forecasts the main assumed exchange rates are as follows.

1 U.S.$	112 yen
1 Euro	136 yen

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II. FINANCIAL CONDITION

CASH FLOW

(Unit: million yen)

	The first half of FY2005	The first half of FY2004	Increase (Decrease)
Cash Flows from Operating Activities	**9,649**	12,168	(2,519)
Cash Flows from Investing Activity	**(3,218)**	(10,957)	7,739
Cash Flows from Financing Activity	**(3,635)**	(7,314)	3,679
Effect of Exchange Rate Changes on Cash and Cash Equivalents	**93**	(155)	248
Net increase (Decrease) in Cash and Cash Equivalents	**2,889**	(6,257)	9,146
Cash and Cash Equivalents at end of period	**55,798**	40,462	15,336

[Overview of Cash Flow]

In this period for the 6 months ended June 30, 2005, net cash provided by operating activities was approximately 9,649 million yen, decreased 2,519 million yen compared with the same period in previous year. This decrease is primarily due to drastic decrease of income tax payable despite growth of net income, etc.

Net cash used in investing activities was approximately 3,218 million yen, decreased 7,739 million yen compared with the same period in previous year. This decrease is primarily due to drastic decrease of net payments for purchase of marketable securities and security investments, etc.

Net cash used in financing activities was approximately 3,635 million yen, decreased 3,679 million yen comparer with the same period in previous year. This decrease is mainly due to there are no redemption of bonds and treasury stock related cash flow changed from net payments to net proceeds, etc.

As a result of adding effect of exchange rate changes, the balance of cash and cash equivalents as of June 30, 2005 was million amounted to 55,798 million yen increased by 15,336 million yen from at the end of the same period in previous year.

[Trends of Cash Flow Indexes]

(U.S. GAAP)

	FY2003	FY2004	The first half of FY2005
Shareholder s equity Ratio (%)	54.1	59.2	**61.5**
Capital Adequacy Ratio on Market Value Basis (%)	462.2	690.0	**472.8**
Debt Redemption Period (years)	0.4		
Interest Coverage Ratio	103.3	218.2	**4,305.7**

(Japan GAAP)

	FY2000	FY2001	FY2002
Shareholder s equity Ratio (%)	59.9	47.3	50.0
Capital Adequacy Ratio on Market Value Basis (%)	2,475.5	626.7	360.4
Debt Redemption Period (years)	1.3	1.2	0.8
Interest Coverage Ratio	35.7	44.2	49.4

(Note) Shareholder s equity Ratio : (Total shareholder s Equity)/(Total Assets)
Capital Adequacy Ratio on Market Value Basis : (Total Market Value of Shares)/(Total Assets)
Debt Redemption Period : (Interest-bearing Debt)/(Operating Cash Flow)
Interest Coverage Ratio : (Operating Cash Flow)/(Interest Payment)

* All indexes are calculated from the financial values on a consolidated basis.

* Total Market Value of Shares is calculated as follows; closing share price at the term end multiplies by number of shares issued at the term end (net treasury stocks).

* Operating Cash Flow is Net cash flows provided by operating activity in the consolidated statement of cash flows. Interest-bearing Debt is all debts with interest payments among the debts reported on consolidated balance sheet. Interest Payment is the amount of payment for interest expense in the consolidated statement of cash flows

* With the enforcement of revision of Rules on the terms, forms and making method of a consolidated financial statement in March 2002, consolidated financial statements had been prepared based on U.S.GAAP from the year ended December 31, 2003.

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III. RISK FACTORS

The occurrence of any of the following risks could hurt our business, financial condition or results of operations. In such case, the trading price of our shares could decline and you could lose all or part of your investment. Other risks and uncertainties not now known to us or that we think are immaterial may also impair our business.

MAJOR SOFTWARE AND HARDWARE VENDORS MAY INCORPORATE ANTI-VIRUS PROTECTION IN THEIR PRODUCT OFFERINGS, WHICH COULD RENDER OUR PRODUCTS OBSOLETE OR UNMARKETABLE.

Major vendors of operating system software and other software such as firewall or e-mail software or computer hardware may decide to enhance or bundle their products with their other products to include anti-virus functions. These companies may offer anti-virus protection as a standard feature in their products, at minimal or no additional cost to customers. This could render our products obsolete or unmarketable, particularly if anti-virus products offered by these vendors were comparable or superior to our products. In addition, even if these vendors anti-virus products offered fewer functions than our products, or were less effective in detecting and cleaning virus-infected files, customers could still choose them over our products due to lower cost or for any other reasons.

In June 2003, Microsoft Corp., a major operating system vendor, announced that it acquired certain valuable intellectual property and technology assets from GeCAD Software Srl., an anti-virus software vendor in Romania. In February 2005, Microsoft Corp. also announced that it has signed contracts to acquire Sybari Software Inc., a leading provider of anti-virus and messaging security products in the United States. At this time, we do not know the intentions of Microsoft with regard to these transactions, but if antivirus functions were to be included in its operating system products, and/or, if Microsoft decides to sell antivirus products under their own brand, this could have a material adverse effect on our business, financial condition and results of operations.

BECAUSE WE GENERATE SUBSTANTIALLY ALL OF OUR SALES FROM A SINGLE PRODUCT LINE, WE ARE VULNERABLE TO DECREASED DEMAND FOR SUCH PRODUCTS.

Unlike software companies with diversified product lines, we derive substantially all of our net sales from licensing and selling anti-virus software products. Although we have begun to offer more comprehensive network and internet security and management software and services, we expect anti-virus products to continue to account for the largest portion of our net sales for the foreseeable future. If the demand for, or the prices of, anti-virus products drop as a result of competition, technological change or other factors such as lower growth or a contraction in the worldwide anti-virus software market, this could have a material adverse effect on our business, financial condition and results of operations.

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DETERIORATION IN OUR RELATIONSHIP WITH SOFTBANK BB CORP. COULD RESULT IN A DECREASE IN SALES OF OUR PRODUCTS.

We depend on our relationship with SOFTBANK BB (formerly SOFTBANK COMMERCE CORP.), which has played an instrumental role in the development of our business in Japan. SOFTBANK BB also has close relationships with many resellers and systems integrators through which we sell our anti-virus software to corporate end users in Japan. An adverse change in our relationship with SOFTBANK BB would result in decreased sales to SOFTBANK BB and could disrupt our relationship with many resellers of our products. This could make it difficult for us to market our products in Japan. Sales to SOFTBANK BB totaled approximately (Yen) 10.1 billion, or 23.6%, of our net sales in fiscal 2002, approximately (Yen) 9.2 billion, or 19.1%, of our net sales in fiscal 2003 and approximately (Yen) 10.4 billion ($101.0 million), or 16.8%, of our net sales in fiscal 2004. Because of our dependence on SOFTBANK BB, the price of shares could fall as a result of adverse events affecting SOFTBANK BB, even if the events do not relate directly to us.

OUR PRODUCTS MAY BECOME OBSOLETE BECAUSE RAPID TECHNOLOGICAL CHANGE REGULARLY OCCURS IN THE ANTI-VIRUS SOFTWARE MARKET.

The anti-virus software market is characterized by:

- rapid technological change;
- the proliferation of new and changing computer viruses;
- frequent product introductions and updates; and
- changing customer needs.

These characteristics of our market create significant risks and uncertainties for our business success. For example, our competitors might introduce anti-virus products that are technologically superior to our products. Additionally, new software operating system, network system or anti-virus software industry standards could emerge. Emerging trends in these systems and standards currently include applications distributed over the Internet and the use of a Web browser to access client-server systems. Our existing products might be incompatible with some or all of such standards. Our business, financial condition and results of operations could materially suffer unless we are able to respond quickly and effectively to these developments.

We rely on a small number of third parties to manufacture some of our hardware-based products, such as the Trend Micro Network VirusWall described in Item 4.B. We expect our reliance on third-party manufacturers to become more important as the number of our hardware-based products increases. Reliance on third-party manufacturers involves a number of risks, including a lack of control over the manufacturing process and the potential absence or unavailability of adequate capacity. If any of our third-party manufacturers cannot or will not manufacture our products in required volumes in compliance with environmental and other regulations in the markets we serve, on a cost-effective basis, in a timely manner, or at all, we will have to secure additional manufacturing capacity. The unexpected loss of any of our manufacturers could disrupt our business. Furthermore, our hardware-based products contain critical components supplied by a single or a limited number of third parties. Any significant shortage of components or the failure of the third-party supplier to maintain or enhance these products could lead to cancellation of customer orders or delays in the placement of orders and adversely affect our financial condition and results of operation.

WE MAY NOT GENERATE EXPECTED RESULTS IN STRATEGIC ALLIANCES.

Because we are mainly focusing our business on the field of anti-virus software and do not offer other security products such as firewalls, we actively pursue strategic alliances with other companies that allow us to provide customers with integrated or other new products and services derived from the alliances. In fiscal year 2004, we began to provide a third party URL filtering solution and have signed contracts with Cisco Systems to integrate network worm and virus outbreak prevention services with Cisco s products and services. To launch and provide such products and services, we may invest substantial cash and other resources in product developments, marketing promotions and support and maintenance activities. But we may not earn revenue successfully from alliances despite our efforts, and such alliance may be terminated or dissolved by various causes before generating revenue.

WE MAY NOT BE ABLE TO INCREASE OUR MARKET SHARE IN THE U.S. AND EUROPEAN MARKETS BECAUSE OUR COMPETITORS ARE MORE ESTABLISHED THAN WE ARE IN THESE MARKETS.

We believe that our share of the anti-virus software market in the U.S. and Europe is significantly small relative to the market shares of our principal competitors, despite the growth of our sales in these markets in fiscal 2003 and 2004. Because our competitors are already well-established in these key markets and have greater financial and other resources and market recognition, we may not be able to compete effectively for market share. If this happens, we may not be able to increase sales or our market share in these markets, which could materially hurt the prospects for growth in our business.

Some of our major competitors have the following important advantages over us in the U.S. and European markets:

- greater name recognition;
- more diversified product lines;
- larger customer bases; and
- significantly greater financial, technical, marketing and other resources.

As a result, as compared to us, our competitors may be able to:

- better withstand downturns in the anti-virus software market and in the computer software market in general;
- adapt more quickly to new or emerging technologies or changes in customer requirements; or
- more effectively and profitably market, sell and support their products.

Our major competitors, McAfee, Inc. and Symantec Corporation, are active in the Japanese anti-virus software market and have allocated significant resources to achieve success in the Japanese anti-virus software market. Although these competitors currently have smaller shares of the Japanese market than us, each has significantly greater financial, marketing and other resources than we do. Additionally, competition in our core Japanese market could intensify in the future if other competitors emerge. As a result of our competitors efforts, we may not be able to maintain our current leading market position in Japan in the future. Also, in order to respond effectively to increased competition, we may be required to devote more of our product development, marketing and other resources to the Japanese market, which could limit our ability to grow in other markets. A material loss of sales and market share in Japan as a result of our competitors success could have a material adverse effect on our business, financial condition and results of operations.

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BECAUSE WE MAY ACQUIRE COMPANIES TO GROW OUR BUSINESS, FUTURE ACQUISITIONS MAY REDUCE OUR EARNINGS AND RESULT IN INCREASED COSTS IN OUR BUSINESS OPERATIONS.

In a rapidly changing industry, we occasionally review acquisition opportunities. Accordingly, we may seek to expand our business through acquisitions. Unlike some of our major competitors, we have limited experience in acquiring existing businesses. Future acquisitions could result in numerous risks and uncertainties, including:

- our inability to retain customers, suppliers and other important business relationships of an acquired business;
- difficulties in integrating an acquired company into Trend Micro, including the acquired company s operations, personnel, products and information systems;
- diversion of our management s attention from other business concerns; and
- adverse effects on our results of operations from acquisition-related charges, impairment of goodwill and purchased technology and possible recognition of impairment charge.

If we make such an acquisition using stock, our current shareholders ownership interests will be diluted. Any of these factors could materially hurt our business, financial condition and results of operations.

For example, in 2000, we acquired ipTrend to start a new business selling a Linux based remotely managed server appliance solution to small and medium sized companies. However, ipTrend performed poorly and was liquidated in December 2001. Due to the liquidation of ipTrend, (Yen) 2.3 billion was booked as goodwill write-off in 2001.

We may be more susceptible to problems caused by hackers than other software companies. As an anti-virus software company that delivers virus protection products over the Internet, hackers specifically target us in order to cause us to transmit computer viruses or interrupt the delivery of our anti-virus software monitoring and security services over the Internet which could result in further interruptions. We could suffer substantial disruptions in our business and material damage to our reputation which could in turn result in a significant loss of our customers and other important business relationships. We could also incur costs for public relations efforts following attacks by hackers. Hacker activities could also force us to incur substantial costs to fix technical problems or result in hackers gaining access to our proprietary information.

WE MUST EFFECTIVELY MANAGE OUR GROWTH.

Our business has grown rapidly. This growth has placed, and any future growth would continue to place, a significant strain on our limited personnel, management and other resources. Our ability to manage any future growth in our business will require us to:

- attract, train, retain, motivate and manage new employees successfully;

effectively integrate new employees into our operations; and

continue to improve our operational, financial, management and information systems and controls.

If we continue to grow, our management systems currently in place may be inadequate or we may not be able to effectively manage our growth. In particular, we may be unable to:

provide effective customer service;

develop and deliver products in a timely manner;

implement effective financial reporting and control systems; and

exploit new market opportunities and effectively respond to competitive pressures.

We market substantially all of our products to end users through intermediaries, including distributors, resellers and value-added resellers. Our distributors sell other products that are complementary to, or compete with, our products. While we encourage our distributors to focus on our products, these distributors may give greater priority to products of other suppliers, including competitors . They may also return the products to us under certain circumstances.

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OUR CUSTOMERS MAY CANCEL OR DELAY THEIR PURCHASES OF OUR PRODUCTS, WHICH COULD ADVERSELY AFFECT OUR BUSINESS.

Our products may be considered to be capital purchases by certain enterprise customers. Capital purchases are often uncertain and, therefore, are canceled or delayed if the customer experiences a downturn in its business prospects or as a result of unfavorable economic conditions. Any cancellation or delay could adversely affect our results of operations.

WEAK FINANCIAL CONDITIONS OF SOME OF OUR DISTRIBUTORS MAY ADVERSELY AFFECT OUR OPERATING RESULTS.

Some of our distributors are experiencing financial difficulties worldwide, which may adversely impact our collection of accounts receivable. We regularly review the collectibility and creditworthiness of our distributors to determine an appropriate allowance for doubtful receivables. Our uncollectible accounts could exceed our current or future allowance for doubtful receivables, which would adversely impact our operating results.

We guarantee a certain quality of product support to our customers through our service level agreements. Pursuant to the terms of these agreements, under some circumstances, we are required to make penalty payments to our customers. For example, if we fail to provide our customers a virus pattern file within two hours of our receipt of a virus from the customer, the terms of the agreement require us to make a penalty payment to the dissatisfied customer which may amount up to 100% of the initial sale price. We have established reserves based on our assumptions and estimates. However, our assumptions and estimates may be wrong and our actual total penalty payments could materially exceed our reserves and adversely affect our results of operations and financial condition.

WE RELY HEAVILY ON OUR MANAGEMENT AND TECHNICAL PERSONNEL, WHO MAY NOT REMAIN WITH US IN THE FUTURE.

We rely, and will continue to rely, on a number of key technical and management employees, including our Chief Executive Officer, Eva Yi-Fen Chen. While we require our employees to sign employment agreements, our employees are generally not otherwise subject to noncompetition covenants. If any of our key employees leave, our business, results of operations and financial condition could suffer.

FLUCTUATIONS IN OUR QUARTERLY FINANCIAL RESULTS COULD CAUSE THE MARKET PRICE FOR OUR SHARES TO BE VOLATILE.

We believe that our quarterly financial results may fluctuate in ways that do not reflect the long-term trend of our future financial performance. It is likely that in some future quarterly periods, our operating results may be below the expectations of public market analysts and investors. In this event, the price of our shares could fall.

Factors which could cause our quarterly financial results to fluctuate include:

timing of sales of our products and services due to customers budgetary constraints, seasonal buying patterns and our promotional activities;

new product introductions by our competitors;

significant marketing campaigns, research and development efforts, employee hirings, and other capital expenditures by us to drive the growth of our business;

changes in customer needs for anti-virus software; and

changes in economic conditions in our major markets.

While our sales in the U.S. and Europe have increased in recent years, we remain significantly dependent on the Japanese market. Net sales in Japan accounted for approximately 43% of our net sales in fiscal 2002, approximately 42% in fiscal 2003 and approximately 41% in fiscal 2004. In the past three years, the Japanese economy has performed poorly due to a number of factors, including weak consumer spending and lower capital investment by Japanese companies. We believe the sluggish Japanese economy has hindered growth in our net sales during the last three years. Because of our dependence on the Japanese market, any further deterioration in the condition of the Japanese economy could negatively impact our net sales.

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FOREIGN EXCHANGE FLUCTUATIONS COULD LOWER OUR RESULTS OF OPERATIONS BECAUSE WE EARN REVENUES DENOMINATED IN SEVERAL DIFFERENT CURRENCIES.

Our reporting currency is the Japanese yen and the functional currency of each of our subsidiaries is the currency of the country in which the subsidiary is domiciled. However, a significant portion of our revenues and operating expenses is denominated in currencies other than the Japanese yen, primarily the U.S. dollar, euro and the New Taiwan dollar. As a result, appreciation or depreciation in the value of other currencies as compared to the Japanese yen could result in material transaction or translation gains or losses which could reduce our operating results. These negative effects from currency fluctuations could become more significant if we are successful in increasing our sales in markets outside of Japan. We do not currently engage in currency hedging activities.

BECAUSE OUR BUSINESS DEPENDS SIGNIFICANTLY ON INTELLECTUAL PROPERTY, INFRINGEMENT OF OUR INTELLECTUAL PROPERTY COULD HURT OUR BUSINESS.

Our success depends upon the development of proprietary software technology. We rely on a combination of contractual rights and patent, copyright, trademark and trade secret laws to establish and protect proprietary rights in our software. If we are unable to establish and protect these rights, our competitors may be able to use our intellectual property to compete against us. This could limit our growth and hurt our business. At present, our U.S. consolidated subsidiary holds seven issued U.S. patents and our Taiwan consolidated subsidiary holds four issued U.S. patents. It is possible that no additional patents will be issued to us or any of our subsidiaries. In addition, our issued patents may not prevent other companies from competing with us. We also enter into confidentiality agreements with our employees and license agreements with our customers, and limit access to our proprietary information and its distribution. However, we cannot guarantee that any of these measures will discourage others from misappropriating our technology or independently developing similar technology.

Our products are designed to protect customers network systems and personal computers from damage caused by computer viruses. As a result, if a customer suffers damage from viruses, the customer could sue us on product liability or related grounds, claim damages for data loss or make other claims. Additionally, as viruses are constantly evolving, purchasers of our software products must regularly update the software they have purchased from us with virus protection files that we make available for download from our website. Should we fail to properly test these virus protection files and distribute a defective file, these files could cause damage to the personal computers of our customers who have downloaded a defective file. For example, a file that we distributed on April 23, 2005 for an approximately 90 minute period caused the computers of those updating with the file to slow and, in some cases, shut down. Cases of our files damaging the computers or our customers could lead to significant damage to our reputation and customers could sue on product liability or related grounds. Furthermore, starting in 2001, we began selling hardware devices which could give rise to a higher incidence of product liability claims than we have up until now experienced. Our license agreements typically contain provisions, such as disclaimers of warranty and limitations of liability, which seek to limit our exposure to certain types of product liability claims. However, in some jurisdictions these provisions may not be enforceable on statutory, public policy or other grounds. We currently do not carry product liability insurance covering claims arising in the U.S. Damage to our reputation or successful product liability or related claims brought against us could materially harm our business.

OUR BUSINESS FACES THE RISK OF INTERRUPTION FROM POWER SHORTAGES, EARTHQUAKES, OUTBREAK OF BIOLOGICAL VIRUSES AND OTHER HAZARDS.

We face a number of potential business interruption risks that are beyond our control. The State of California experienced intermittent power shortages in 2000, sharp increases in the cost of energy and even interruptions of service to some business customers. If power shortages continue to be a problem, our business may be materially adversely affected. Additionally, we may experience natural disasters that could interrupt our business.

Tokyo, where our corporate headquarter is located, is near a major earthquake fault. The impact of a major earthquake on our facilities, infrastructure and overall operations is not known. There is no guarantee that an earthquake would not seriously disturb our entire business operations. We are largely uninsured for losses and business disruptions caused by an earthquake and other natural disasters.

