Healthsouth Corporation:
The First Case Against A Company
Under The Sarbanes-Oxley Act

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ABSTRACT

HealthSouth Corporation, one of the nation’s largest healthcare providers, was the first company charged under the provisions of the Sarbanes-Oxley Act. HealthSouth’s CEO, Richard Scrushy, and 16 of its executives were indicted for allegedly using a sophisticated scheme to overstate the company’s earnings by as much as $2.7 billion between 1986 and 2002. Fifteen of the sixteen indicted executives pleaded guilty and another was convicted by jurors. After five months of court hearing, Scrushy was acquitted of all criminal charges. However, he remains a defendant in 40 cases filed by former HealthSouth investors and creditors. This case is based on court materials and other publicly available information and has been used in several undergraduate and MBA courses. The case and the accompanying teaching notes have proven to be an effective tool in teaching students the Sarbanes-Oxley Act and in helping students become more ethically conscious.

Keywords: HealthSouth

PART ONE

HealthSouth Corporation, a Fortune 500 company, was founded in 1984 by its Chairman and CEO Richard Scrushy. Under Scrushy’s leadership, the company had enjoyed exponential growth throughout the 1990s. Analysts and shareholders alike praised Scrushy for turning the company from a regional player into one of the nation’s largest healthcare providers. By the end of 2002, HealthSouth employed 51,000 people at 1,700 outpatient surgery, rehabilitation, and diagnostic imaging centers, rehabilitation hospitals, and acute-care medical centers located in the United States, the United Kingdom, Australia, Puerto Rico, Canada, and Saudi Arabia.

As the Vice President of Accounts Payable at HealthSouth Corporation, Barbara Patton was responsible for creating and maintaining an internal control system to ensure that the accounts payable function was running smoothly, correctly, and in accordance with generally accepted accounting principles (GAAP). Barbara knew that the firm’s independent auditors, Ernst & Young, placed a great deal of importance on tests of controls during their annual audits of HealthSouth Corporation. Barbara worked to continuously refine and improve the controls, taking into account the atmosphere of explosive growth in revenues and in accounts payable transactions at HealthSouth Corporation. She was proud of her system of controls, and was proud to work for HealthSouth Corporation.

On March 19, 2003, Barbara Patton went to work as normal; but, this day was anything but normal for HealthSouth. She would learn that the Securities and Exchange Commission (SEC) was charging HealthSouth Corporation with falsifying at least $1.4 billion in profits since 1999 in order to meet Wall Street earnings expectations. The SEC further indicated that the scheme to overstate earnings (by as much as $2.7 billion) may have dated back to 1986, shortly after the company became public. In addition to investigations by the SEC, the Energy and Commerce Committee of the U. S. House of Representatives had also started an investigation into the actions of
both HealthSouth and Ernst & Young. The congressional investigation was on allegations that HealthSouth knowingly submitted a significant number of improperly billed rehabilitation therapy claims to the Medicare and Medicaid programs for higher reimbursements from these federal- and state-funded programs.

HealthSouth was the first company charged under the provisions of the Sarbanes-Oxley Act. The Act was designed to increase the accountability of corporate executives. Under the Act, corporate executives are required to sign SEC filings to indicate that they have reviewed the financial statements for accuracy and compliance with GAAP. Executives are then personally responsible if the financial statements are found to be fraudulent. The charge against Richard Scrushy was the first levied against the chief executive of a major company since the passage of the Sarbanes-Oxley Act. HealthSouth' Board of Directors asked Scrushy to resign on March 31, 2003. The Board also dismissed Ernst & Young on the same date, for failing to detect the fraud.

PART TWO

After investing much time and effort into creating effective controls, Barbara Patton was stunned to learn that some of the earnings fraud had been perpetrated in the accounts payable function right under her nose. She quickly pieced together how it happened and became a crucial witness for the government, testifying before a federal judge in April 2003 to explain how the earnings fraud happened.