In addition, many of the key countries and regions in which we operate have sustained negative economic impact from events such as the continued fear of future terrorist attacks and the outbreak of severe acute respiratory syndrome, or SARS. Prolonged continuation of these adverse factors may hurt our results of operations and financial condition.

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WE MAY HAVE TO CONSTRAIN OUR BUSINESS ACTIVITIES TO AVOID BEING DEEMED AN INVESTMENT COMPANY UNDER THE U.S. INVESTMENT COMPANY ACT OF 1940.

In general, a company which is or holds itself out as being engaged primarily in the business of investing, reinvesting or trading in securities, may be deemed to be an investment company under the U.S. Investment Company Act of 1940. We do not believe that we are an investment company as defined under the U.S. Investment Company Act of 1940. However, if we were to be deemed an investment company, we would be prohibited from issuing our securities in the United States and may have to terminate our U.S. listing or other sponsorship promoting a U.S. trading market for our issued securities. In order to avoid these prohibitions, we may be forced to forego otherwise attractive business opportunities, potentially limiting our growth and our profitability.

Our principal shareholders, including major shareholders who beneficially own more than 5% of the issued shares of our common stock and directors, beneficially owned approximately 43.1% of our outstanding shares as of December 31, 2004. These shareholders, if they act together, would be able to significantly influence all matters requiring approval by our shareholders, including the election of directors and the approval of mergers or other business combination transactions. Our principal shareholders may have strategic or other interests that conflict with the interests of our other shareholders. As a result, the concentration in our shareholdings may have the effect of delaying or preventing a change in control of Trend Micro, which could result in the loss of a significant financial gain to our shareholders.

OUR STOCK PRICE IS VOLATILE, AND INVESTORS BUYING THE SHARES MAY NOT BE ABLE TO RESELL THEM AT OR ABOVE THEIR PURCHASE PRICE.

Shares of our common stock are traded on the Tokyo Stock Exchange, which is the principal market for our shares. Recently, the U.S. and Japanese securities markets have experienced significant price and volume fluctuations. The market prices of securities of high-tech companies, and internet companies in particular, have been especially volatile. Since trading in our shares commenced on the Tokyo Stock Exchange on August 17, 2000, our stock price has fluctuated between a low of 1,440 yen and a high of 9,005 yen. The closing price on the Tokyo Stock Exchange for our stock on July 29, 2005 was 4,030 yen. The market price of our shares is likely to fluctuate in the future.

BECAUSE OF DAILY PRICE RANGE LIMITATIONS UNDER JAPANESE STOCK EXCHANGE RULES, YOU MAY NOT BE ABLE TO SELL YOUR SHARES OF OUR COMMON STOCK AT A PARTICULAR PRICE ON ANY PARTICULAR TRADING DAY, OR AT ALL.

Stock prices on Japanese stock exchanges are determined on a real-time basis by the equilibrium between bids and offers. These exchanges are order-driven markets without specialists or market makers to guide price formation. To prevent excessive volatility, these exchange set daily upward and downward price fluctuation limits for each stock, based on the previous day s closing price. Although transactions may continue at the upward or downward limit price if the limit price is reached on a particular trading day, no transactions may take place outside these limits. Consequently, an investor wishing to sell at a price above or below the relevant daily limit may not be able to sell his or her shares at such price on a particular trading day, or at all.

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3 CONSOLIDATED FINANCIAL STATEMENTS

(1) CONSOLIDATED BALANCE SHEETS

(Thousands of yen)

	June 30, 2004		June 30, 2005		December 31, 2004	
Account	**Amount**	**%**	**Amount**	**%**	**Amount**	**%**
<Assets>						
Current assets:						
Cash and cash equivalents	40,462,189		55,797,854		52,908,357	
Time deposits	460,391		906,397		383,276	
Marketable securities	13,792,770		14,915,254		15,288,575	
Notes and accounts receivable, trade -less allowance for doubtful accounts and sales returns of (Yen) 842,681 in the first half of FY2004, (Yen) 1,077,276 in the first half of FY2005 and (Yen) 864,938 in FY2004, respectively	12,323,100		13,742,453		15,245,213	
Inventories	189,226		280,722		201,243	
Deferred income taxes	5,955,785		6,272,727		6,224,972	
Prepaid expenses and other current assets	1,108,786		1,457,490		1,560,058	
Total current assets	74,292,247	86.1	93,372,897	83.7	91,811,694	86.0
Investments and other assets:						
Securities investments	6,867,926		9,321,151		9,831,913	
Investment in and advances to affiliate companies	138,183		206,944		175,281	
Software development costs	530,841		640,578		438,464	
Other intangibles	307,188		1,260,470		296,368	
Goodwill			2,442,109			
Deferred income taxes	1,774,102		1,543,222		1,695,771	
Other	652,561		662,846		636,009	
Total investments and other assets	10,270,801	11.9	16,077,320	14.4	13,073,806	12.3
Property and equipment:						
Office furniture and equipment	2,943,219		3,841,551		3,323,526	

Other properties	1,162,394		1,349,320		1,165,173	
	4,105,613		5,190,871		4,488,699	
Less: Accumulated depreciation	(2,389,676)		(3,094,701)		(2,640,288)	
Total property and equipment	1,715,937	2.0	2,096,170	1.9	1,848,411	1.7
Total assets	86,278,985	100.0	111,546,387	100.0	106,733,911	100.0

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(Thousands of yen)

Account	June 30, 2004 Amount	%	June 30, 2005 Amount	%	December 31, 2004 Amount	%
<Liabilities, minority interest and shareholders equity>						
Current liabilities:						
Notes payable, trade	63,044		139,895		88,087	
Accounts payable, trade	1,824,187		744,285		1,271,067	
Accounts payable, other	1,987,842		2,970,364		2,699,762	
Withholding income taxes	572,839		839,157		882,693	
Accrued expenses	2,185,496		2,886,400		2,143,694	
Accrued income and other taxes	4,638,402		4,133,554		7,192,085	
Deferred revenue	20,409,178		26,240,519		24,634,662	
Other	796,297		781,518		651,503	
Total current liabilities	32,477,285	37.6	38,735,692	34.7	39,563,553	37.1
Long-term liabilities:						
Deferred revenue	3,187,325		3,425,101		3,268,892	
Accrued pension and severance costs	588,430		767,945		656,041	
Other	160,329		64,108		70,665	
Total long-term liabilities	3,936,084	4.6	4,257,154	3.8	3,995,598	3.7
Minority interest			4,613	0.0		
Shareholders equity:						
Common stock						
Authorized						
-June 30, 2004 250,000,000 shares						
-June 30, 2005 250,000,000 shares						
-December 31, 2004 250,000,000 shares (no par value)						
Issued						
-June 30, 2004 133,997,891 shares	9,144,983					
-June 30, 2005 136,051,155 shares			11,803,201			
-December 31, 2004 135,755,872 shares					11,426,977	
Additional paid-in capital	14,756,997		18,035,675		17,359,335	
Retained earnings	33,355,669		45,829,022		42,165,026	
Accumulated other comprehensive income (loss)						
Net unrealized gain (loss) on debt and equity securities	(91,832)		(2,654)		284,348	
Cumulative translation adjustments	(565,491)		230,810		(606,463)	
	(657,323)		228,156		(322,115)	
Treasury stock, at cost						
-June 30, 2004 2,504,854 shares	(6,734,710)					
-June 30, 2005 2,545,688 shares			(7,347,126)			
-December 31, 2004 2,588,439 shares					(7,454,463)	
Total shareholders equity	49,865,616	57.8	68,548,928	61.5	63,174,760	59.2

Total liabilities, minority interest and shareholders equity	86,278,985	100.0	111,546,387	100.0	106,733,911	100.0

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(2) CONSOLIDATED STATEMENTS OF INCOME

(Thousands of yen)

	For the six months ended June 30, 2004		For the six months ended June 30, 2005		For the year ended December 31, 2004	
Account	**Amount**	**%**	**Amount**	**%**	**Amount**	**%**
Net sales	28,464,157	100.0	34,489,740	100.0	62,049,254	100.0
Cost of sales	1,926,769		1,191,244		3,236,499	
Gross profit	26,537,388	93.2	33,298,496	96.5	58,812,755	94.8
Operating expenses:						
Selling	7,457,213		10,338,819		16,009,409	
Research and development and maintenance	2,278,974		2,891,775		4,858,259	
Customer support	2,717,490		3,190,146		5,723,426	
General and administrative	2,705,635		4,106,616		6,143,985	
Total operating expenses	15,159,312	53.2	20,527,356	59.5	32,735,079	52.8
Operating income	11,378,076	40.0	12,771,140	37.0	26,077,676	42.0
Other incomes (expenses):						
Interest income	160,957		326,282		451,217	
Interest expense	(44,644)		(2,241)		(87,464)	
Gain (loss) on sales of marketable securities	82,857		20,534		101,199	
Foreign exchange gain (loss), net	(29,075)		197,132		(183,292)	
Other income (expense), net	(21,451)		2,897		(34,350)	
Total other income (expenses)	148,644	0.5	544,604	1.6	247,310	0.4
Net income before tax	11,526,720	40.5	13,315,744	38.6	26,324,986	42.4
Income taxes:						
Current	5,498,022		4,698,548		11,893,659	
Deferred	(922,416)		158,283		(1,390,387)	
	4,575,606	16.1	4,856,831	14.1	10,503,272	16.9
Income before minority interest and equity in earnings of affiliated companies	6,951,114	24.4	8,458,913	24.5	15,821,714	25.5
Minority interest in income of consolidated subsidiaries			(420)	0.0		
Equity in earnings of affiliated companies	17,893	0.1	31,663	0.1	53,122	0.1
Net income	6,969,007	24.5	8,490,156	24.6	15,874,836	25.6

Per share data:			
Net income	Yen	Yen	Yen
-Basic	52.41	63.67	120.64
-Diluted	51.47	62.71	118.59
Cash dividends	14.00	36.00	14.00

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(3) CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME

(Thousands of yen)

Account	For the six months ended June 30, 2004	For the six months ended June 30, 2005	For the year ended December 31, 2004
Net income	6,969,007	8,490,156	15,874,836
Other comprehensive income (loss), before tax:			
Unrealized gains (losses) on debt and equity securities:			
Unrealized holding gains (losses) arising during period	(198,675)	(279,612)	514,117
Less reclassification adjustment for (gains) losses included in net income	(67,303)	(186,353)	(143,702)
	(265,978)	(465,965)	370,415
Foreign currency translation adjustments	(64,545)	837,273	(105,517)
Total	(330,523)	371,308	264,898
Income tax expense related to unrealized gains (losses) on debt and equity securities	103,181	178,963	(157,032)
Other comprehensive income (loss), net of tax	(227,342)	550,271	107,866
Comprehensive income	6,741,665	9,040,427	15,982,702

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(4) CONSOLIDATED STATEMENT OF SHAREHOLDERS EQUITY

(Thousands of yen)

Account	For the six months ended June 30, 2004	For the six months ended June 30, 2005	For the year ended December 31, 2004
<Common stock>			
Balance at beginning of period	7,396,194	11,426,977	7,396,194
Exercise of stock purchase warrants and stock acquisition rights	1,748,789	376,224	4,030,783
Balance at end of period	9,144,983	11,803,201	11,426,977
<Additional paid-in capital>			
Balance at beginning of period	13,165,881	17,359,335	13,165,881
Tax benefit from exercise of non-qualified stock warrants	115,383	300,271	498,905
Tax recognition derived from elimination of reversed warrant related with stock option plan	(249,978)		(312,708)
Loss on sales of treasury stock, net of tax	(22,941)		(22,941)
Exercise of stock purchase warrants and stock acquisition rights	1,748,652	376,069	4,030,198
Balance at end of period	14,756,997	18,035,675	17,359,335
<Retained earnings>			
Balance at beginning of period	28,236,466	42,165,026	28,236,466
Net income	6,969,007	8,490,156	15,874,836
Stock issue costs, net of tax	(3,735)	(1,829)	(11,977)
Cash dividends	(1,829,260)	(4,794,028)	(1,829,260)
Loss on sales of treasury stock, net of tax	(16,809)	(30,303)	(105,039)
Balance at end of period	33,355,669	45,829,022	42,165,026
<Net unrealized gain (loss) on debt and equity securities>			
Balance at beginning of period	70,965	284,348	70,965
Net change during the period	(162,797)	(287,002)	213,383
Balance at end of period	(91,832)	(2,654)	284,348
<Cumulative translation adjustments>			
Balance at beginning of period	(500,946)	(606,463)	(500,946)
Aggregate translation adjustments for the period	(64,545)	837,273	(105,517)
Balance at end of period	(565,491)	230,810	(606,463)
<Treasury stock, at cost>			
Balance at beginning of period	(4,416,763)	(7,454,463)	(4,416,763)
Purchase of treasury stock	(2,616,694)	(42,631)	(3,759,507)
Sales of treasury stock	298,747	149,968	721,807

Balance at end of period	(6,734,710)	(7,347,126)	(7,454,463)
Total shareholders equity	49,865,616	68,548,928	63,174,760

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(5) CONSOLIDATED STATEMENTS OF CASH FLOWS

(Thousands of yen)

Account	For the six months ended June 30, 2004	For the six months ended June 30, 2005	For the year ended December 31, 2004
Cash flows from operating activities:			
Net income	6,969,007	8,490,156	15,874,836
Adjustments to reconcile net income to net cash provided by operating activities -			
Depreciation and amortization	785,396	942,777	1,590,743
Pension and severance costs, less payments	99,262	91,650	166,649
Deferred income taxes	(922,416)	158,283	(1,390,387)
(Gain) loss on sales of marketable securities	(82,857)	(20,534)	(101,199)
Equity in earnings of affiliated companies	(17,893)	(31,663)	(53,122)
Minority interest		420	
Changes in assets and liabilities:			
Increase (decrease) in deferred revenue	3,201,387	1,424,155	7,293,488
(Increase) decrease in accounts receivable, net of allowances	(719,133)	1,552,014	(3,421,729)
(Increase) decrease in inventories	(112,030)	(53,076)	(124,093)
Increase (decrease) in notes and accounts payable, trade	896,839	(510,190)	379,882
Increase (decrease) in accrued income and other taxes	358,248	(3,219,572)	2,912,481
(Increase) decrease in other current assets	16,948	133,075	(90,479)
Increase (decrease) in accounts payable, other	279,029	250,129	823,199
Increase (decrease) in other current liabilities	908,479	321,916	1,107,855
(Increase) decrease in other assets	390,684	5,754	110,628
Other	117,191	113,694	(178,744)
Net cash provided by operating activities	12,168,141	9,648,988	24,900,008
Cash flows from investing activities:			
Payments for purchases of property and equipment	(226,434)	(507,160)	(801,935)
Software development cost	(402,096)	(475,129)	(645,166)
Payments for purchases of other intangibles	(200,253)	(83,946)	(229,167)
Proceeds from sales of marketable securities	954,474	8,545,586	4,986,012
(Payments for) / Proceeds from marketable securities maturing within three months or less (net)		784,865	(2,156,191)
Payments for purchases of marketable securities and security investments	(11,062,351)	(8,241,925)	(17,240,100)
Payment for business acquisition		(2,716,702)	
(Payments for) / Proceeds from time deposits	(20,068)	(523,121)	57,047
Net cash used in investing activities	(10,956,728)	(3,217,532)	(16,029,500)
Cash flows from financing activities:			
Issuance of common stock pursuant to exercise of stock purchase warrants and stock acquisition rights	3,493,706	750,464	8,049,004
Redemption of bonds	(6,500,000)		(6,500,000)

Proceeds from / (Purchase of) treasury stock (net)	(2,357,697)	77,034	(3,165,679)
Tax benefit from exercise of non-qualified stock warrants	115,383	300,271	498,905
Tax recognition derived from elimination of reversed warrant related with stock option plan	(249,978)		(312,708)
Capital contribution from minority interest		4,193	
Dividend paid	(1,814,984)	(4,766,610)	(1,819,607)
Net cash used in financing activities	(7,313,570)	(3,634,648)	(3,250,085)
Effect of exchange rate changes on cash and cash equivalents	(154,594)	92,689	568,994
Net increase (decrease) in cash and cash equivalents	(6,256,751)	2,889,497	6,189,417
Cash and cash equivalents at beginning of period	46,718,940	52,908,357	46,718,940
Cash and cash equivalents at end of period	40,462,189	55,797,854	52,908,357
Supplementary information of cash flow:			
Payment for interest expense	19,424	2,241	114,121
Payment for income taxes	5,754,866	7,350,227	8,990,398

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NOTES TO INTERIM CONSOLIDATED FINANCIAL INFORMATION

1. Accounting Principles, Accounting Procedures and Methods for Presenting Interim Consolidated Financial Statements

The accompanying consolidated financial statements are prepared in accordance with accounting principles generally accepted in the United States of America (U.S. GAAP), including Accounting Principles Board Opinion (APB), Statement of Financial Accounting Standards (SFAS), Emerging Issues Task Force Consensus (EITF) and the American Institute of Certified Public Accountants Statement of Position (SOP). The Company listed on the NASDAQ in July 1999, and prepares its consolidated financial statements pursuant to the terminology, forms and preparation methods required in order to issue American Depositary Shares, which are registered with the U.S. Securities and Exchange Commission. The Company maintains their books and records in conformity with accounting principles and practices generally accepted in Japan (Japan GAAP), and its foreign subsidiaries in conformity with those in the respective countries of their domicile. Certain adjustments and reclassifications, including those relating to the tax effects of temporary differences, valuation of debt and equity securities and revenue on post-contract support, have been incorporated in the accompanying consolidated financial statements to conform with accounting principles generally accepted in the United States of America (U.S. GAAP). These adjustments were not recorded in the statutory books of account.

The preparation of financial statements in conformity with U.S. GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

The significant differences between accounting principles, accounting procedures and methods of presentation which are adopted by the Company and its subsidiaries (U.S. GAAP) and those in Japan (Japan GAAP) are as follows. However, the effect on income before income tax caused by the GAAP differences indicated below, are immaterial.

(1) Pension Accounting

The Company and subsidiaries account for the retirement benefit plan in accordance with SFAS No. 87 Employers Accounting for Pensions . The transitional difference, when SFAS No. 87 is first applied, shall be amortized on a straight-line basis over the average remaining service period. However, in our non-consolidated financial statements, the transitional difference was all charged to income in the first year of application of local pension accounting, in accordance with Japan GAAP.

(2) Disclosure of the loss on disposal of fixed assets

Under Japan GAAP, the loss on disposal of fixed assets is disclosed in unusual profit and loss . We have disclosed this amount in Other incomes (expenses) in our consolidated statement of income.

(3) Common stock issue costs

Common stock issue costs are directly charged to retained earnings, net of tax, in the accompanying consolidated financial statements. Under Japan GAAP, these costs are charged to income as incurred.

(4) Goodwill

The Company accounts for goodwill in accordance with SFAS 142, Goodwill and Other Intangible Assets which requires the discontinuance of amortization for goodwill and at least an annual test for impairment.

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2. Summary of significant accounting policies

Basis of consolidation

The consolidated financial statements include the accounts of the parent company and those of its majority-owned subsidiaries. All intercompany transactions and accounts are eliminated on consolidation.

Investments in affiliated companies (20 to 50 percent-owned companies) in which the ability to exercise significant influence exists are stated at cost plus the equity in undistributed earnings (losses). Net consolidated income includes the company s equity in the current net earnings (losses) of such companies, after elimination of unrealized intercompany profit.

Consolidated subsidiaries:

All subsidiaries which are composed of the following 21 companies are consolidated:

Trend Micro Incorporated (Taiwan)
Trend Micro Inc. (USA)
Trend Micro Korea Inc.
Trend Micro Italy S.r.l.
Trend Micro Deutschland Gmbh (Germany)
Trend Micro Australia Pty. Ltd.
Trend Micro do Brasil Ltda. (Brazil)
Trend Micro France
Trend Micro Hong Kong Limited (China)
Trend Micro (UK) Limited
Trend Micro Latinoamerica S.A.de C.V. (Mexico)
Trend Micro (NZ) Limited (NewZealand)
ipTrend Incorporated (Taiwan)
Trend Micro (China) Incorporated
Trend Micro (EMEA) Limited (Ireland)
Servicentro TMLA, S.A.de C.V. (Mexico)
Trend Micro (Singapore) Private Limited
Trend Micro Malaysia Sdn. Bhd.
Trend Micro (Thailand) Limited
Trend Micro Braintree, Inc. (USA)
Trend Micro San Jose, Inc. (USA)

ipTrend Incorporated (Taiwan) was liquided for the first six month ended June 30, 2005.

During the first half of FY2005, the Company acquired 100% of the outstanding capital shares of Trend Micro Braintree Inc. (former InterMute, Inc.,) and Trend Micro San Jose, Inc (former Kelkea Inc.) as a purchase. However, the purchase price allocation based on estimates of the fair values of the tangible and intangible assets acquired and liabilities assumed are being tested closely and the amount of goodwill is subject to change.

Affiliated companies:

Equity method is applied to investments in affiliated companies, which are composed of the following 2 companies.

Soft Trend Capital Corporation (Japan)

Net STAR, Inc. (Japan)

Translation of foreign currencies

All asset and liability accounts of foreign subsidiaries are translated into Japanese yen at year-end rates of exchange and all income and expense accounts are translated at rates of exchange that approximate to those prevailing at the time of the transactions. The resulting translation adjustments are included in accumulated other comprehensive income (loss).

Foreign currency denominated receivables and payables are translated into Japanese yen at year-end rates of exchange and the resulting translation gains or losses are taken into current income.

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Revenue recognition

The Company s revenue is derived primarily from product revenue, which includes software product license and post-contract customer support services. Other revenue is composed of hardware revenue, royalty revenue and supplementary service revenue. Royalty revenue is comprised of fees from Application service providers and Internet service providers and supplementary services are comprised of fees from services based on Premium support program and Service level agreement . Product revenue includes the type of limited sales of our products to other companies for inclusion in their products.

The Company licenses its software products under perpetual licenses. The Company sells its products and services via its direct sales force and through domestic and foreign intermediaries.

The Company applies the provisions of SOP 97-2, *Software Revenue Recognition* , as amended by SOP 98-9 *Modification of SOP 97-2, Software Revenue Recognition, With Respect to Certain Transactions* to all transactions involving the sale of software products and hardware transactions where software is not incidental. For hardware transactions where software is not incidental, the Company does not bifurcate the fee and apply separate accounting guidance to the hardware and software elements.

Revenue from the Company s software product license and hardware where software is not incidental is recognized when persuasive evidence of an arrangement exists, the product has been delivered, the fee is fixed and determinable, and collection of the resulting receivable, net of allowances for doubtful accounts and sales returns, is reasonably assured. Post-contract customer support services revenue which includes virus pattern updates, unspecified product version updates, telephone and online technical support and supplementary services revenue are deferred and recognized ratably over the service period. The Company allocates revenue to post-contract customer support services based on the fair value of the post-contract customer support services, which are determined based on separate sales of renewals to customers. Royalty revenue is recognized as earned unless collection of the related receivables is not assured in which case, it is recognized upon receipt of cash.

For all sales, the Company uses either a binding purchase order or signed license agreement as evidence of an arrangement. Sales through our intermediaries are evidenced by a master agreement governing the relationship together with binding purchase orders on a transaction-by-transaction basis.

At the time of the transaction, the Company assesses whether the fee associated with our revenue transactions is fixed and determinable and whether or not collection is reasonably assured. The Company assesses whether the fee is fixed and determinable based on the payment terms associated with the transaction. If a significant portion of a fee is due after our normal payment terms, which are 30 to 90 days from the invoice date, the Company accounts for the fee as not being fixed and determinable. In these cases, the Company recognizes revenue as the fees become due. The Company assesses collection based on a number of factors, including past transaction history with the customer and the credit-worthiness of the customer. The Company does not request collateral from our customers. If the Company determines that collection of a fee is not reasonably assured, the Company defers the fee and recognizes revenue at the time collection becomes reasonably assured, which is generally upon receipt of cash.

The Company recognizes revenue from sales to intermediaries when products have been delivered to the intermediary. The Company primarily sells retail packages through intermediaries. After sale of a retail package, the Company may approve certain returns from intermediaries or end-users; therefore, the Company makes an estimate of returns from intermediaries or end-users based on its historical experience. The provision for estimated returns is recorded as a reduction to revenue at the time of the sale.

Cash and cash equivalents

Cash and cash equivalents include cash on hand, cash on deposit with banks and all highly liquid investments, with original maturities of three months or less, that are readily convertible to known amounts of cash and are so near maturity that they present insignificant risk of changes in value because of changes in interest rates.

Marketable securities and Security investments

Marketable securities and security investments consist of debt and equity securities. Debt and equity securities designated as available-for-sale are carried at fair value with unrealized gains or losses included in accumulated other comprehensive income (loss), net of applicable taxes. Debt securities designated as held-to-maturity are carried at amortized cost. The Company classifies available for sale debt securities with maturities longer than one year as Securities investments in investments and other assets. Individual securities classified as either available-for-sale or held-to-maturity are reduced to net realizable value for other than temporary declines in market value. Realized gains and losses, which are determined on the average cost method, are reflected in income.

Inventories

Finished products and raw materials are valued at the lower of weighted average cost or net realizable value. Work in process is stated at accumulated production costs.

Property and equipment

Property and equipment are stated at cost less accumulated depreciation. Major renewals and improvements are capitalized; minor replacements, maintenance and repairs are charged to current operations. Depreciation of property and equipment is computed on the declining-balance method for the parent company and on the straight-line method for foreign subsidiaries at rates based on estimated useful lives of the assets according to general class, type of construction and use. Estimated useful lives range mainly from 3 to 6 years for office furniture and equipment, and mainly from 3 to 6 years for other properties.

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Intangible assets

Intangible assets, which mainly consist of software development costs and purchased software, are amortized on a straight-line basis over the estimated economic lives of the products, generally over twelve-month period for software development costs and a five-year period for purchased software and other intangibles.

Goodwill

We account for goodwill in accordance with SFAS 142, Goodwill and Other Intangible Assets (SFAS 142). SFAS 142 requires, among other things, the discontinuance of amortization for goodwill and at least an annual test for impairment. An impairment review may be performed more frequently in the event circumstances indicate that the carrying value may not be recoverable.

Impairment of long-lived assets

The Company evaluates long-lived assets and definite lived intangible assets to be held and used whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Determination of recoverability is based on the sum of expected future cash flows (undiscounted and without interest charges) from the use and eventual disposition of the asset. If the fair value is less than the carrying amount of the asset, an impairment loss is recognized, based on the fair value of the asset.

Research and development costs and software development costs

All costs relating to research and development, to establish the technological feasibility of software products, are expensed as incurred. Under the Company s software development process, technological feasibility is established on completing all substantial testing for the original English language version of the software. Local language versions of software, such as Japanese or Chinese, are produced from the English language version, by adding Japanese language or Chinese language related functions. Production costs for such local language versions of software product masters, incurred subsequent to the availability of original English language version software, are capitalized. Production costs of the local language software product masters, which include direct labor and overhead costs, are amortized to cost of sales using the straight-line method over the current estimated economic lives of the products, generally up to twelve months.

Management considers the Company s capitalized software development costs to be fully recoverable from future product sales. Management estimates are based upon supporting facts and circumstances, and may be significantly impacted based upon subsequent changes in business conditions.

Advertising costs

Advertising costs are expensed as incurred.

Stock-based compensation

The Company accounts for its stock-based incentive awards in accordance with the intrinsic value method as per APB No. 25, Accounting for Stock Issued to Employees and related interpretations. The Company complies with the disclosure provisions of SFAS No. 123, Accounting for Stock-Based Compensation, as amended by SFAS No. 148.

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In October 1995, SFAS 123 established a fair value based method of accounting for employee stock based compensation. If compensation cost for the stock options with warrants, and the stock options with Stock acquisition rights been determined based on the fair value at the grant dates, as prescribed by SFAS 123, the Company s pro forma net income and net income per share would have been as follows:

	Thousands of Yen, except per share data		
	For the six months ended June 30, 2004	For the six months ended June 30, 2005	For the year ended December 31, 2004
Net income:			
As reported	6,969,007	8,490,156	15,874,836
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects	(1,058,726)	(1,758,066)	(2,640,021)
Pro forma net income	5,910,281	6,732,090	13,234,815
Net income per share:			
As reported			
Basic	(Yen) 52.41	(Yen) 63.67	(Yen) 120.64
Diluted	51.47	62.71	118.59
Pro forma net income			
Basic	(Yen) 44.45	(Yen) 50.49	(Yen) 100.58
Diluted	43.65	49.73	98.87

The fair values of the stock options with Stock acquisition rights were estimated on the date of grant using the Black-Scholes option pricing model with the following assumptions used for grants during the first six months ended June 30, 2004 and the year ended December 31, 2004; expected life of 5.00 years, volatility of 59.570 % and dividend yield of 0.39 % for first half of 2004 ; expected life of 5.0 years, volatility of 51.710-59.570 % and dividend yield of 0.39-0.43% for 2004; and risk-free interest rates of 0.674 % for options granted during the first half of 2004, and risk-free interest rates of ranging from 0.634 % to 0.674 % for options granted during the year ended December 31, 2004. The fair value per share of options granted above during first half of 2004 and fiscal 2004 were (Yen) 2,235 and (Yen) 2,190 to 2,235, respectively. There was no additional issuance of Stock acquisition rights as stock option during the first six months ended June 30, 2005.

Income taxes

The current provision for income taxes is computed based on the pretax income included in the consolidated statement of income. The asset and liability approach is used to recognize deferred tax assets and liabilities for the expected future tax consequences of temporary differences between the carrying amounts and the tax bases of assets and liabilities. Deferred tax assets and liabilities are measured using enacted tax rates in effect for the year in which those temporary differences are expected to be recovered or settled. The effect on deferred assets (including deferred tax assets and liabilities on net unrealized gain or loss on debt and equity securities) of a change in tax rates is recognized in income in the period that includes the enactment date. Valuation allowances are recorded to reduce deferred tax assets when it is more likely than not that a tax benefit will not be realized.

Net income per share

Basic net income per share is computed based on the average number of shares of common stock outstanding for the period. Diluted net income per share assumes the dilution that could occur if securities or other contracts to issue common stock were exercised or converted into common stock, or resulted in the issuance of common stock. Net income per share is appropriately adjusted for any stock splits or free distributions of common stock.

Free distribution of common stock

On occasion, the Company has made free distributions of common stock to its shareholders which have been accounted for either by a transfer of the applicable par value from additional paid-in capital to the common stock account or with no entry if free shares were distributed from the portion of previously issued shares accounted for as excess of par value in the common stock account in accordance with the Japanese Commercial Code. However, as a result of the amendments to the Japanese Commercial Code in 2001 where the concept of par-value of shares was eliminated effective from October 1, 2001, a free distribution of common stock to its shareholders is accounted for with no accounting entry. Under the Japanese Commercial Code, a stock dividend which is paid out of profits can be effected by an appropriation of retained earnings to the common stock account by resolution of the general shareholders meeting, followed by a free distribution with respect to the amount as appropriated by resolution of the Board of Directors.

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Common stock issue costs

Common stock issue costs are directly charged to retained earnings, net of tax, in the accompanying consolidated financial statements as the Japanese Commercial Code prohibits charging such stock issue costs to capital accounts, which is the prevailing practice in the United States of America.

Comprehensive income

Other comprehensive income refers to revenues, expenses, gains and losses that under U.S. GAAP are included in comprehensive income but are excluded from net income as these amounts are recorded directly as adjustments to shareholders equity. The Company s other comprehensive income primarily comprises unrealized gains or losses on debt and equity securities and foreign currency translation adjustments.

Market and credit risks

The anti-virus software market is characterized by rapid technological change and evolving industry standards in computer hardware and software technology. In addition, the markets for the Company s products are highly competitive and rapidly changing. The Company could incur substantial operating losses if it is unable to offer products, which address technological and market place change in the anti-virus software industry.

Other financial instruments that potentially subject the Company to significant concentrations of credit risk consist principally of cash equivalents, marketable securities and accounts receivable. The Company invests primarily in time deposits, money market funds and marketable securities and places its investments with high rating financial institutions. The Company performs ongoing credit evaluations of its customers financial condition and maintains an allowance for uncollectible accounts receivable, if any, based upon the expected collectibility of accounts receivable.

3. Reclassifications

Previously, the Company has disclosed all of available for sale debt securities as Marketable securities in current assets.

However, since the balance of cash and cash equivalents has increased, in fiscal 2004, the possibility of sales before maturity of available for sale debt securities classified into working capital has decreased. Therefore, from fiscal 2004, the Company discloses available for sale debt securities with maturities longer than one year as Securities investments in investments and other assets.

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4. Reconciliation of the difference between basic and diluted net income per share (EPS)

Reconciliation of the differences between basic and diluted EPS for the six month ended June 30, 2004 and 2005 and for the year ended December 31, 2004, is as follows:

	For the six month ended June 30, 2004	For the six month ended June 30, 2005	For the year ended December 31, 2004
		Thousands of Yen	
Net income available to common stock holders	(Yen) 6,969,007	(Yen) 8,490,156	(Yen) 15,874,836
		Thousands of Shares	
Weighted-Average shares	132,974	133,341	131,589
Effect of dilutive securities:			
Stock options	2,419	2,045	2,274
Weighted-Average shares for diluted EPS computation	135,393	135,386	133,863
		Yen	
Basic EPS:	52.41	63.67	120.64
Diluted EPS:	51.47	62.71	118.59

Shareholders equity per share as of June 30, 2004 and 2005 and December 31, 2004, were as follows:

	June 30,		December 31,
	2004	2005	2004
Shareholders equity per share	(Yen) 379.23	(Yen) 513.45	(Yen) 474.40

5. Cash and cash equivalents

Cash and cash equivalents as of June 30,2004 and 2005 and December 31,2004 were as follows:

(Thousands of yen)

	June 30, 2004	June 30, 2005	December 31, 2004
Cash	37,679,103	49,444,324	49,189,396
Time deposits with original maturities of three months or less	2,783,086	6,353,530	3,718,961

	40,462,189	55,797,854	52,908,357

6. Time deposits

The U.S. subsidiary had (Yen) 60,221 thousand, (Yen) 29,005 thousand and (Yen) 26,720 thousand of restricted cash set aside in accordance with the terms of building lease agreement as at June 30, 2004 and 2005 and December 31, 2004, respectively. The restricted cash is included in time deposits.

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7. Marketable securities and securities investments

Marketable securities include mutual funds and debt and equity securities for which the aggregate fair value, gross unrealized gains and losses and cost pertaining to available-for-sale investments as of June 30, 2004 and 2005 and December 31, 2004, were as follows:

Available for sale: (Thousands of yen)

	June 30, 2004				June 30, 2005				December 31, 2004			
	Cost	Gains	Losses	Fair value	Cost	Gains	Losses	Fair value	Cost	Gains	Losses	Fair value
Mutual funds	6,403,293	8,243		6,411,536	8,169,757	49,018		8,218,775	6,823,896	466,020		7,289,916
Equity securities												
Debt securities	13,737,424	82,346	151,985	13,667,785	15,378,111	98,745	113,363	15,363,493	17,142,091	226,557	185,123	17,183,525
Total	20,140,717	90,589	151,985	20,079,321	23,547,868	147,763	113,363	23,582,268	23,965,987	692,577	185,123	24,473,441

The net unrealized gain on available-for-sale securities included in the separate component of shareholders equity, net of applicable taxes, decreased by (Yen) 137,754 thousand, decreased by (Yen) 291,206 thousand, and increased by (Yen) 197,606 thousand, for the six month ended June 30, 2004 and 2005 and for the year ended December 31, 2004, respectively.

Proceeds from sales of available-for-sale securities for the six month ended June 30, 2004 and 2005 and for the year ended December 31, 2004 were (Yen) 954,474 thousand, (Yen) 9,330,451 thousand and (Yen) 4,986,012 thousand, respectively. Realized gains (losses) on sales of available-for-sale securities for the six month ended June 30, 2004 and 2005 and for the year ended December 31, 2004 were (Yen) 82,857 thousand, (Yen) 20,534 thousand and (Yen) 101,199 thousand, respectively.

8. Research and development and maintenance costs, and software development costs

Research and development and maintenance costs in operating expenses are comprised of research and development costs and maintenance costs.

Research and development costs incurred up to the point where all substantial testing for the original English version product is complete, are charged to income. Such research and development costs charged to income were (Yen) 1,227,714 thousand, (Yen) 2,196,929 thousand and (Yen) 2,597,325 thousand for the six month ended June 30, 2004 and 2005 and for the year ended December 31, 2004, respectively.

Maintenance costs are fees, which relate to product version updates to enable product to cope with newly prevailing computer viruses and bug fixing. The maintenance costs were (Yen) 1,051,260 thousand, (Yen) 694,846 thousand and (Yen) 2,260,934 thousand for the six month ended June 30,2004 and 2005 and for the years ended December 31, 2004, respectively.

Software development costs relating to the local language related functions (representing software development costs as shown in consolidated balance sheets) after netting the related accumulated amortization, are capitalized and amortized to cost of sales as follows:

	Thousands of yen		
	For the six month ended June 30, 2004	For the six month ended June 30, 2005	For the year ended December 31, 2004
Software development costs:			
Balance at beginning of year	(Yen) 505,616	(Yen) 438,464	(Yen) 505,616
Additions, at cost	402,096	421,614	645,166
Amortization for the period	(376,871)	(219,500)	(712,318)
Balance at end of period	(Yen) 530,841	(Yen) 640,578	(Yen) 438,464

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9. Long-term debt

Long-term debt comprises the following:

	Thousands of yen		
	June 30, 2004	June 30, 2005	December 31, 2004
Unsecured 1.75% bonds, due 2004 with detachable warrants	6,000,000		
Unsecured 1.9% bonds, due 2006 with detachable warrants	4,000,000	4,000,000	4,000,000
	10,000,000	4,000,000	4,000,000
Less treasury bonds:			
Unsecured 1.75% bonds, due 2004 with detachable warrants	(6,000,000)		
Unsecured 1.9% bonds, due 2006 with detachable warrants	(4,000,000)	(4,000,000)	(4,000,000)

Based on the Company s incentive plans, the parent company issued unsecured bonds with detachable warrants and bought all of the warrants at the same time for the purpose of distributing such instruments to the directors and certain employees of the parent company and its subsidiaries as a part of their remuneration.

The Japanese Commercial Code restricts redemptions and extinguishments of these bonds in case the amount of each outstanding bond is less than the aggregate amount of exercise price of each outstanding warrant. Therefore, in order to reduce interest costs, the parent company repurchased a part of the bonds through the market with an intention to hold the treasury bonds until they can be extinguished legally. However, as the repurchase transaction is deemed as redemption of the bonds in substance, the treasury bonds are offset with the bonds on the face of consolidated balance sheets. There was no repurchase transaction for the first six month ended June 30, 2004 and 2005 and for the year ended December 31, 2004.

10. Stock Option

Based on the Company s 2002 incentive plans, the Company issued the following bonds with detachable warrants to the public.

1.	Board meeting approval	March 26, 2002
		April 2, 2002
2.	Date of bond issuance	April 18, 2002
3.	Maturity date	April 18, 2006
4.	Amount of each bond (Thousands of yen)	(Yen) 4,000,000

5.	Issued to	Public
6.	Date on which the bonds were fully redeemed	
7.	Exercise price per each warrant	(Yen) 3,450
8.	Warrant exercise period	April 3, 2003 to April 11, 2006
9.	Number of shares represented by warrants	1,159,420
10.	Outstanding as of December 31, 2004	737,391
11.	Outstanding as of June 30, 2005	680,579

Upon issuance of each bond, the Company bought all of the warrants and distributed such instruments to the directors and certain employees of the Company and its subsidiaries as a part of their remuneration.

These transactions were accounted for as issuance of debt to the public, as an issuance of warrants to the directors and certain employees of the Company and its subsidiaries. The issuance of warrants to the directors and employees was accounted for under APB 25.

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Warrant activity was as follows:

	Thousands of shares represented by warrants
Outstanding at December 31, 2004	737
Granted	
Exercised	56
Redeemed	
Cancelled	
Outstanding at June 30, 2005	681
Exercisable Stock warrants at June 30, 2005	681

The grants of April 18, 2002 did not result in deferred compensation.

Based on the resolution of the extraordinary general shareholders meeting of the Company on September 12, 2002, Trend Micro adopted at the meeting of the board of directors on February 4, 2003 the following resolutions regarding Stock acquisition rights to be issued to the directors and employees of the Company and its subsidiaries in order to introduce the stock option plan. In accordance with the terms of this plan, the Company granted options to purchase up to 1,999,500 shares of the Company s common stock to certain directors and employees of the Company and its subsidiaries on February 12, 2003. The options granted are exercisable from November 1, 2003 through October 31, 2007.

Based on the resolution of the fourteenth ordinary general shareholders meeting of the Company on March 26, 2003, Trend Micro adopted at the meeting of the board of directors on May 20, 2003 the following resolutions regarding Stock acquisition rights to be issued to the directors and employees of the Company and its subsidiaries in order to introduce the stock option plan. In accordance with the terms of this plan, the Company granted options to purchase up to 2,500,000 shares of the Company s common stock to certain directors and employees of the Company and its subsidiaries on May 28, 2003. The options granted are exercisable from May 28, 2004 through May 27, 2008.

Based on the resolution of the fourteenth ordinary general shareholders meeting of the Company on March 26, 2003, Trend Micro adopted at the meeting of the board of directors on November 6, 2003 the following resolutions regarding Stock acquisition rights to be issued to the directors and employees of the Company and its subsidiaries in order to introduce the stock option plan. In accordance with the terms of this plan, the Company granted options to purchase up to 1,500,000 shares of the Company s common stock to certain directors and employees of the Company and its subsidiaries on November 14, 2003. The options granted are exercisable from November 14, 2004 through November 13, 2008.

Based on the resolution of the fifteenth ordinary general shareholders meeting of the Company on March 25, 2004, Trend Micro adopted at the meeting of the board of directors on April 20, 2004 the following resolutions regarding Stock acquisition rights to be issued to the directors and employees of the Company and its subsidiaries in order to introduce the stock option plan. In accordance with the terms of this plan, the Company granted options to purchase up to 3,000,000 shares of the Company s common stock to certain directors and employees of the Company and its subsidiaries on April 28, 2004. The options granted are exercisable from April 28, 2005 through April 27, 2009.

Based on the resolution of the fifteenth ordinary general shareholders meeting of the Company on March 25, 2004, Trend Micro adopted at the meeting of the board of directors on October 20, 2004 the following resolutions regarding Stock acquisition rights to be issued to the directors and employees of the Company and its subsidiaries in order to introduce the stock option plan. In accordance with the terms of this plan, the Company granted options to purchase up to 2,000,000 shares of the Company s common stock to certain directors and employees of the Company and its subsidiaries on October 28, 2004. The options granted are exercisable from October 28, 2005 through October 27, 2009.

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Option activity under this plan was as follows:

	Thousands of shares represented by options
Outstanding at December 31, 2004	9,037
Granted	
Exercised	291
Redeemed	
Cancelled	948
Outstanding at June 30, 2005	7,798
Exercisable Stock acquisition rights at June 30, 2005	2,441

The grants of Stock acquisition rights to the directors and employees were accounted for under APB No. 25. The exercise price per share for the rights granted of (Yen) 2,230 issued on February 12, 2003, (Yen) 1,955 issued on May 28, 2003, (Yen) 2,695 issued on November 14, 2003, (Yen) 4,310 issued on April 28, 2004 and (Yen) 5,090 issued on October 28, 2004 was determined as equivalent to the fair market value of the Company s share at the time of the grants. Consequently, the grant of the Stock acquisition rights did not result in deferred compensation.

11. Employee benefit plans

Pension and severance plans

The parent company has an unfunded retirement allowance plan (Plan) covering substantially all of its employees who meet eligibility requirements under the Plan. Under the Plan, employees whose service with the company is terminated are, under most circumstances, entitled to lump-sum severance indemnities, determined by reference to current basic rate of pay, length of service and conditions under which the termination occurs.

Additionally, the parent company has been a member of Tokyo Small Computer Software Industry Welfare pension plan, which is categorized as multi-employer pension plan. Total pension expense for this multi-employer pension plan were (Yen) 40,401 thousand, (Yen) 53,529 thousand and (Yen) 83,833 thousand for the six month ended June 30, 2004 and 2005 and for the year ended December 31, 2004, respectively.

Effective from March 1, 1998, the Taiwan subsidiary introduced a defined benefit pension plan, which covers substantially all of its employees. Under the plan, only employees who are 55 years or older with services for more than 15 years or who have been employed for more than 25 years at the retirement date are entitled to receive benefits. Benefits awarded under the plan are based primarily on current rate of pay and length of service.

Effective from July 1, 1998, the parent company s U.S. subsidiary has a 401(k) retirement plan, which covers substantially all of its employees. Under the plan, employees contribute a certain percentage of their pre-tax salary up to the maximum dollar limitation prescribed by the United States Internal Revenue Code.

Certain other subsidiaries have defined benefit pension plans or retirement plans, which cover substantially all of their employees, under which the cost of benefits is currently funded or accrued. Benefits awarded under these plans are based primarily on current rate of pay and length of service.

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Information about net periodic benefit cost regarding the Japanese defined benefit pension plans of the Company based on unfunded plan is shown below:

	For the six months ended June 30,		For the year ended December 31,
	2004	2005	2004
	Thousands of yen		Thousands of yen
Components of net periodic benefit cost:			
Service cost	(Yen) 71,856	(Yen) 64,467	(Yen) 143,711
Interest cost	3,191	3,366	6,383
Amortization of unrecognized transition obligation	156		311
Recognized actuarial loss			
Net periodic pension cost	(Yen) 75,203	(Yen) 67,833	(Yen) 150,405

Information about net periodic benefit cost regarding the defined benefit pension plans for consolidated foreign subsidiaries is shown below:

	For the six months ended June 30,		For the year ended December 31,
	2004	2005	2004
	Thousands of yen		Thousands of yen
Components of net periodic benefit cost:			
Service cost	(Yen) 31,809	(Yen) 49,494	(Yen) 78,024
Interest cost	4,629	7,345	9,220
Expected return on plan assets	(1,814)	(2,371)	(3,614)
Amortization of prior service cost	1,227	1,272	2,444
Recognized actuarial loss	504	1,464	1,004
Net periodic pension cost	(Yen) 36,355	(Yen) 57,204	(Yen) 87,078

Employer Contributions in foreign subsidiaries

For the six month ended June 30, 2005 foreign subsidiaries had made (Yen) 18,315 thousand contributions to their pension plans. The foreign subsidiaries anticipate contributing an additional (Yen) 15,591 thousand to fund the foreign subsidiaries pension plans in 2005 for a total of (Yen) 33,906 thousand.

12. Financial instruments

Fair value of financial instruments

Other than debt and equity securities, the fair value of which are disclosed in Marketable securities and securities investments , the Company s involvement in financial assets and liabilities with market risk is limited to cash and cash equivalents, time deposits, notes and accounts receivable, trade, notes and accounts payable, trade, and long-term debt. The estimated fair value of cash and cash equivalents, time deposits, notes and accounts receivable, trade, and notes and accounts payable, trade are carried at amounts, which approximate fair value. At June 30, 2004 and 2005, there was substantially no long-term debt including the current portion.

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13. Commitments and contingent liabilities

The Company provides a service based on Service level agreement (the Agreement) where the Company guarantees a certain level of services rendered to customers. The Company is required to pay penalties up to the limited amounts defined in the Agreement if the Company cannot perform the services as specified in the Agreement. The Company has established (Yen) 1,980 thousand of reserves for specific liabilities, as of June 30, 2004 in connection with the Agreement that we currently deem to be probable and estimable. Based on yearly experiences of payment, the Company has established no liabilities for specific liabilities as of June 30, 2005 and December 31, 2004. As of June 30, 2005, the Company had notes receivable balances amounting to (Yen) 36,737 thousand which were discounted. The company recorded notes receivable, net of those, which were discounted, on balance sheets.

Effect on Our Results of Operations from Distribution of a Defective Virus Pattern File in April 2005

On April 23, 2005, the Company distributed a defective virus pattern file that resulted in damage to the computers of our customers who downloaded the file. As a result, we took steps to resolve our customers problems and ensure that a similar problem would not reoccur. We have incurred approximately (Yen) 903 million related to this issue for the six months ended June 30, 2005 as operating expenses. There is some possibility of incurring further cost, however Management expects additional cost will be insignificant.

14. Segment Information

The Company has been specializing in the Security software business .

The Company discloses Operating Segment information as required by SFAS 131 Disclosures about Segments of an Enterprise and Related Information . The information provided to the chief operating decision maker for assessing the Company s performance includes 5 regional segments and a corporate segment. The five operating segments by region are Japan, North America, Europe, Asia Pacific and Latin America. The other operating segment is Corporate, which is comprised of Research and development, Marketing, Customer support and Administrative departments that operate and bring benefits to the Company worldwide.

Below is summarized information of our operating segments sales and operating income (loss). These figures comply with the accounting policies disclosed in the Notes to these consolidated financial statements.

	For the six months ended June 30, 2004	For the six months ended June 30, 2005	For the year ended December 31, 2004
	Thousands of yen		
Net sales to external customers:			
Japan	12,066,931	14,247,671	25,443,297
North America	5,341,630	6,884,623	11,891,452
Europe	7,374,532	8,828,580	16,417,611
Asia Pacific	2,821,212	3,765,821	6,304,675

Latin America	859,852	763,045	1,992,219
Corporate			
Consolidated Total	28,464,157	34,489,740	62,049,254
Operating income (loss)			
Japan	7,793,910	9,005,153	16,599,993
North America	3,146,516	4,587,286	7,543,325
Europe	4,157,410	4,899,005	9,732,567
Asia Pacific	586,045	1,516,628	1,678,826
Latin America	385,447	319,536	1,282,044
Corporate	(4,691,252)	(7,556,468)	(10,759,079)

)	(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.

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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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Notes to Condensed Consolidated Financial Statements

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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Encompass Health Corporation and Subsidiaries
Notes to Condensed Consolidated Financial Statements

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.

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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.

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Condensed Consolidating Statement of Operations

	Three Months Ended June 30, 2018				
	Encompass Health Corporation	Guarantor Subsidiaries	Nonguarantor Subsidiaries	Eliminating Entries	Encompass Health Consolidated
	(In Millions)				
Net operating revenues	$5.7	$ 581.5	$ 513.7	$ (33.2)	$ 1,067.7
Operating expenses:					
Salaries and benefits	9.4	277.7	296.5	(5.4)	578.2
Other operating expenses	9.3	89.8	63.3	(13.0)	149.4
Occupancy costs	0.5	23.9	9.9	(14.8)	19.5
Supplies	—	23.5	15.8	—	39.3
General and administrative expenses	41.2	—	13.7	—	54.9
Depreciation and amortization	3.5	26.7	19.5	—	49.7
Total operating expenses	63.9	441.6	418.7	(33.2)	891.0
Interest expense and amortization of debt discounts and fees	31.9	5.2	7.2	(6.6)	37.7
Other income	(6.2)	(0.3)	(1.4)	6.6	(1.3)
Equity in net income of nonconsolidated affiliates	—	(1.7)	(0.3)	—	(2.0)
Equity in net income of consolidated affiliates	(117.4)	(17.6)	—	135.0	—
Management fees	(38.5)	28.1	10.4	—	—
Income from continuing operations before income tax (benefit) expense	72.0	126.2	79.1	(135.0)	142.3
Provision for income tax (benefit) expense	(19.6)	34.0	14.9	—	29.3
Income from continuing operations	91.6	92.2	64.2	(135.0)	113.0
Income from discontinued operations, net of tax	0.2	—	—	—	0.2
Net income	91.8	92.2	64.2	(135.0)	113.2
Less: Net income attributable to noncontrolling interests	—	—	(21.4)	—	(21.4)
Net income attributable to Encompass Health	$91.8	$ 92.2	$ 42.8	$ (135.0)	$ 91.8
Comprehensive income	$91.8	$ 92.2	$ 64.2	$ (135.0)	$ 113.2
Comprehensive income attributable to Encompass Health	$91.8	$ 92.2	$ 42.8	$ (135.0)	$ 91.8

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

	Three Months Ended June 30, 2017				
	Encompass Health Corporation	Guarantor Subsidiaries	Nonguarantor Subsidiaries	Eliminating Entries	Encompass Health Consolidated
	(In Millions)				
Net operating revenues	$5.3	$ 558.4	$ 434.3	$ (31.6)	$ 966.4
Operating expenses:					
Salaries and benefits	8.7	267.1	257.2	(5.2)	527.8
Other operating expenses	7.5	78.9	55.0	(12.1)	129.3
Occupancy costs	0.5	23.3	8.8	(14.3)	18.3
Supplies	—	23.4	13.7	—	37.1
General and administrative expenses	37.6	—	14.8	—	52.4
Depreciation and amortization	2.4	25.7	17.7	—	45.8
Total operating expenses	56.7	418.4	367.2	(31.6)	810.7
Loss on early extinguishment of debt	10.4	—	—	—	10.4
Interest expense and amortization of debt discounts and fees	34.5	5.3	5.9	(5.3)	40.4
Other income	(5.4)	(0.1)	(0.7)	5.3	(0.9)
Equity in net income of nonconsolidated affiliates	—	(1.8)	(0.2)	—	(2.0)
Equity in net income of consolidated affiliates	(85.2)	(7.7)	—	92.9	—
Management fees	(36.1)	27.1	9.0	—	—
Income from continuing operations before income tax (benefit) expense	30.4	117.2	53.1	(92.9)	107.8
Provision for income tax (benefit) expense	(32.4)	46.8	14.2	—	28.6
Income from continuing operations	62.8	70.4	38.9	(92.9)	79.2
Income from discontinued operations, net of tax	0.2	—	—	—	0.2
Net income	63.0	70.4	38.9	(92.9)	79.4
Less: Net income attributable to noncontrolling interests	—	—	(16.4)	—	(16.4)
Net income attributable to Encompass Health	$63.0	$ 70.4	$ 22.5	$ (92.9)	$ 63.0
Comprehensive income	$63.0	$ 70.4	$ 38.9	$ (92.9)	$ 79.4
Comprehensive income attributable to Encompass Health	$63.0	$ 70.4	$ 22.5	$ (92.9)	$ 63.0

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

	Six Months Ended June 30, 2018				
	Encompass Health Corporation	Guarantor Subsidiaries	Nonguarantor Subsidiaries	Eliminating Entries	Encompass Health Consolidated
	(In Millions)				
Net operating revenues	$11.1	$ 1,168.5	$ 999.9	$ (65.8)	$ 2,113.7
Operating expenses:					
Salaries and benefits	22.6	556.9	579.7	(10.8)	1,148.4
Other operating expenses	17.7	173.5	124.8	(25.4)	290.6
Occupancy costs	1.0	47.6	19.1	(29.6)	38.1
Supplies	—	47.9	31.3	—	79.2
General and administrative expenses	80.6	—	35.4	—	116.0
Depreciation and amortization	5.5	52.8	37.3	—	95.6
Total operating expenses	127.4	878.7	827.6	(65.8)	1,767.9
Interest expense and amortization of debt discounts and fees	61.7	10.4	12.9	(11.7)	73.3
Other income	(10.9)	(0.5)	(1.5)	11.7	(1.2)
Equity in net income of nonconsolidated affiliates	—	(3.6)	(0.7)	—	(4.3)
Equity in net income of consolidated affiliates	(229.4)	(35.4)	—	264.8	—
Management fees	(76.9)	56.5	20.4	—	—
Income from continuing operations before income tax (benefit) expense	139.2	262.4	141.2	(264.8)	278.0
Provision for income tax (benefit) expense	(36.7)	70.7	25.3	—	59.3
Income from continuing operations	175.9	191.7	115.9	(264.8)	218.7
Loss from discontinued operations, net of tax	(0.3)	—	—	—	(0.3)
Net income	175.6	191.7	115.9	(264.8)	218.4
Less: Net income attributable to noncontrolling interests	—	—	(42.8)	—	(42.8)
Net income attributable to Encompass Health	$175.6	$ 191.7	$ 73.1	$ (264.8)	$ 175.6
Comprehensive income	$175.6	$ 191.7	$ 115.9	$ (264.8)	$ 218.4
Comprehensive income attributable to Encompass Health	$175.6	$ 191.7	$ 73.1	$ (264.8)	$ 175.6

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

	Six Months Ended June 30, 2017				
	Encompass Health Corporation	Guarantor Subsidiaries	Nonguarantor Subsidiaries	Eliminating Entries	Encompass Health Consolidated
	(In Millions)				
Net operating revenues	$10.6	$ 1,119.1	$ 856.6	$ (62.8)	$ 1,923.5
Operating expenses:					
Salaries and benefits	19.9	537.4	511.1	(10.5)	1,057.9
Other operating expenses	15.7	155.8	109.6	(24.0)	257.1
Occupancy costs	1.0	46.6	16.9	(28.3)	36.2
Supplies	—	46.9	27.2	—	74.1
General and administrative expenses	69.2	—	19.7	—	88.9
Depreciation and amortization	4.8	51.4	34.8	—	91.0
Total operating expenses	110.6	838.1	719.3	(62.8)	1,605.2
Loss on early extinguishment of debt	10.4	—	—	—	10.4
Interest expense and amortization of debt discounts and fees	69.7	10.7	11.7	(10.4)	81.7
Other income	(10.8)	(0.2)	(1.3)	10.4	(1.9)
Equity in net income of nonconsolidated affiliates	—	(3.7)	(0.4)	—	(4.1)
Equity in net income of consolidated affiliates	(171.4)	(17.5)	—	188.9	—
Management fees	(72.0)	54.2	17.8	—	—
Income from continuing operations before income tax (benefit) expense	74.1	237.5	109.5	(188.9)	232.2
Provision for income tax (benefit) expense	(55.8)	94.8	29.3	—	68.3
Income from continuing operations	129.9	142.7	80.2	(188.9)	163.9
Loss from discontinued operations, net of tax	(0.1)	—	—	—	(0.1)
Net income	129.8	142.7	80.2	(188.9)	163.8
Less: Net income attributable to noncontrolling interests	—	—	(34.0)	—	(34.0)
Net income attributable to Encompass Health	$129.8	$ 142.7	$ 46.2	$ (188.9)	$ 129.8
Comprehensive income	$130.1	$ 142.7	$ 80.2	$ (188.9)	$ 164.1
Comprehensive income attributable to Encompass Health	$130.1	$ 142.7	$ 46.2	$ (188.9)	$ 130.1

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

	As of June 30, 2018				
	Encompass Health Corporation	Guarantor Subsidiaries	Nonguarantor Subsidiaries	Eliminating Entries	Encompass Health Consolidated
	(In Millions)				
Assets					
Current assets:					
Cash and cash equivalents	$34.2	$ 3.9	$ 20.9	$—	$ 59.0
Restricted cash	—	—	65.8	—	65.8
Accounts receivable	—	268.2	188.4	—	456.6
Other current assets	76.4	17.1	60.7	(64.0)	90.2
Total current assets	110.6	289.2	335.8	(64.0)	671.6
Property and equipment, net	120.6	1,007.1	438.1	—	1,565.8
Goodwill	—	854.6	1,220.1	—	2,074.7
Intangible assets, net	21.9	102.3	319.2	—	443.4
Deferred income tax assets	106.8	8.4	—	(39.8)	75.4
Other long-term assets	51.2	103.4	103.9	—	258.5
Intercompany notes receivable	589.4	—	—	(589.4)	—
Intercompany receivable and investments in consolidated affiliates	2,844.9	577.1	—	(3,422.0)	—
Total assets	$3,845.4	$ 2,942.1	$ 2,417.1	$(4,115.2)	$ 5,089.4
Liabilities and Shareholders' Equity					
Current liabilities:					
Current portion of long-term debt	$34.5	$ 7.7	$ 11.3	$(17.5)	$ 36.0
Accounts payable	12.7	47.6	25.3	—	85.6
Accrued expenses and other current liabilities	190.2	66.4	242.2	(46.5)	452.3
Total current liabilities	237.4	121.7	278.8	(64.0)	573.9
Long-term debt, net of current portion	2,318.3	238.1	44.1	—	2,600.5
Intercompany notes payable	—	—	589.4	(589.4)	—
Other long-term liabilities	34.8	17.1	177.6	(39.7)	189.8
Intercompany payable	—	—	80.3	(80.3)	—
	2,590.5	376.9	1,170.2	(773.4)	3,364.2
Commitments and contingencies					
Redeemable noncontrolling interests	—	—	223.9	—	223.9
Shareholders' equity:					
Encompass Health shareholders' equity	1,254.9	2,565.2	776.6	(3,341.8)	1,254.9
Noncontrolling interests	—	—	246.4	—	246.4
Total shareholders' equity	1,254.9	2,565.2	1,023.0	(3,341.8)	1,501.3
Total liabilities and shareholders' equity	$3,845.4	$ 2,942.1	$ 2,417.1	$(4,115.2)	$ 5,089.4

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

	As of December 31, 2017				
	Encompass Health Corporation	Guarantor Subsidiaries	Nonguarantor Subsidiaries	Eliminating Entries	Encompass Health Consolidated
	(In Millions)				
Assets					
Current assets:					
Cash and cash equivalents	$34.3	$ 2.9	$ 17.2	$—	$ 54.4
Restricted cash	—	—	62.4	—	62.4
Accounts receivable	—	285.2	186.9	—	472.1
Other current assets	61.4	21.7	48.7	(18.5)	113.3
Total current assets	95.7	309.8	315.2	(18.5)	702.2
Property and equipment, net	101.8	991.5	423.8	—	1,517.1
Goodwill	—	854.6	1,118.0	—	1,972.6
Intangible assets, net	11.8	105.1	286.2	—	403.1
Deferred income tax assets	97.4	8.4	—	(42.2)	63.6
Other long-term assets	49.2	100.5	85.4	—	235.1
Intercompany notes receivable	486.2	—	—	(486.2)	—
Intercompany receivable and investments in consolidated affiliates	2,839.1	311.3	—	(3,150.4)	—
Total assets	$3,681.2	$ 2,681.2	$ 2,228.6	$(3,697.3)	$ 4,893.7
Liabilities and Shareholders' Equity					
Current liabilities:					
Current portion of long-term debt	$32.8	$ 7.4	$ 9.6	$(17.5)	$ 32.3
Accounts payable	10.4	43.5	24.5	—	78.4
Accrued expenses and other current liabilities	166.8	82.0	159.0	(1.0)	406.8
Total current liabilities	210.0	132.9	193.1	(18.5)	517.5
Long-term debt, net of current portion	2,258.5	242.2	44.7	—	2,545.4
Intercompany notes payable	—	—	486.2	(486.2)	—
Other long-term liabilities	31.0	17.8	178.6	(42.1)	185.3
Intercompany payable	—	—	144.8	(144.8)	—
	2,499.5	392.9	1,047.4	(691.6)	3,248.2
Commitments and contingencies					
Redeemable noncontrolling interests	—	—	220.9	—	220.9
Shareholders' equity:					
Encompass Health shareholders' equity	1,181.7	2,288.3	717.4	(3,005.7)	1,181.7
Noncontrolling interests	—	—	242.9	—	242.9
Total shareholders' equity	1,181.7	2,288.3	960.3	(3,005.7)	1,424.6
Total liabilities and shareholders' equity	$3,681.2	$ 2,681.2	$ 2,228.6	$(3,697.3)	$ 4,893.7

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

	Six Months Ended June 30, 2018				
	Encompass Health Corporation	Guarantor Subsidiaries	Nonguarantor Subsidiaries	Eliminating Entries	Encompass Health Consolidated
	(In Millions)				
Net cash (used in) provided by operating activities	$(13.8)	$ 219.5	$ 179.8	$ —	$ 385.5
Cash flows from investing activities:					
Purchases of property and equipment	(18.0)	(60.6)	(30.2)	—	(108.8)
Additions to capitalized software costs	(8.7)	—	(1.0)	—	(9.7)
Acquisitions of businesses, net of cash acquired	(129.7)	—	(6.1)	—	(135.8)
Proceeds from repayment of intercompany note receivable	30.0	—	—	(30.0)	—
Other, net	(5.2)	(0.1)	(1.4)	—	(6.7)
Net cash used in investing activities	(131.6)	(60.7)	(38.7)	(30.0)	(261.0)
Cash flows from financing activities:					
Principal payments on debt, including pre-payments	(7.6)	—	(1.5)	—	(9.1)
Principal payments on intercompany note payable	—	—	(30.0)	30.0	—
Borrowings on revolving credit facility	245.0	—	—	—	245.0
Payments on revolving credit facility	(190.0)	—	—	—	(190.0)
Dividends paid on common stock	(49.8)	—	(0.1)	—	(49.9)
Purchase of equity interests in consolidated affiliates	(65.1)	—	—	—	(65.1)
Distributions paid to noncontrolling interests of consolidated affiliates	—	—	(35.2)	—	(35.2)
Taxes paid on behalf of employees for shares withheld	(7.4)	—	(0.9)	—	(8.3)
Other, net	0.5	(3.7)	(0.7)	—	(3.9)
Change in intercompany advances	219.7	(154.1)	(65.6)	—	—
Net cash provided by (used in) financing activities	145.3	(157.8)	(134.0)	30.0	(116.5)
(Decrease) increase in cash, cash equivalents, and restricted cash	(0.1)	1.0	7.1	—	8.0
Cash, cash equivalents, and restricted cash at beginning of period	34.3	2.9	79.6	—	116.8
Cash, cash equivalents, and restricted cash at end of period	$34.2	$ 3.9	$ 86.7	$ —	$ 124.8

Reconciliation of Cash, Cash Equivalents, and Restricted Cash					
Cash and cash equivalents at beginning of period	$34.3	$ 2.9	$ 17.2	$ —	$ 54.4
Restricted cash at beginning of period	—	—	62.4	—	62.4
Cash, cash equivalents, and restricted cash at beginning of period	$34.3	$ 2.9	$ 79.6	$ —	$ 116.8
Cash and cash equivalents at end of period	$34.2	$ 3.9	$ 20.9	$ —	$ 59.0
Restricted cash at end of period	—	—	65.8	—	65.8
Cash, cash equivalents, and restricted cash at end of period	$34.2	$ 3.9	$ 86.7	$ —	$ 124.8
Supplemental schedule of noncash financing activity:					
Intercompany note activity	$(134.2)	$ —	$ 134.2	$ —	$ —

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

	Six Months Ended June 30, 2017				
	Encompass Health Corporation	Guarantor Subsidiaries	Nonguarantor Subsidiaries	Eliminating Entries	Encompass Health Consolidated
	(In Millions)				
Net cash provided by operating activities	$26.8	$ 169.9	$ 135.3	$ —	$ 332.0
Cash flows from investing activities:					
Purchases of property and equipment	(13.1)	(39.7)	(47.1)	—	(99.9)
Additions to capitalized software costs	(8.3)	(0.2)	(1.2)	—	(9.7)
Acquisitions of businesses, net of cash acquired	(10.9)	—	(10.0)	—	(20.9)
Proceeds from repayment of intercompany note receivable	17.0	—	—	(17.0)	—
Other, net	(1.7)	9.0	3.7	—	11.0
Net cash used in investing activities	(17.0)	(30.9)	(54.6)	(17.0)	(119.5)
Cash flows from financing activities:					
Principal payments on debt, including pre-payments	(11.9)	—	(1.5)	—	(13.4)
Principal payments on intercompany note payable	—	—	(17.0)	17.0	—
Borrowings on revolving credit facility	105.0	—	—	—	105.0
Payments on revolving credit facility	(187.0)	—	—	—	(187.0)
Repurchases of common stock, including fees and expenses	(18.1)	—	—	—	(18.1)
Dividends paid on common stock	(43.5)	—	—	—	(43.5)
Proceeds from exercising stock warrants	26.6	—	—	—	26.6
Distributions paid to noncontrolling interests of consolidated affiliates	—	—	(24.1)	—	(24.1)
Taxes paid on behalf of employees for shares withheld	(19.5)	—	(0.3)	—	(19.8)
Other, net	0.4	(3.3)	7.4	—	4.5
Change in intercompany advances	158.4	(133.4)	(25.0)	—	—
Net cash provided by (used in) financing activities	10.4	(136.7)	(60.5)	17.0	(169.8)
Increase in cash, cash equivalents, and restricted cash	20.2	2.3	20.2	—	42.7
Cash, cash equivalents, and restricted cash at beginning of period	20.6	1.6	79.2	—	101.4
Cash, cash equivalents, and restricted cash at end of period	$40.8	$ 3.9	$ 99.4	$ —	$ 144.1
Reconciliation of Cash, Cash Equivalents, and Restricted Cash					
Cash and cash equivalents at beginning of period	$20.6	$ 1.6	$ 18.3	$ —	$ 40.5
Restricted cash at beginning of period	—	—	60.9	—	60.9
Cash, cash equivalents, and restricted cash at beginning of period	$20.6	$ 1.6	$ 79.2	$ —	$ 101.4
Cash and cash equivalents at end of period	$40.8	$ 3.9	$ 26.4	$ —	$ 71.1
Restricted cash at end of period	—	—	73.0	—	73.0
Cash, cash equivalents, and restricted cash at end of period	$40.8	$ 3.9	$ 99.4	$ —	$ 144.1
Supplemental schedule of noncash financing activity:					
Conversion of convertible debt	$319.4	$ —	$ —	$ —	$ 319.4

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Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

The following Management's Discussion and Analysis of Financial Condition and Results of Operations ("MD&A") relates to Encompass Health Corporation and its subsidiaries and should be read in conjunction with our condensed consolidated financial statements included under Part I, Item 1, Financial Statements (Unaudited), of this report. In addition, the following MD&A should be read in conjunction with our audited consolidated financial statements for the year ended December 31, 2017, Part II, Item 7, Management's Discussion and Analysis of Financial Condition and Results of Operations, Part I, Item 1, Business and Item 1A, Risk Factors included in our Annual Report on Form 10-K for the year ended December 31, 2017 filed on February 27, 2018 (collectively, the "2017 Form 10-K").

This MD&A is designed to provide the reader with information that will assist in understanding our condensed consolidated financial statements, the changes in certain key items in those financial statements from period to period, and the primary factors that accounted for those changes, as well as how certain accounting principles affect our condensed consolidated financial statements. See "Cautionary Statements Regarding Forward-Looking Statements" on page i of this report for a description of important factors that could cause actual results to differ from expected results. See also Item 1A, Risk Factors, of this report and to the 2017 Form 10-K.

Executive Overview

Our Business

We are 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 our network of inpatient rehabilitation hospitals, home health agencies, and hospice agencies. As discussed in this Item, "Segment Results of Operations," we manage our operations using two operating segments which are also our reportable segments: (1) inpatient rehabilitation and (2) home health and hospice. For additional information about our business, see Item 1, Business, of the 2017 Form 10-K.

Effective January 1, 2018, we changed our name from HealthSouth Corporation to Encompass Health Corporation, and our NYSE ticker symbol changed from "HLS" to "EHC." Our operations in both business segments are transitioning to the Encompass Health branding on a rolling basis.

Inpatient Rehabilitation

We are the nation's largest owner and operator of inpatient rehabilitation hospitals in terms of patients treated and discharged, revenues, and number of hospitals. We provide specialized rehabilitative treatment on both an inpatient and outpatient basis. We operate hospitals in 31 states and Puerto Rico, with concentrations 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 to our hospitals, we manage five inpatient rehabilitation units through management contracts. Our inpatient rehabilitation segment represented approximately 78% and 79% of our Net operating revenues for the three and six months ended June 30, 2018, respectively.

Home Health and Hospice

Our home health and hospice business is the nation's fourth largest provider of Medicare-certified skilled home health services in terms of revenues. 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, and home health aide services. We also provide hospice services to terminally ill patients and their families that address patients' physical needs, including pain control and symptom management, and to provide emotional and spiritual support. 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 home health locations operate as joint ventures that we account for using the equity method of accounting. Our home health and hospice segment represented approximately 22% and 21% of our Net operating revenues for the three and six months ended June 30, 2018, respectively.

2018 Overview

Our 2018 strategy focuses on the following priorities:

- providing high-quality, cost-effective care to patients in our existing markets;
-

achieving organic growth at our existing inpatient rehabilitation hospitals, home health agencies, and hospice agencies;

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- expanding our services to more patients who require post-acute healthcare services by constructing and acquiring hospitals in new markets and acquiring and opening home health and hospice agencies in new markets;
- making shareholder distributions via common stock dividends and repurchases of our common stock; and
- positioning the Company for success in the evolving healthcare delivery system through key operational initiatives that include implementing the rebranding and name change, developing and implementing post-acute patient navigation tools (Post-Acute Innovation Center), enhancing clinical collaboration between our inpatient rehabilitation hospitals and home health locations, refining and expanding use of clinical data analytics to further improve patient outcomes, and increasing participation in alternative payment models.

During the three and six months ended June 30, 2018, Net operating revenues increased 10.5% and 9.9% over the same periods of 2017 due primarily to pricing and volume growth in our inpatient rehabilitation segment and volume growth in our home health and hospice segment.

Within our inpatient rehabilitation segment, discharge growth of 5.2% coupled with a 2.5% increase in net patient revenue per discharge in the second quarter of 2018 generated 7.3% growth in net patient revenue compared to the second quarter of 2017. Discharge growth included a 3.6% increase in same-store discharges. During the six months ended June 30, 2018, discharge growth of 5.9% coupled with a 2.1% increase in net patient revenue per discharge generated 7.7% growth in net patient revenue from our hospitals compared to the six months ended June 30, 2017. Our inpatient rehabilitation outcomes and certain quality measures, as reported through the Uniform Data System for Medical Rehabilitation (the "UDS_{MR}"), remained well above the average for hospitals included in the UDS_{MR} database.

Within our home health and hospice segment, home health admission growth of 10.4% coupled with the impact of a 0.2% decrease in revenue per episode in the second quarter of 2018 contributed to 23.5% growth in home health and hospice revenue compared to the second quarter of 2017. Home health admission growth included a 5.1% increase in same-store admissions. During the six months ended June 30, 2018, home health admission growth of 10.1% coupled with the impact of a 0.8% decrease in revenue per episode contributed to 19.2% growth in home health and hospice revenue compared to the six months ended June 30, 2017. Home health admission growth for the six-month period included a 6.2% increase in same-store admissions. The quality of patient care star rating for our home health agencies continued to be well above the national average, as reported by the United States Department of Health and Human Services, Centers for Medicare and Medicaid Services ("CMS"). In addition, 30-day readmission rates at our home health agencies continued to be well below the national average, as reported by Avalere Health and the Alliance for Home Health Quality and Innovation.

Our growth efforts thus far in 2018 related to our inpatient rehabilitation segment have included the following:

- entered into an agreement with Saint Alphonsus Regional Medical Center in February 2018 to own and operate a new 40-bed inpatient rehabilitation hospital in Boise, Idaho. The joint venture hospital is expected to begin operating in 2019 subject to customary closing conditions, including regulatory approvals;
- began accepting patients at our new, 34-bed inpatient rehabilitation hospital in Shelby County, Alabama in April 2018 and our new 38-bed inpatient rehabilitation hospital in Hilton Head, South Carolina in June 2018;
- continued planning the operation of our 29-bed joint venture hospital with Tidelands Health in Murrells Inlet, South Carolina. The hospital is expected to begin operating in the third quarter of 2018;
- continued the construction of our 68-bed joint venture hospital with Novant Health, Inc. in Winston-Salem, North Carolina. The hospital is expected to begin operating in the fourth quarter of 2018;
- continued the construction of our 40-bed joint venture hospital with University Medical Center Health System in Lubbock, Texas. The hospital is expected to begin operating in 2019; and

• continued development of the following de novo hospitals:

Location	# of Beds	Actual / Expected Construction Start Date	Expected Operational Date
Murrieta, California	50	Q2 2018	Q4 2019
Katy, Texas	40	Q3 2018	Q4 2019

We also continued our growth efforts in our home health and hospice segment. On May 1, 2018, we completed the previously announced acquisition of privately owned Camellia Healthcare and affiliated entities ("Camellia"). The Camellia portfolio consists of 18 hospice, 14 home health, and 2 private duty locations in Mississippi, Alabama, Louisiana and Tennessee. The Camellia 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. With the closing of this transaction, we are positioned as a top 25 provider of hospice services. We funded the cash purchase price of the acquisition with cash on hand and borrowings under our revolving credit facility. We expect to realize a tax benefit with an estimated present value of $20 million to $25 million related to this transaction.

In addition to completing the Camellia transaction, we acquired two hospice locations located in Oklahoma City, Oklahoma and Las Vegas, Nevada and began accepting patients at our four new home health locations in Owasso, Oklahoma; Atlanta, Georgia; Vernon, Alabama; and Boise, Idaho.

We also continued our shareholder distributions. 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. In February 2018, we purchased one-third of the equity interests held by members of the home health and hospice management team for approximately $65 million. For additional information on this transaction, see the "Liquidity and Capital Resources" section of this Item and Note 5, Redeemable Noncontrolling Interests, to the accompanying condensed consolidated financial statements.

Business Outlook

We believe our business outlook remains positive. Favorable demographic trends, such as population aging, should increase long-term demand for facility-based and home-based care. While we treat patients of all ages, most of our patients are 65 and older, and the number of Medicare enrollees is expected to grow approximately 3% per year for the foreseeable future. We believe the demand for facility-based and home-based care will continue to increase as the U.S. population ages. We believe these factors align with our strengths in, and focus on, post-acute services. In addition, we believe we can address the demand for facility-based and home-based post-acute care services in markets where we currently do not have a presence by constructing or acquiring new hospitals and by acquiring or opening home health and hospice agencies in that extremely fragmented industry.

We are an industry leader in the growing post-acute sector. As the nation's largest owner and operator of inpatient rehabilitation hospitals in terms of patients treated and discharged, revenues, and number of hospitals, we believe we differentiate ourselves from our competitors based on the quality of our clinical outcomes, our cost-effectiveness, our financial strength, and our extensive application of technology. As the fourth largest provider of Medicare-certified skilled home health services in terms of revenues, we believe we differentiate ourselves from our competitors by the application of a highly integrated technology platform, our ability to manage a variety of care pathways, and a proven track record of consummating and integrating acquisitions.

We have invested considerable resources into clinical and management systems and protocols that have allowed us to consistently produce high-quality outcomes for our patients while continuing to contain cost growth. Our proprietary hospital management reporting system aggregates data from each of our key business systems into a comprehensive reporting package used by the management teams in our hospitals, as well as executive management, and allows them to analyze data and trends and create custom reports on a timely basis. Our commitment to technology also includes our electronic clinical information system ("ACE-IT"). We believe this system will improve patient care and safety, enhance staff recruitment and retention, and set the stage for connectivity with other providers and health information exchanges. Our home health and hospice segment also uses information technology to enhance patient care and manage the business by utilizing Homecare Homebase^{SM}, an industry leading comprehensive information platform designed to manage the entire patient work flow and allow home health providers to process clinical, compliance, and marketing information as well as analyze data and trends for management purposes using custom reports on a timely basis. Homecare Homebase^{SM} also allows providers to share valuable data with

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payors to promote better patient outcomes on a more cost-effective basis. All of these systems allow us to enhance our clinical and business processes. Our information systems allow us to collect, analyze, and share information on a timely basis, making us an ideal partner for other healthcare providers in a coordinated care delivery environment.

Our short-term priorities include our operational initiatives. The implementation of our rebranding and name change reflects our expanding national footprint and our strategy to deliver high-quality, cost-effective integrated care across the post-acute continuum. Through the Post-Acute Innovation Center, we will combine our clinical expertise with Cerner's technology in an effort to assume a leading position in the development and utilization of market-specific clinical decision support tools. We will also continue to enhance the clinical collaboration efforts between our two segments, refine and expand our predictive data analytics to further improve patient outcomes, and increase our participation in alternative payment models.

Longer term, the nature and timing of the transformation of the current healthcare system to coordinated care delivery and payment models is uncertain and will likely remain so for some time, as the development and implementation of new care delivery and payment systems will require significant time and resources. Furthermore, many of the alternative approaches being explored may not work as intended. However, as outlined in the 2017 Form 10-K (see Item 1, Business, "Competitive Strengths"), our goal is to position the Company in a prudent manner to be responsive to industry shifts. We have invested in our core business and created an infrastructure that enables us to provide high-quality care on a cost-effective basis. We have been disciplined in creating a capital structure that is flexible with no significant debt maturities prior to 2022. We continue to have a strong, well-capitalized balance sheet, including a substantial portfolio of owned real estate. We have significant availability under our revolving credit facility, and we continue to generate strong cash flows from operations. We intend to deploy free cash flow to fund the growth opportunities in both of our business segments and augment these investments with shareholder distributions, including a regular quarterly cash dividend on our common stock.

For these and other reasons, we believe we will be able to adapt to changes in reimbursement, sustain our business model, and grow through acquisition and consolidation opportunities as they arise.

Key Challenges

Healthcare is a highly-regulated industry facing many well-publicized regulatory and reimbursement challenges. The industry also is facing uncertainty associated with the efforts, primarily arising from initiatives included in the Patient Protection and Affordable Care Act (as subsequently amended, the "2010 Healthcare Reform Laws"), to identify and implement workable coordinated care and integrated delivery payment models. Successful healthcare providers are those able to adapt to changes in the regulatory and operating environments, build strategic relationships across the healthcare continuum, and consistently provide high-quality, cost-effective care. We believe we have the necessary capabilities — change agility, strategic relationships, quality of patient outcomes, cost effectiveness, and ability to capitalize on growth opportunities — to adapt to and succeed in a dynamic, highly regulated industry, and we have a proven track record of doing so.

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

- Operating in a Highly Regulated Industry. We are required to comply with extensive and complex laws and regulations at the federal, state, and local government levels. These rules and regulations have affected, or could in the future affect, our business activities by having an impact on the reimbursement we receive for services provided or the costs of compliance, mandating new documentation standards, requiring additional licensure or certification, regulating our relationships with physicians and other referral sources, regulating the use of our properties, and limiting our ability to enter new markets or add new capacity to existing hospitals and agencies. Ensuring continuous compliance with extensive laws and regulations is an operating requirement for all healthcare providers.

We have invested, and will continue to invest, substantial time, effort, and expense in implementing and maintaining training programs as well as internal controls and procedures designed to ensure regulatory compliance, and we are committed to continued adherence to these guidelines. More specifically, because Medicare comprises a significant portion of our Net operating revenues, it is particularly important for us to remain compliant with the laws and regulations governing the Medicare program and related matters including anti-kickback and anti-fraud requirements. The federal government's reliance on sub-regulatory guidance, such as handbooks, FAQs, internal memoranda, and press releases, presents a unique challenge. Such sub-regulatory guidance purports to explain validly promulgated regulations but often expands or supplements existing regulations without constitutionally and statutorily required notice and comment and other procedural protections. Without procedural protections, sub-regulatory guidance poses a risk above and beyond reasonable efforts to follow validly promulgated regulations, particularly when the agency or MAC seeking to enforce such sub-regulatory guidance is not the agency or MAC issuing the guidance. If we were unable to remain compliant with

Medicare and other regulations, our financial position, results of operations, and cash flows could be materially, adversely impacted.

Concerns held by federal policymakers about the federal deficit and national debt levels, as well as other healthcare policy priorities, could result in enactment of legislation affecting portions of the Medicare program, including post-acute care services we provide. It is not clear whether Congress will pass legislation to modify or repeal the provisions of the 2010 Healthcare Reform Laws most relevant to us, nor is it clear what, if any, other Medicare-related changes may ultimately be enacted and signed into law or otherwise implemented or caused by the Trump Administration through regulatory procedures, but it is possible that any reductions in Medicare spending will have a material impact on reimbursements for healthcare providers generally and post-acute providers specifically. We cannot predict what, if any, changes in Medicare spending or modifications to the healthcare laws and regulations will result from future budget or other legislative or regulatory initiatives.

On February 9, 2018, President Trump signed into law the Bipartisan Budget Act of 2018 (the "2018 Budget Act"). The 2018 Budget Act requires CMS to update the home health prospective payment system (the "HH-PPS") with a market basket update of 1.5% and eliminates the productivity adjustment for 2020. The 2018 Budget Act also mandates several significant changes to the HH-PPS, including establishing in 2020 a 30-day unit of service for home health payment purposes to replace the current 60-day episode of payment methodology. We cannot predict the impact of these significant changes to the HH-PPS on our home health agencies and their Medicare reimbursements. For additional discussion on changes included in the 2018 Budget Act see Item 1A, Risk Factors, to the 2017 Form 10-K.

On July 31, 2018, CMS released its Notice of Final Rulemaking for Fiscal Year 2019 (the "2019 Final IRF Rule") for inpatient rehabilitation facilities under the inpatient rehabilitation facility prospective payment system (the "IRF-PPS"). The 2019 Final IRF Rule will implement a net 1.35% market basket increase effective for discharges between October 1, 2018 and September 30, 2019, calculated as follows:

Market basket update	2.9%
Healthcare reform reduction	75 basis points
Productivity adjustment	80 basis points

The 2019 Final IRF Rule also includes other changes that impact our hospital-by-hospital base rate for Medicare reimbursement. Such changes include, but are not limited to, revision to the wage index values, updates to the case-mix group relative weights and average length of stay values using fiscal year 2017 claims data and 2016 cost report data, and an increase to the outlier fixed loss threshold. CMS has estimated the 2019 Final IRF Rule will increase Medicare IRF payments in fiscal year 2019 by approximately 1.3%. Based on our analysis that utilizes, among other things, the acuity of our patients over the 12-month period prior to the 2019 Final IRF Rule's release, our experience with outlier payments over this same time frame, and other factors, we believe the 2019 Final IRF Rule will result in a net increase to our Medicare payment rates of approximately 1.2% effective October 1, 2018.

The 2019 Final IRF Rule will also modify certain IRF coverage requirements and remove two quality reporting measures. Beginning in FY 2020, CMS will no longer utilize the functional assessment items contained in the FIM™ instrument as part of the IRF Patient Assessment Instrument. This will affect patients' classification into case-mix groupings and length-of-stay values under the IRF-PPS. CMS will be further modifying the case-mix groupings, length-of-stay values and other definitions in the FY 2020 Notice of Proposed Rulemaking after incorporating a second year of data in its regression modeling. At present, we are unable to determine the impact the changes to the case-mix classification system starting in FY 2020 would have on Medicare payments beginning October 1, 2019.

On July 2, 2018, CMS released its Notice of Proposed Rulemaking for Calendar Year 2019 (the "2019 Proposed HH Rule") for home health agencies under the HH-PPS. CMS estimates the 2019 Proposed HH Rule would increase Medicare payments to home health agencies by 2.1%. Specifically, while the proposed rule provides for a market basket update of 2.8%, that update is reduced by 0.7% for a productivity adjustment and 0.1% for the extension of the rural payment add-on factor as mandated by the 2018 Budget Act and increased by 0.1% for a change in the outlier fixed-dollar loss ratio. The 2019 Proposed HH Rule included other changes that would impact our agency-by-agency episode payment for Medicare reimbursement in 2019. Such changes include, but are not limited to, revisions to the case-mix weights, wage index values, and national per-visit payment amounts.

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The 2019 Proposed HH Rule would provide further updates to the home health value-based purchasing and home health quality reporting programs. While we continue to review the details of the 2019 Proposed HH Rule, we believe it will result in an increase to our Medicare home health payment rates of approximately 1.6% effective for episodes ending in calendar year 2019.

The 2019 Proposed HH Rule also proposes significant changes to the HH-PPS that would be effective on or after January 1, 2020. These changes would include the implementation of a new home health payment system, called the Patient-Driven Groupings Model ("PDGM"), as mandated by the 2018 Budget Act discussed above. The PDGM would use 30-day payment periods and rely more heavily on clinical characteristics and other patient information (such as principal diagnosis, functional level, referral source, and timing), rather than the current therapy service-use thresholds, to set payments. It is too early to assess the potential effect of PDGM on our business in 2020. The details of the rule are likely to change before the rule goes into effect. We cannot at this time assess potential changes to our patient mix between now and 2020. Current projections do not account for actions we may take to adapt to the rule.

To present PDGM as budget neutral, CMS has proposed significant Medicare rate reductions to offset expected provider behavioral changes in response to PDGM. Based on 2017 data, and assuming no change in the foregoing and other factors, which are subject to potentially significant change, we estimate an approximate 5.4% reduction in Medicare payments assuming the PDGM is implemented on a budget neutral basis. We are unable to assess the likelihood or effect of these potential behavioral changes.

Reimbursement claims made by healthcare providers, including inpatient rehabilitation hospitals as well as home health and hospice agencies, are subject to audit from time to time by governmental payors and their agents, such as the Medicare Administrative Contractors ("MACs"), fiscal intermediaries and carriers, as well as the Office of Inspector General, CMS, and state Medicaid programs. These audits as well as the ordinary course claim reviews of our billings result in payment denials. Healthcare providers can challenge any denials through an administrative appeals process that can be extremely lengthy, taking up to eight years or longer. For additional details of these claim reviews, See Item 1A, Risk Factors, to the 2017 Form 10-K.

For additional discussion of our regulatory environment, see Item 1, Business, "Sources of Revenues" and "Regulation," Item 1A, Risk Factors, and Item 7, Management's Discussion and Analysis of Financial Condition and Results of Operations, "Executive Overview—Key Challenges," to the 2017 Form 10-K and Note 10, Contingencies and Other Commitments, "Governmental Inquiries and Investigations," to the condensed consolidated financial statements included in Part I, Item 1, Financial Statements (Unaudited), of this report.

- Changes to Our Operating Environment Resulting from Healthcare Reform. Many provisions within the 2010 Healthcare Reform Laws have impacted, or could in the future impact, our business. Most notable for us are Medicare reimbursement reductions, such as reductions to annual market basket updates to providers and reimbursement rate rebasing adjustments, and promotion of alternative payment models, such as accountable care organizations ("ACOs") and bundled payment initiatives such as the Bundled Payment for Care Improvement Initiative ("BPCI"), the Comprehensive Care for Joint Replacement ("CJR") program, and the BPCI-Advanced program. Our challenges related to healthcare reform are discussed in Item 1, Business, "Sources of Revenues," and Item 1A, Risk Factors to the 2017 Form 10-K.

While the change in administration has added to regulatory uncertainty, the healthcare industry in general has been facing uncertainty associated with the efforts to identify and implement workable coordinated care and integrated delivery payment models. In these models, hospitals, physicians, and other care providers work together to provide coordinated healthcare on a more efficient, patient-centered basis. These providers are then paid based on the efficiency and overall value and quality of the services they provide to a patient. While this is consistent with our goal and proven track record of being a high-quality, cost-effective provider, broad-based implementation of a new care delivery and payment model would represent a significant transformation for the healthcare industry. As the industry and its regulators explore this transformation, we are attempting to position the Company in preparation for whatever changes are ultimately made to the delivery system as discussed in Item 1, Business, "Competitive Strengths" to the 2017 Form 10-K.

Given the complexity and the number of changes in the 2010 Healthcare Reform Laws and other pending regulatory initiatives, we cannot predict their ultimate impact. As noted above, it is not clear whether Congress will pass legislation to modify or repeal the 2010 Healthcare Laws, nor can we predict whether other legislation affecting Medicare and post-acute care providers will be enacted, or what actions the Trump Administration may take or cause through the regulatory process that may result in modifications to the 2010 Healthcare Laws or the Medicare program. Therefore, the ultimate nature and timing of the transformation of the healthcare delivery system is uncertain, and will likely remain so for some time. We will continue to evaluate these laws and regulations and position the Company for this industry shift. Based on our track record, we believe we can adapt to these regulatory and industry changes. Further, we have engaged, and will continue to engage, actively in discussions with key legislators and regulators to attempt to ensure any healthcare laws or regulations adopted or amended promote our goal of high-quality, cost-effective care.

Additionally, in October 2014, President Obama signed into law the IMPACT Act. The IMPACT Act was developed on a bi-partisan basis by the House Ways and Means and Senate Finance Committees and incorporated feedback from healthcare providers and provider organizations that responded to the Committees' solicitation of post-acute payment reform ideas and proposals. It directs the United States Department of Health and Human Services ("HHS"), in consultation with healthcare stakeholders, to implement standardized data collection processes for post-acute quality and outcome measures. Although the IMPACT Act does not specifically call for the development of a new post-acute payment system, we believe this act will lay the foundation for possible future post-acute payment policies that would be based on patients' medical conditions and other clinical factors rather than the setting where the care is provided, also referred to as "site neutral" reimbursement. For additional details on the IMPACT Act, see Item 1A, Risk Factors to the 2017 Form 10-K.

- Maintaining Strong Volume Growth. Various factors, including competition and increasing regulatory and administrative burdens, may impact our ability to maintain and grow our hospital, home health, and hospice volumes. In any particular market, we may encounter competition from local or national entities with longer operating histories or other competitive advantages, such as acute care hospitals who provide post-acute services similar to ours or other post-acute providers with relationships with referring acute care hospitals or physicians. Aggressive payment review practices by Medicare contractors, aggressive enforcement of regulatory policies by government agencies, and restrictive or burdensome rules, regulations or statutes governing admissions practices may lead us to not accept patients who would be appropriate for and would benefit from the services we provide. In addition, from time to time, we must get regulatory approval to expand our services and locations in states with certificate of need laws. This approval may be withheld or take longer than expected. In the case of new-store volume growth, the addition of hospitals, home health agencies, and hospice agencies to our portfolio also may be difficult and take longer than expected.
- Recruiting and Retaining High-Quality Personnel. See Item 1A, Risk Factors, to the 2017 Form 10-K for a discussion of competition for staffing, shortages of qualified personnel, and other factors that may increase our labor costs. Recruiting and retaining qualified personnel for our inpatient hospitals and home health and hospice agencies remain a high priority for us. We attempt to maintain a comprehensive compensation and benefits package that allows us to remain competitive in this challenging staffing environment while remaining consistent with our goal of being a high-quality, cost-effective provider of post-acute services.

See also Item 1, Business, Item 1A, Risk Factors, and Item 7, Management's Discussion and Analysis of Financial Condition and Results of Operations, "Executive Overview—Key Challenges," to the 2017 Form 10 K.

These key challenges notwithstanding, we believe we have a strong business model, a strong balance sheet, and a proven track record of achieving strong financial and operational results. We are attempting to position the Company to respond to changes in the healthcare delivery system and believe we will be in a position to take advantage of any opportunities that arise as the industry moves to this new stage. We believe we are positioned to continue to grow, adapt to external events, and create value for our shareholders in 2018 and beyond.

Results of Operations

Payor Mix

We derived consolidated Net operating revenues from the following payor sources:

	Three Months Ended June 30,				Six Months Ended June 30,			
	2018		2017		2018		2017	
Medicare	75.5	%	75.6	%	76.1	%	75.7	%
Medicare Advantage	9.4	%	8.9	%	9.1	%	8.8	%
Managed care	8.9	%	9.5	%	8.9	%	9.6	%
Medicaid	2.8	%	2.5	%	2.6	%	2.5	%
Other third-party payors	1.2	%	1.3	%	1.2	%	1.2	%
Workers' compensation	0.7	%	0.7	%	0.7	%	0.7	%
Patients	0.4	%	0.4	%	0.4	%	0.5	%
Other income	1.1	%	1.1	%	1.0	%	1.0	%
Total	100.0	%	100.0	%	100.0	%	100.0	%

For additional information regarding our payors, see the "Sources of Revenues" section of Item 1, Business, of the 2017 Form 10-K.

Our Results

For the three and six months ended June 30, 2018 and 2017, our consolidated results of operations were as follows:

	Three Months Ended June 30,		Percentage Change	Six Months Ended June 30,		Percentage Change
	2018	2017	2018 vs. 2017	2018	2017	2018 vs. 2017
	(In Millions, Except Percentage Change)					
Net operating revenues	$1,067.7	$966.4	10.5 %	$2,113.7	$1,923.5	9.9 %
Operating expenses:						
Salaries and benefits	578.2	527.8	9.5 %	1,148.4	1,057.9	8.6 %
Other operating expenses	149.4	129.3	15.5 %	290.6	257.1	13.0 %
Occupancy costs	19.5	18.3	6.6 %	38.1	36.2	5.2 %
Supplies	39.3	37.1	5.9 %	79.2	74.1	6.9 %
General and administrative expenses	54.9	52.4	4.8 %	116.0	88.9	30.5 %
Depreciation and amortization	49.7	45.8	8.5 %	95.6	91.0	5.1 %
Total operating expenses	891.0	810.7	9.9 %	1,767.9	1,605.2	10.1 %
Loss on early extinguishment of debt	—	10.4	(100.0)%	—	10.4	(100.0)%
Interest expense and amortization of debt discounts and fees	37.7	40.4	(6.7)%	73.3	81.7	(10.3)%
Other income	(1.3)	(0.9)	44.4 %	(1.2)	(1.9)	(36.8)%
Equity in net income of nonconsolidated affiliates	(2.0)	(2.0)	— %	(4.3)	(4.1)	4.9 %
Income from continuing operations before income tax expense	142.3	107.8	32.0 %	278.0	232.2	19.7 %
Provision for income tax expense	29.3	28.6	2.4 %	59.3	68.3	(13.2)%
Income from continuing operations	113.0	79.2	42.7 %	218.7	163.9	33.4 %
Income (loss) from discontinued operations, net of tax	0.2	0.2	— %	(0.3)	(0.1)	200.0 %
Net income	113.2	79.4	42.6 %	218.4	163.8	33.3 %
Less: Net income attributable to noncontrolling interests	(21.4)	(16.4)	30.5 %	(42.8)	(34.0)	25.9 %
Net income attributable to Encompass Health	$91.8	$63.0	45.7 %	$175.6	$129.8	35.3 %

Operating Expenses as a % of Net Operating Revenues

	Three Months Ended June 30,		Six Months Ended June 30,	
	2018	2017	2018	2017
Operating expenses:				
Salaries and benefits	54.2%	54.6%	54.3%	55.0%
Other operating expenses	14.0%	13.4%	13.7%	13.4%
Occupancy costs	1.8 %	1.9 %	1.8 %	1.9 %
Supplies	3.7 %	3.8 %	3.7 %	3.9 %
General and administrative expenses	5.1 %	5.4 %	5.5 %	4.6 %
Depreciation and amortization	4.7 %	4.7 %	4.5 %	4.7 %
Total operating expenses	83.5%	83.9%	83.6%	83.5%

In the discussion that follows, we use “same-store” comparisons to explain the changes in certain performance metrics and line items within our financial statements. We calculate same-store comparisons based on hospitals and locations open

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throughout both the full current periods and prior periods presented. These comparisons include the financial results of market consolidation transactions in existing markets, as it is difficult to determine, with precision, the incremental impact of these transactions on our results of operations.

Net Operating Revenues

Our consolidated Net operating revenues increased in the three and six months ended June 30, 2018 over the same periods of 2017 due primarily to volume and pricing growth in our inpatient rehabilitation segment and volume growth in our home health and hospice segment. The three and six months ended June 30, 2018 benefited from retroactive price adjustments and a year-over-year reduction in bad debt, which is now a component of revenues as a result of the new revenue recognition accounting guidance discussed in Note 1, Basis of Presentation, “Recent Accounting Pronouncements,” of the condensed consolidated financial statements included in Part I, Item 1, Financial Statements (Unaudited), of this report.

Salaries and Benefits

Salaries and benefits increased in the three and six months ended June 30, 2018 compared to the same periods of 2017 primarily due to increased patient volumes, including an increase in the number of full-time equivalents as a result of our development activities, salary increases for our employees, and an increase in benefit costs.

Salaries and benefits as a percent of Net operating revenues decreased during the three and six months ended June 30, 2018 compared to the same periods of 2017 primarily from labor management and higher volumes which contributed to lower employees per occupied bed, as defined in “Segment Results” of this Item, and benefited from the aforementioned retroactive price adjustments and reduction in bad debt.

Other Operating Expenses

Other operating expenses increased during the three and six months ended June 30, 2018 compared to the same periods of 2017 primarily due to increased patient volumes. As a percent of Net operating revenues, Other operating expenses increased during the three and six months ended June 30, 2018 compared to the same period of 2017 primarily due to increases in contract services and increases in provider taxes.

Supplies

Supplies increased during the three and six months ended June 30, 2018 compared to the same periods of 2017 due primarily to increased patient volumes.

General and Administrative Expenses

General and administrative expenses increased during the three months ended June 30, 2018 compared to the same periods of 2017 due primarily to increased salary and benefit costs and costs associated with our rebranding and name change. General and administrative expenses as a percent of Net operating revenues decreased during the three months ended June 30, 2018 compared to the same period of 2017 due primarily to operating leverage resulting from revenue growth. General and administrative expenses increased during the six months ended June 30, 2018 compared to the same periods of 2017 in terms of dollars and as a percent of Net operating revenues due primarily to increased salary and benefit costs, including expenses associated with stock appreciation rights, and costs associated with our rebranding and name change.

The 2018 rebranding investment is estimated to be approximately $16 million to $19 million, of which $2.8 million and $6.4 million was spent during the three and six months ended June 30, 2018, respectively, compared to $1.7 million and $2.2 million spent during the three and six months ended June 30, 2017, respectively. For additional information on stock appreciation rights, see Note 13, Share-Based Payments, to the consolidated financial statements accompanying the 2017 Form 10-K, and on the rebranding and name change, see the “Executive Overview” section of this Item.

Depreciation and Amortization

Depreciation and amortization increased during the three and six months ended June 30, 2018 compared to the same periods of 2017 due to our capital expenditures and development activities.

Loss on Early Extinguishment of Debt

The Loss on early extinguishment of debt during the three and six months ended June 30, 2017 resulted from exercising the early redemption option on all $320 million of Convertible Notes resulting in the issuance of 8.9 million shares

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of common stock. See Note 9, Long-term Debt, to the consolidated financial statements accompanying the 2017 Form 10-K for additional information regarding these transactions.

Interest Expense and Amortization of Debt Discounts and Fees

The decrease in Interest expense and amortization of debt discounts and fees during the three and six months ended June 30, 2018 compared to the same periods of 2017 primarily resulted from the redemption of the 2.0% Convertible Senior Subordinated Notes due 2043 in June 2017. See Note 9, Long-term Debt, to the consolidated financial statements accompanying the 2017 Form 10-K.

Income from Continuing Operations Before Income Tax Expense

Our pre-tax income from continuing operations increased during the three and six months ended June 30, 2018 compared to the same periods of 2017 primarily due to increased Net operating revenues as discussed above.

Provision for Income Tax Expense

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. Our Provision for income tax expense declined during the six months ended June 30, 2018 compared to the same period of 2017 due to the impact of the Tax Cuts and Jobs Act (the “Tax Act”).

We currently estimate our cash payments for taxes to be approximately $105 million to $135 million, net of refunds, for 2018. These payments are expected to primarily result from federal and state income tax expenses based on estimates of taxable income for 2018. As discussed in Note 8, Income Taxes, to the condensed consolidated financial statements included in Part I, Item 1, Financial Statements (Unaudited), of this report, the Tax Act included revisions to Internal Revenue Code §451 that may eliminate the deferral of revenue associated with pre-payment claims denials and require us to pay tax on such denied claims. We are currently evaluating this provision of the Tax Act and its impact on the tax deferral associated with pre-payment claims denials we received in 2017. Our estimate of 2018 cash taxes considers some or all of the deferred revenue will be reversed.

In certain jurisdictions, we do not expect to generate sufficient income to use all of the available state NOLs and other credits prior to their expiration. This determination is based on our evaluation of all available evidence in these jurisdictions including results of operations during the preceding three years, our forecast of future earnings, and prudent tax planning strategies. It is possible we may be required to increase or decrease our valuation allowance at some future time if our forecast of future earnings varies from actual results on a consolidated basis or in the applicable tax jurisdiction, if the timing of future tax deductions differs from our expectations, or pursuant to changes in state tax laws and rates.

We recognize the financial statement effects of uncertain tax positions when it is more likely than not, based on the technical merits, a position will be sustained upon examination by and resolution with the taxing authorities. Total remaining unrecognized tax benefits were $1.1 million and $0.3 million as of June 30, 2018 and December 31, 2017, respectively.

See Note 8, Income Taxes, to the condensed consolidated financial statements included in Part I, Item 1, Financial Statements (Unaudited), of this report and Note 15, Income Taxes, to the consolidated financial statements accompanying the 2017 Form 10-K.

Net Income Attributable to Noncontrolling Interests

The increase in Net Income Attributable to Noncontrolling Interests during the three and six months ended June 30, 2018 compared to the same periods of 2017 primarily resulted from our new joint ventures and increased profitability of our existing joint ventures.

Segment Results of Operations

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. For additional information regarding our business segments, including a detailed description of the services we provide, financial data for each segment, and a reconciliation of total segment Adjusted EBITDA to income from continuing operations before income tax expense, see Note 11, Segment Reporting, to the condensed consolidated financial statements included in Part I, Item 1, Financial Statements (Unaudited), of this report.

Inpatient Rehabilitation

Our inpatient rehabilitation segment derived its Net operating revenues from the following payor sources:

	Three Months Ended June 30,				Six Months Ended June 30,			
	2018		2017		2018		2017	
Medicare	72.8	%	73.2	%	73.6	%	73.5	%
Medicare Advantage	9.4	%	8.6	%	9.0	%	8.5	%
Managed care	10.4	%	11.0	%	10.2	%	10.9	%
Medicaid	3.2	%	3.0	%	3.1	%	2.9	%
Other third-party payors	1.5	%	1.6	%	1.5	%	1.5	%
Workers' compensation	0.8	%	0.8	%	0.8	%	0.9	%
Patients	0.5	%	0.5	%	0.5	%	0.5	%
Other income	1.4	%	1.3	%	1.3	%	1.3	%
Total	100.0	%	100.0	%	100.0	%	100.0	%

Additional information regarding our inpatient rehabilitation segment's operating results for the three and six months ended June 30, 2018 and 2017 is as follows:

	Three Months Ended June 30,		Percentage Change	Six Months Ended June 30,		Percentage Change
	2018	2017	2018 vs. 2017	2018	2017	2018 vs. 2017
	(In Millions, Except Percentage Change)					
Net operating revenues:						
Inpatient	$809.6	$751.5	7.7 %	$1,626.7	$1,504.2	8.1 %
Outpatient and other	25.0	26.1	(4.2)%	48.2	51.2	(5.9)%
Inpatient rehabilitation segment revenues	834.6	777.6	7.3 %	1,674.9	1,555.4	7.7 %
Operating expenses:						
Salaries and benefits	416.5	394.3	5.6 %	840.7	792.5	6.1 %
Other operating expenses	126.9	112.9	12.4 %	249.8	224.7	11.2 %
Supplies	34.7	33.8	2.7 %	70.6	67.5	4.6 %
Occupancy costs	16.0	15.5	3.2 %	31.5	30.6	2.9 %
Other income	(1.2)	(0.9)	33.3 %	(1.7)	(1.9)	(10.5)%
Equity in net income of nonconsolidated affiliates	(1.6)	(1.8)	(11.1)%	(3.6)	(3.7)	(2.7)%
Noncontrolling interests	19.8	15.4	28.6 %	40.3	31.9	26.3 %
Segment Adjusted EBITDA	$223.5	$208.4	7.2 %	$447.3	$413.8	8.1 %
	(Actual Amounts)					
Discharges	45,010	42,805	5.2 %	90,118	85,064	5.9 %
Net patient revenue per discharge	$17,987	$17,556	2.5 %	$18,051	$17,683	2.1 %
Outpatient visits	131,041	153,415	(14.6)%	258,349	305,869	(15.5)%
Average length of stay (days)	12.5	12.7	(1.6)%	12.6	12.8	(1.6)%
Occupancy %	70.1 %	69.3 %	1.2 %	71.0 %	69.7 %	1.9 %
# of licensed beds	8,848	8,641	2.4 %	8,848	8,641	2.4 %
Full-time equivalents*	21,010	20,474	2.6 %	20,994	20,364	3.1 %
Employees per occupied bed	3.43	3.46	(0.9)%	3.38	3.42	(1.2)%

* Full-time equivalents included in the above table represent our employees who participate in or support the operations of our hospitals and exclude an estimate of full-time equivalents related to contract labor.

We actively manage the productive portion of our Salaries and benefits utilizing certain metrics, including employees per occupied bed, or "EPOB." This metric is determined by dividing the number of full-time equivalents, including an estimate of full-time equivalents from the utilization of contract labor, by the number of occupied beds during each period. The number of occupied beds is determined by multiplying the number of licensed beds by our occupancy percentage.

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Operating Expenses as a % of Net Operating Revenues

	Three Months Ended June 30,		Six Months Ended June 30,	
	2018	2017	2018	2017
Operating expenses:				
Salaries and benefits	49.9%	50.7%	50.2%	51.0%
Other operating expenses	15.2%	14.5%	14.9%	14.4%
Supplies	4.2 %	4.3 %	4.2 %	4.3 %
Occupancy costs	1.9 %	2.0 %	1.9 %	2.0 %
Total operating expenses	71.2%	71.6%	71.2%	71.7%

Net Operating Revenues

Net operating revenues were 7.3% higher during the three months ended June 30, 2018 compared to the same period of 2017. This increase included a 5.2% increase in patient discharges and a 2.5% increase in net patient revenue per discharge. Discharge growth included a 3.6% increase in same-store discharges. Discharge growth from new stores resulted from joint ventures in Westerville, Ohio (April 2017) and Jackson, Tennessee (July 2017), as well as wholly owned hospitals in Pearland, Texas (October 2017) and Shelby County, Alabama (April 2018). Growth in net patient revenue per discharge primarily resulted from an increase in reimbursement rates, retroactive price adjustments, and a year-over-year reduction in bad debt, which is now a component of revenue as a result of the new revenue recognition accounting guidance discussed in Note 1, Basis of Presentation, “Recent Accounting Pronouncements,” to the condensed consolidated financial statements included in Part I, Item 1, Financial Statements (Unaudited), of this report.

Net operating revenues were 7.7% higher during the six months ended June 30, 2018 compared to the same period of 2017. This increase included a 5.9% increase in patient discharges and a 2.1% increase in net patient revenue per discharge. Discharge growth included a 4.1% increase in same-store discharges. Discharge growth and net patient revenue per discharge for the year-to-date period of 2018 were impacted by the same factors as discussed above for the second quarter of 2018.

See Note 2, Business Combinations, to the consolidated financial statements accompanying the 2017 Form 10-K for information regarding the joint ventures discussed above.

Adjusted EBITDA

The increase in Adjusted EBITDA during the three and six months ended June 30, 2018 compared to the same periods of 2017 primarily resulted from revenue growth, as discussed above. Expense ratios benefited from retroactive price adjustments and a year-over-year reduction in bad debt, which is now a component of revenue as discussed above. Salaries and benefits as a percent of Net operating revenues benefited from labor management and higher volumes, as well as a year-over-year decrease in expenses related to workers compensation. Other operating expenses as a percent of Net operating revenues increased primarily due to increases in contract services and increases in provider taxes.

Home Health and Hospice

Our home health and hospice segment derived its Net operating revenues from the following payor sources:

	Three Months Ended June 30,				Six Months Ended June 30,			
	2018		2017		2018		2017	
Medicare	85.5	%	85.5	%	85.8	%	85.3	%
Medicare Advantage	9.3	%	10.1	%	9.5	%	10.1	%
Managed care	3.7	%	3.5	%	3.7	%	3.7	%
Medicaid	1.2	%	0.7	%	0.7	%	0.7	%
Workers' compensation	0.1	%	—	%	0.1	%	—	%
Patients	0.1	%	0.1	%	0.1	%	0.1	%
Other income	0.1	%	0.1	%	0.1	%	0.1	%
Total	100.0	%	100.0	%	100.0	%	100.0	%

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Additional information regarding our home health and hospice segment's operating results for the three and six months ended June 30, 2018 and 2017 is as follows:

	Three Months Ended June 30, 2018	Three Months Ended June 30, 2017	Percentage Change 2018 vs. 2017	Six Months Ended June 30, 2018	Six Months Ended June 30, 2017	Percentage Change 2018 vs. 2017
	(In Millions, Except Percentage Change)					
Net operating revenues:						
Home health	$204.8	$ 171.9	19.1 %	$390.1	$ 335.8	16.2 %
Hospice	28.3	16.9	67.5 %	48.7	32.3	50.8 %
Home health and hospice segment revenues	233.1	188.8	23.5 %	438.8	368.1	19.2 %
Operating expenses:						
Cost of services sold (excluding depreciation and amortization)	109.1	87.5	24.7 %	207.7	175.2	18.6 %
Support and overhead costs	80.8	67.7	19.4 %	152.8	134.5	13.6 %
Other income	(0.5)	—	N/A	(0.5)	—	N/A
Equity in net income of nonconsolidated affiliates	(0.4)	(0.2)	100.0 %	(0.7)	(0.4)	75.0 %
Noncontrolling interests	2.5	1.0	150.0 %	4.4	2.1	109.5 %
Segment Adjusted EBITDA	$41.6	$ 32.8	26.8 %	$75.1	$ 56.7	32.5 %
	(Actual Amounts)					
Home health:						
Admissions	34,026	30,823	10.4 %	67,881	61,633	10.1 %
Recertifications	28,089	22,568	24.5 %	53,318	43,114	23.7 %
Episodes	61,238	52,101	17.5 %	117,896	101,361	16.3 %
Revenue per episode	$2,968	$ 2,975	(0.2)%	$2,952	$ 2,976	(0.8)%
Episodic visits per episode	17.5	18.1	(3.3)%	17.7	18.4	(3.8)%
Total visits	1,240,490	1,095,225	13.3 %	2,415,440	2,165,581	11.5 %
Cost per visit	$76	$ 73	4.1 %	$76	$ 74	2.7 %
Hospice:						
Admissions	1,797	1,114	61.3 %	3,390	2,242	51.2 %
Patient days	192,404	113,028	70.2 %	335,635	221,746	51.4 %
Revenue per day	$148	$ 149	(0.7)%	$145	$ 145	— %

Operating Expenses as a % of Net Operating Revenues

	Three Months Ended June 30, 2018	Three Months Ended June 30, 2017	Six Months Ended June 30, 2018	Six Months Ended June 30, 2017
Operating expenses:				
Cost of services sold (excluding depreciation and amortization)	46.8%	46.3%	47.3%	47.6%
Support and overhead costs	34.7%	35.9%	34.8%	36.5%
Total operating expenses	81.5%	82.2%	82.2%	84.1%

Net Operating Revenues

Home health and hospice revenue was 23.5% higher during the three months ended June 30, 2018 compared to the same period of 2017. This increase included a 10.4% increase in home health admissions and was impacted by a 0.2% decrease

in average revenue per episode. Home health admission growth included a 5.1% increase in same-store admissions. Home health revenue growth resulted from strong same-store and new-store volume growth, which included the acquisition of Camellia. Revenue per episode was impacted by Medicare reimbursement rate cuts that were partially offset by the favorable resolution of a prior period Zone Program Integrity Contractor audit. The increase in hospice revenue primarily resulted from same-store admission growth and acquisitions.

Home health and hospice revenue was 19.2% higher during the six months ended June 30, 2018 compared to the same period of 2017. This increase included a 10.1% increase in home health admissions and was impacted by a 0.8% decrease in average revenue per episode. Home health admission growth included a 6.2% increase in same-store admissions. The decrease in revenue per episode resulted from the same factors discussed above for the second quarter of 2018.

Note 2, Business Combinations, to the condensed consolidated financial statements included in Part I, Item 1, Financial Statements (Unaudited), of this report for information regarding the Camellia acquisition discussed above.

Adjusted EBITDA

The increase in Adjusted EBITDA during the three and six months ended June 30, 2018 compared to the same periods of 2017 primarily resulted from revenue growth, which included the acquisition of Camellia. Expense ratios were negatively impacted by Medicare reimbursement rate cuts. Cost of services as a percent of Net operating revenues for the three months ended June 30, 2018 increased primarily due to merit increases, changes in patient mix, and integration expenses associated with the Camellia acquisition. Cost of services as a percent of Net operating revenues for the six months ended June 30, 2018 decreased primarily due to improvements in caregiver productivity and efficiency. Support and overhead costs as a percent of Net operating revenues for the three and six months ended June 30, 2018 decreased primarily due to operating leverage resulting from revenue growth.

Liquidity and Capital Resources

Our primary sources of liquidity are cash on hand, cash flows from operations, and borrowings under our revolving credit facility.

The objectives of our capital structure strategy are to ensure we maintain adequate liquidity and flexibility. Pursuing and achieving those objectives allow us to support the execution of our operating and strategic plans and weather temporary disruptions in the capital markets and general business environment. Maintaining adequate liquidity is a function of our unrestricted Cash and cash equivalents and our available borrowing capacity. Maintaining flexibility in our capital structure is a function of, among other things, the amount of debt maturities in any given year, the options for debt prepayments without onerous penalties, and limiting restrictive terms and maintenance covenants in our debt agreements.

We have been disciplined in creating a capital structure that is flexible with no significant debt maturities prior to 2022. We continue to have a strong, well-capitalized balance sheet, including a substantial portfolio of owned real estate, and we have significant availability under our revolving credit facility. We continue to generate strong cash flows from operations, and we have significant flexibility with how we choose to invest our cash and return capital to shareholders.

For additional information regarding our indebtedness, see Note 9, Long-term Debt, to the consolidated financial statements accompanying the 2017 Form 10-K.

Current Liquidity

As of June 30, 2018, we had $59.0 million in Cash and cash equivalents. This amount excludes $65.8 million in Restricted cash and $61.0 million of restricted marketable securities ($9.1 million included in Other current assets and $51.9 million included in Other long-term assets). Our restricted assets pertain primarily to obligations associated with our captive insurance company, as well as obligations we have under agreements with joint venture partners. See Note 4, Cash and Marketable Securities, to the consolidated financial statements accompanying the 2017 Form 10-K.

In addition to Cash and cash equivalents, as of June 30, 2018, we had approximately $512 million available to us under our revolving credit facility. Our credit agreement governs the substantial majority of our senior secured borrowing capacity and contains a leverage ratio and an interest coverage ratio as financial covenants. Our leverage ratio is defined in our credit agreement as the ratio of consolidated total debt (less up to $100 million of cash on hand) to Adjusted EBITDA for the trailing four quarters. In calculating the leverage ratio under our credit agreement, we are permitted to use pro forma Adjusted EBITDA, the calculation of which includes historical income statement items and pro forma adjustments resulting from (1) the dispositions and repayments or incurrence of debt and (2) the investments, acquisitions, mergers, amalgamations, consolidations and operational changes from acquisitions to the extent such items or effects are not yet reflected in our trailing four-quarter financial statements. Our interest coverage ratio is defined in our credit agreement as the ratio of Adjusted EBITDA to consolidated interest expense, excluding the amortization of financing fees, for the trailing four quarters. As of June 30, 2018, the maximum leverage ratio requirement per our credit agreement was 4.50x and the minimum interest coverage ratio requirement was 3.0x, and we were in compliance with these covenants. Based on Adjusted EBITDA for the trailing four quarters and the interest rate in effect under our credit agreement during the three-month period ended June 30, 2018, if we had drawn on the first day and maintained the maximum amount of outstanding draws under our revolving credit facility for that entire period, we would still be in compliance with the maximum leverage ratio and minimum interest coverage ratio requirements.

We do not face near-term refinancing risk, as the amounts outstanding under our credit agreement do not mature until 2022, and our bonds all mature in 2023 and beyond. See the "Contractual Obligations" section below for information related to our contractual obligations as of June 30, 2018.

We acquired a significant portion of our home health and hospice business when we purchased EHHI Holdings, Inc ("EHHI") on December 31, 2014. 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 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. The fair value is determined using the product of the trailing twelve-month adjusted EBITDA measure for Holdings 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. 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 fair value of those outstanding shares of Holdings owned by management investors is approximately $195 million. See Note 5, Redeemable Noncontrolling Interests, to the condensed consolidated financial statements included in Part I, Item 1, Financial Statements (Unaudited), of this report.

In conjunction with the EHHI acquisition, we granted stock appreciation rights ("SARs") based on Holdings common stock to certain members of EHHI management at closing. Half of the SARs will vest on December 31, 2018 with the remainder vesting on December 31, 2019. Upon exercise, each SAR must be settled for cash in the amount by which the per share fair value of Holdings' common stock on the exercise date exceeds the per share fair value on the grant date. As of June 30, 2018, the fair value of the SARs is approximately $65 million, of which approximately $36 million is included in Accrued expenses and other current liabilities and approximately $29 million is included in Other long-term liabilities in the condensed consolidated balance sheet included in Part I, Item 1, Financial Statements (Unaudited), of this report. See also Note 13, Share-Based Payments, to the consolidated financial statements accompanying the 2017 Form 10 K.

We anticipate we will continue to generate strong cash flows from operations that, together with availability under our revolving credit facility, will allow us to invest in growth opportunities and continue to improve our existing business. We also will continue to consider additional shareholder value-enhancing strategies such as repurchases of our common stock and distribution of common stock dividends, including the potential growth of the quarterly cash dividend on our common stock, recognizing that these actions may increase our leverage ratio. See also the

"Authorizations for Returning Capital to Stakeholders" section of this Item.
For a discussion of risks and uncertainties facing us see Item 1A, Risk Factors under Part II, Other Information, of this report and Item 1A, Risk Factors, of the 2017 Form 10-K.

Sources and Uses of Cash

The following table shows the cash flows provided by or used in operating, investing, and financing activities for the six months ended June 30, 2018 and 2017 (in millions):

	Six Months Ended June 30,	
	2018	2017
Net cash provided by operating activities	$385.5	$332.0
Net cash used in investing activities	(261.0)	(119.5)
Net cash used in financing activities	(116.5)	(169.8)
Increase in cash and cash equivalents	$8.0	$42.7

Operating activities. The increase in Net cash provided by operating activities for the six months ended June 30, 2018 compared to the same period of 2017 primarily resulted from revenue growth, as described above, and improved collection of accounts receivable as a result of fewer claims denials.

Investing activities. The increase in Net cash used in investing activities during the six months ended June 30, 2018 compared to the same period of 2017 primarily resulted from the acquisition of Camellia Healthcare described in Note 2, Business Combinations, to the condensed consolidated financial statements included in Part I, Item 1, Financial Statements (Unaudited), of this report.

Financing activities. The decrease in Net cash used in financing activities during the six months ended June 30, 2018 compared to the same period of 2017 primarily resulted from the increase in borrowings on our revolving credit facility offset by our purchase of one-third of the equity interests held by the home health and hospice management team.

Contractual Obligations

Our consolidated contractual obligations as of June 30, 2018 are as follows (in millions):

	Total	July 1 through December 31, 2018	2019 - 2020	2021 - 2022	2023 and thereafter
Long-term debt obligations:					
Long-term debt, excluding revolving credit facility and capital lease obligations [a]	$2,219.0	$ 10.6	$40.2	$263.7	$1,904.5
Revolving credit facility	150.0	—	—	150.0	—
Interest on long-term debt [b]	801.0	64.0	254.4	247.7	234.9
Capital lease obligations [c]	468.8	18.8	64.9	57.4	327.7
Operating lease obligations [d][e]	391.3	33.9	117.3	72.9	167.2
Purchase obligations [e][f]	93.8	20.9	43.8	17.0	12.1
Other long-term liabilities [g][h]	3.3	0.1	0.4	0.4	2.4
Total	$4,127.2	$ 148.3	$521.0	$809.1	$2,648.8

(a) Included in long-term debt are amounts owed on our bonds payable and other notes payable. These borrowings are further explained in Note 9, Long-term Debt, to the consolidated financial statements accompanying the 2017 Form 10-K.

(b) Interest on our fixed rate debt is presented using the stated interest rate. Interest expense on our variable rate debt is estimated using the rate in effect as of June 30, 2018. Interest pertaining to our credit agreement and bonds is included to their respective ultimate maturity dates. Interest related to capital lease obligations is excluded from this line. Future minimum payments, which are accounted for as interest, related to sale/leaseback transactions involving real estate accounted for as financings are included in this line (see Note 6, Property and Equipment, and Note 9, Long-term Debt, to the consolidated financial statements accompanying the 2017 Form 10-K). Amounts exclude amortization of

debt discounts, amortization of loan fees, or fees for lines of credit that would be included in interest expense in our consolidated statements of operations.

(c) Amounts include interest portion of future minimum capital lease payments.

(d) Our inpatient rehabilitation segment leases approximately 16% of its hospitals as well as other property and equipment under operating leases in the normal course of business. Our home health and hospice segment leases relatively small office spaces in the localities it serves, space for its corporate office, and other equipment under operating leases in the normal course of business. Some of our hospital leases contain escalation clauses based on changes in the Consumer Price Index while others have fixed escalation terms. The minimum lease payments do not include contingent rental expense. Some lease agreements provide us with the option to renew the lease or purchase the leased property. Our future operating lease obligations would change if we exercised these renewal options and if we entered into additional operating lease agreements. For more information, see Note 6, Property and Equipment, to the consolidated financial statements accompanying the 2017 Form 10-K.

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

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

(g) Because their future cash outflows are uncertain, the following noncurrent liabilities are excluded from the table above: general liability, professional liability, and workers' compensation risks, noncurrent amounts related to third-party billing audits, stock appreciation rights, and deferred income taxes. Also, as of June 30, 2018, we had $1.1 million of total gross unrecognized tax benefits. For more information, see Note 10, Self-Insured Risks, Note 13, Share-Based Payments, Note 15, Income Taxes, and Note 17, Contingencies and Other Commitments, to the consolidated financial statements accompanying the 2017 Form 10-K and Note 8, Income Taxes, to the condensed consolidated financial statements included in Part I, Item 1, Financial Statements (Unaudited), of this report.

(h) The table above does not include Redeemable noncontrolling interests of $223.9 million because of the uncertainty surrounding the timing and amounts of any related cash outflows.

Our capital expenditures include costs associated with our hospital refresh program, de novo projects, capacity expansions, technology initiatives, and building and equipment upgrades and purchases. During the six months ended June 30, 2018, we made capital expenditures of approximately $123 million for property and equipment and capitalized software. During 2018, we expect to spend approximately $280 million to $350 million for capital expenditures. Approximately $130 million to $150 million of this budgeted amount is considered nondiscretionary expenditures, which we may refer to in other filings as “maintenance” expenditures. In addition, we expect to spend approximately $160 million to $185 million on home health and hospice acquisitions during 2018 inclusive of the Camellia acquisition discussed in the “Executive Overview” section of this Item. Actual amounts spent will be dependent upon the timing of construction projects and acquisition opportunities for our home health and hospice business.

Authorizations for Returning Capital to Stakeholders

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. We expect quarterly dividends to be paid in January, April, July, and October. However, the actual declaration of any future cash dividends, and the setting of record and payment dates as well as the per share amounts, will be at the discretion of our board of directors after consideration of various factors, including our capital position and alternative uses of funds. Cash dividends are expected to be funded using cash flows from operations, cash on hand, and availability under our revolving credit facility.

On February 14, 2014, our board of directors approved an increase in our existing common stock repurchase authorization from $200 million to $250 million. As of June 30, 2018, approximately $58 million remained under this authorization. On July 24, 2018, our board of directors approved resetting the aggregate common stock repurchase authorization to $250 million. The repurchase authorization does not require the repurchase of a specific number of shares, has an indefinite term, and is subject to termination at any time by our board of directors. Subject to certain terms and conditions, including a maximum price per share and compliance with federal and state securities and other laws, the repurchases may be made from time to time in open market transactions, privately negotiated transactions, or other transactions, including trades under a plan established in accordance with Rule 10b5-1 under the Securities Exchange Act of 1934, as amended. Future repurchases under this authorization generally are expected to be funded using a combination of cash on hand and availability under our $700 million revolving credit facility.

Adjusted EBITDA

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

We use Adjusted EBITDA on a consolidated basis as a liquidity measure. We believe this financial measure on a consolidated basis is important in analyzing our liquidity because it is the key component of certain material covenants contained within our credit agreement, which is discussed in more detail in Note 9, Long-term Debt, to the consolidated financial statements accompanying the 2017 Form 10-K. These covenants are material terms of the credit agreement. Noncompliance with these financial covenants under our credit agreement—our interest coverage ratio and our leverage ratio—could result in our lenders requiring us to immediately repay all amounts borrowed. If we anticipated a potential covenant violation, we would seek relief from our lenders, which would have some cost to us, and such relief might be on terms less favorable to us than those in our existing credit agreement. In addition, if we cannot satisfy these financial covenants, we would be prohibited under our credit agreement from engaging in certain activities, such as incurring additional indebtedness, paying common stock dividends, making certain payments, and acquiring and disposing of assets. Consequently, Adjusted EBITDA is critical to our assessment of our liquidity.

In general terms, the credit agreement definition of Adjusted EBITDA, therein referred to as “Adjusted Consolidated EBITDA,” allows us to add back to consolidated Net income interest expense, income taxes, and depreciation and amortization and then add back to consolidated Net income (1) all unusual or nonrecurring items reducing consolidated Net income (of which only up to $10 million in a year may be cash expenditures), (2) any losses from discontinued operations and closed locations, (3) costs and expenses, including legal fees and expert witness fees, incurred with respect to litigation associated with stockholder derivative litigation, (4) share-based compensation expense, and (5) cost and expenses in connection with the Encompass Health rebranding. We also subtract from consolidated Net income all unusual or nonrecurring items to the extent they increase consolidated Net income.

Under the credit agreement, the Adjusted EBITDA calculation does not include net income attributable to noncontrolling interests and includes (1) gain or loss on disposal of assets and hedging and equity instruments, (2) professional fees unrelated to the stockholder derivative litigation, (3) unusual or nonrecurring cash expenditures in excess of $10 million, and (4) pro forma adjustments resulting from debt transactions and development activities.

Items falling within the credit agreement’s “unusual or nonrecurring” classification may occur in future periods, but these items and amounts recognized can vary significantly from period to period and may not directly relate to our ongoing operating performance. Accordingly, these items may not be indicative of our ongoing performance, so the Adjusted EBITDA calculation presented here includes adjustments for them.

Adjusted EBITDA is not a measure of financial performance under generally accepted accounting principles in the United States of America, and the items excluded from Adjusted EBITDA are significant components in understanding and assessing financial performance. Therefore, Adjusted EBITDA should not be considered a substitute for Net income or cash flows from operating, investing, or financing activities. Because Adjusted EBITDA is not a measurement determined in accordance with GAAP and is thus susceptible to varying calculations, Adjusted EBITDA, as presented, may not be comparable to other similarly titled measures of other companies. Revenues and expenses are measured in accordance with the policies and procedures described in Note 1, Summary of Significant Accounting Policies, to the consolidated financial statements accompanying the 2017 Form 10-K.

Our Adjusted EBITDA for the three and six months ended June 30, 2018 and 2017 was as follows (in millions):

Reconciliation of Net Income to Adjusted EBITDA

	Three Months Ended June 30,		Six Months Ended June 30,	
	2018	2017	2018	2017
Net income	$113.2	$79.4	$218.4	$163.8
(Income) loss from discontinued operations, net of tax, attributable to Encompass Health	(0.2)	(0.2)	0.3	0.1
Net income attributable to noncontrolling interests	(21.4)	(16.4)	(42.8)	(34.0)
Provision for income tax expense	29.3	28.6	59.3	68.3
Interest expense and amortization of debt discounts and fees	37.7	40.4	73.3	81.7
Net noncash loss on disposal of assets	2.4	0.8	3.2	0.3
Depreciation and amortization	49.7	45.8	95.6	91.0
Loss on early extinguishment of debt	—	10.4	—	10.4
Stock-based compensation expense	21.4	20.7	47.5	28.7
Transaction costs	—	—	1.0	—
SARs mark-to-market impact on noncontrolling interests	(0.9)	—	(1.9)	—
Change in fair market value of equity securities	0.4	—	1.0	—
Adjusted EBITDA	$231.6	$209.5	$454.9	$410.3

Reconciliation of Net Cash Provided by Operating Activities to Adjusted EBITDA

	Six Months Ended June 30,	
	2018	2017
Net cash provided by operating activities	$385.5	$332.0
Interest expense and amortization of debt discounts and fees	73.3	81.7
Equity in net income of nonconsolidated affiliates	4.3	4.1
Net income attributable to noncontrolling interests in continuing operations	(42.8)	(34.0)
Amortization of debt-related items	(2.0)	(6.7)
Distributions from nonconsolidated affiliates	(3.5)	(4.4)
Current portion of income tax expense	62.9	24.1
Change in assets and liabilities	(22.3)	12.3
Cash used in operating activities of discontinued operations	0.6	0.6
Transaction costs	1.0	—
SARs mark-to-market impact on noncontrolling interests	(1.9)	—
Change in fair market value of equity securities	1.0	—
Other	(1.2)	0.6
Adjusted EBITDA	$454.9	$410.3

Growth in Adjusted EBITDA in 2018 compared to 2017 resulted primarily from revenue growth. For additional information see the “Results of Operations” and “Segment Results of Operations” sections of this Item.

Critical Accounting Estimates

Our significant accounting policies are discussed in Note 1, Summary of Significant Accounting Policies, to the consolidated financial statements accompanying the 2017 Form 10-K. Of those significant accounting policies, those that we consider to be the most critical to aid in fully understanding and evaluating our reported financial results, as they require management’s most difficult, subjective, or complex judgments, resulting from the need to make estimates about the effect of matters that are inherently uncertain, are disclosed in Item 7, Management's Discussion and Analysis of Financial Condition and Results of Operations, "Critical Accounting Estimates," to the 2017 Form 10-K.

Since the filing of the 2017 Form 10-K, there have been no material changes to our critical accounting estimates except as described below to "Net Operating Revenues."

Revenue Recognition

We recognize net operating revenue in the reporting period in which we perform the service based on 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 (principally for patients covered by Medicare, Medicare Advantage, Medicaid, and other third-party payors), potential adjustments that may arise from payment and other reviews, and uncollectible amounts. See Note 1, Basis of Presentation, "Net Operating Revenues," to the accompanying condensed consolidated financial statements included in Part I, Item 1, Financial Statements (Unaudited), of this report for a complete discussion of our revenue recognition policies.

Our patient accounting systems calculate contractual allowances on a patient-by-patient basis based on the rates in effect for each primary third-party payor. Certain other factors that are considered and could influence the estimated transaction price are assumed to remain consistent with the experience for patients discharged in similar time periods for the same payor classes, and additional adjustments are provided to account for these 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. In addition, laws and regulations governing the Medicare and Medicaid programs are complex and subject to interpretation. If actual results are not consistent with our assumptions and judgments, we may be exposed to gains or losses that could be material.

Due to complexities involved in determining amounts ultimately due under reimbursement arrangements with third-party payors, which are often subject to interpretation and review, we may receive reimbursement for healthcare services authorized and provided that is different from our estimates, and such differences could be material. However, we continually review the amounts actually collected in subsequent periods in order to determine the amounts by which our estimates differed. Historically, such differences have not been material from either a quantitative or qualitative perspective.

The collection of outstanding receivables from third-party payors and patients is our primary source of cash and is critical to our operating performance. Our primary collection risks relate to patient responsibility amounts and claims reviews conducted by MACs or other contractors.

Changes in general economic conditions (such as increased unemployment rates or periods of recession), business office operations, payor mix, or trends in federal or state governmental and private employer healthcare coverage could affect our collection of accounts receivable. Our collection risks include patient accounts for which the primary insurance carrier has paid the amounts covered by the applicable agreement, but patient responsibility amounts (deductibles and co-payments) remain outstanding and pre-payment claim reviews by our respective MACs. In addition, reimbursement claims made by health care providers are subject to audit from time to time by governmental payors and their agents. If actual results are not consistent with our assumptions and judgments, we may be exposed to gains or losses that could be material. See Note 1, Basis or Presentation, "Net Operating Revenues" and "Accounts Receivable," to the accompanying condensed consolidated financial statements included in Part I, Item 1, Financial Statements (Unaudited), of this report.

Recent Accounting Pronouncements

For information regarding recent accounting pronouncements, see Note 1, Basis of Presentation, to our condensed consolidated financial statements included under Part I, Item 1, Financial Statements (Unaudited), of this report.

Item 3. Quantitative and Qualitative Disclosures about Market Risk

Our primary exposure to market risk is to changes in interest rates on our variable rate long-term debt. We use sensitivity analysis models to evaluate the impact of interest rate changes on our variable rate debt. As of June 30, 2018, our primary variable rate debt outstanding related to $150.0 million in advances under our revolving credit facility and $287.4 million outstanding under our term loan facilities. Assuming outstanding balances were to remain the same, a 1% increase in interest rates would result in an incremental negative cash flow of approximately $3.9

million over the next 12 months, while a 1% decrease in interest rates would result in an incremental positive cash flow of approximately $3.9 million over the next 12 months.

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See Note 6, Fair Value Measurements, to the condensed consolidated financial statements included in Part I, Item 1, Financial Statements (Unaudited), of this report, and Note 9, Long-term Debt, to the consolidated financial statements accompanying the 2017 Form 10-K for additional information regarding our long-term debt.

Item 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

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

Changes in Internal Control Over Financial Reporting

There have been no changes in our Internal Control over Financial Reporting during the quarter ended June 30, 2018 that have a material effect on our Internal Control over Financial Reporting.

PART II. OTHER INFORMATION

Item 1. Legal Proceedings
Information relating to certain legal proceedings in which we are involved is included in Note 10, Contingencies and Other Commitments, to the condensed consolidated financial statements contained in Part I, Item 1, Financial Statements (Unaudited), of this report and is incorporated herein by reference and should be read in conjunction with the related disclosure previously reported in our Annual Report on Form 10 K for the year ended December 31, 2017 (the “2017 Form 10-K”).
Item 1A. Risk Factors
There have been no material changes from the risk factors disclosed in Part I, Item 1A, Risk Factors, of the 2017 Form 10-K. Certain information in those risk factors has been updated by the discussion in the “Executive Overview—Key Challenges” section of Part I, Item 2, Management’s Discussion and Analysis of Financial Condition and Results of Operations, of this report, which section is incorporated by reference herein.
Item 2. Unregistered Sales of Equity Securities and Use of Proceeds
Purchases of Equity Securities
The following table summarizes our repurchases of equity securities during the three months ended June 30, 2018:

Period	Total Number of Shares (or Units) Purchased[1]	Average Price Paid per Share (or Unit) ($)	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	Maximum Number (or Approximate Dollar Value) of Shares That May Yet Be Purchased Under the Plans or Programs[2]
April 1 through April 30, 2018	696	$ 58.00	—	$ 58,000,873
May 1 through May 31, 2018	—	—	—	58,000,873
June 1 through June 30, 2018	—	—	—	58,000,873
Total	696	58.00	—	

(1) In April, 696 shares were purchased pursuant to our Directors’ Deferred Stock Investment Plan. This plan is a nonqualified deferral plan allowing non-employee directors to make advance elections to defer a fixed percentage of their director fees. The plan administrator acquires the shares in the open market which are then held in a rabbi trust. The plan provides that dividends paid on the shares held for the accounts of the directors will be reinvested in shares of our common stock which will also be held in the trust. The directors’ rights to all shares in the trust are nonforfeitable, but the shares are only released to the directors after departure from our board.

(2) On October 28, 2013, we announced our board of directors authorized the repurchase of up to $200 million of our common stock. On February 14, 2014, our board approved an increase in this common stock repurchase authorization from $200 million to $250 million. On July 24, 2018, our board approved resetting the aggregate common stock repurchase authorization to $250 million. The repurchase authorization does not require the repurchase of a specific number of shares, has an indefinite term, and is subject to termination at any time by our board of directors. Subject to certain terms and conditions, including a maximum price per share and compliance with federal and state securities and other laws, the repurchases may be made from time to time in open market transactions, privately negotiated transactions, or other transactions, including trades under a plan established in accordance with Rule 10b5-1 under the Securities Exchange Act of 1934, as amended.

Dividends

We paid quarterly cash dividends of $0.23 per share on our common stock on January 15, April 15, and July 15 of 2016. On July 21, 2016, our board of directors approved an increase in our quarterly dividend and declared a cash dividend of $0.24 per share that was paid on October 17, 2016, and we paid the same per share quarterly dividend through July 17, 2017. On July 20, 2017, our board approved an increase in our quarterly dividend and declared a cash dividend of $0.25 per share that was paid on October 16, 2017, and we paid the same per share quarterly dividend on January 16, 2018, April 16, 2018, and July 16, 2018. On July 24, 2018, our board 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. We expect quarterly dividends to continue to be paid in January, April, July, and October. However, the actual declaration of any future cash dividends, and the setting of record and payment dates as well as the per share amounts, will be at the discretion of our board each quarter after consideration of various factors, including our capital position and alternative uses of funds.

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 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. We believe we currently have adequate capacity under these covenants to pursue the dividend strategy described in this report for the foreseeable future based on the capacity as of the date of this report and anticipated restricted payments. See Note 9, Long-term Debt, to the consolidated financial statements accompanying the 2017 Form 10-K.

Item 6. Exhibits

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

SIGNATURE

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

ENCOMPASS HEALTH CORPORATION

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

Date: August 2, 2018

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EXHIBIT INDEX

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

No.	Description
3.1.1	Amended and Restated Certificate of Incorporation of Encompass Health Corporation, effective as of January 1, 2018 (incorporated by reference to Exhibit 3.1 to Encompass Health's Current Report on Form 8-K filed on October 25, 2017).
3.1.2	Certificate of Designations of 6.50% Series A Convertible Perpetual Preferred Stock, as filed with the Secretary of State of the State of Delaware on March 7, 2006 (incorporated by reference to Exhibit 3.1 to HealthSouth's Current Report on Form 8-K filed on March 9, 2006).
3.2	Amended and Restated Bylaws of Encompass Health Corporation, effective as of January 1, 2018 (incorporated by reference to Exhibit 3.2 to Encompass Health's Current Report on Form 8-K filed on October 25, 2017).
31.1	Certification of Chief Executive Officer required by Rule 13a-14(a) or Rule 15d-14(a) of the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certification of Chief Financial Officer required by Rule 13a-14(a) or Rule 15d-14(a) of the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1	Certification of Chief Executive Officer pursuant to 18 U.S.C. 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
32.2	Certification of Chief Financial Officer pursuant to 18 U.S.C. 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
101	Sections of the Encompass Health Corporation Quarterly Report on Form 10-Q for the quarter ended June 30, 2018, formatted in XBRL (eXtensible Business Reporting Language), submitted in the following files:

101.INS	XBRL Instance Document
101.SCH	XBRL Taxonomy Extension Schema Document
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document
101.DEF	XBRL Taxonomy Extension Definition Linkbase Document
101.LAB	XBRL Taxonomy Extension Label Linkbase Document

101.PRE XBRL Taxonomy Extension Presentation Linkbase Document