According to the testimony, each quarter HealthSouth’s senior accounting personnel would present Scrushy with the company’s actual earnings for the quarter. If the actual results fell short of Wall Street’s expectations, Scrushy would tell his senior accounting personnel to “fix it.” The senior accounting personnel, who referred themselves as “family members,” then would convene “family meetings” to discuss ways to “fix” the earnings shortfall. Rather than increasing earnings directly, they inflated earnings by decreasing a contra revenue account, called “contractual adjustment,” and by decreasing expenses. They felt that this approach would be more likely to escape detection by HealthSouth’s independent auditor. Contractual adjustment is a contra revenue (i.e., revenue allowance) account that estimates the difference between the gross amounts billed to the patients and the amounts that healthcare insurer will pay for the treatment. Because the amounts booked to this account are estimated, there is a limited paper trail and it’s more difficult to verify than other revenue entries.

Under GAAP, revenue increases and expense decreases must be accompanied by corresponding increases/decreases in assets or liabilities. However, under Barbara Patton’s control system, each invoice received by HealthSouth is entered into a computing system, which first conducts a “computer audit” and then creates a report as it generates checks for payment. In order to circumvent the control system, the fraud perpetrators decided to use manual entries in a computerized accounting system. They waited until monthly operating reports were completed by the computer, effectively sidestepping the system’s checks and balances. After the reports were completed, they typed in false transactions elsewhere in the computer system, which were later merged into consolidated corporate statements. They also created false increases in assets to cover up the inflated earnings. Earnings before taxes and minority interest for 2001 were overstated by as much as 4,700%. According to the SEC, the amounts of earnings overstatement by HealthSouth over the period from 1999 to 2002 were as follows:

<table>
<thead>
<tr>
<th>Income (Loss) before Income Taxes and Minority Interests (in million $)</th>
<th>1999 Form 10-K</th>
<th>2000 Form 10-K</th>
<th>2001 Form 10-K</th>
<th>For 6 months ended June 30, 2002</th>
</tr>
</thead>
<tbody>
<tr>
<td>Actual</td>
<td>$(191)</td>
<td>$194</td>
<td>$9</td>
<td>$157</td>
</tr>
<tr>
<td>Reported</td>
<td>230</td>
<td>559</td>
<td>434</td>
<td>340</td>
</tr>
<tr>
<td>Overstated Amount</td>
<td>421</td>
<td>365</td>
<td>425</td>
<td>183</td>
</tr>
<tr>
<td>Overstated Percentage</td>
<td>220%</td>
<td>188%</td>
<td>4,722%</td>
<td>119%</td>
</tr>
</tbody>
</table>
Because the perpetrators in the fraud were aware of GAAP, they were able to make the false entries appear to be routine entries that complied with GAAP when Ernst & Young’s auditors reviewed the accounts payable and other accounting functions. The auditors did not detect anything out of the ordinary in the accounts payable function, either in Barbara's controls, or in the transactions themselves. Ernst & Young’s officials insisted that fraudulent actions by such a significant portion of management made it much more difficult for Ernst & Young to detect than it would have been in a company with a less pervasive environment of fraud surrounding the top management team.

PART THREE

The fallout from HealthSouth's fraud has been substantial. In July 2003, the Justice Department's investigators announced that they were widening the scope of their investigation to include witness intimidation and money laundering. By November 2003, sixteen HealthSouth executives, including five former Chief Financial Officers, had been charged for participating in a wide range of schemes to inflate HealthSouth’s earnings to meet Wall Street Expectations. Fifteen of them have pleaded guilty and another was convicted by jurors.

On November 4, 2003, Richard Scrushy was indicted on 85 criminal counts, including conspiracy to commit fraud. He was arrested on November 5, 2003. His trial started in January 2005 in Birmingham, Alabama. After five months of hearings and five weeks of jury deliberation, he was acquitted by the jurors of all criminal charges for directing the fraud to falsely inflate earnings. A year later, however, he was convicted of six counts of felony bribery, conspiracy, and mail fraud linked to his days as the chief executive of HealthSouth Corporation. In addition a federal judge has set trial for April 2, 2007 in Birmingham in a lawsuit filed by the Securities Exchange Commission against him over the HealthSouth Scheme. He is also the defendant of over 40 more cases filed by HealthSouth’s stockholders and bondholders. These lawsuits are expected to go to trial in late 2007.

HealthSouth Corporation survived the fraud investigations. PriceWaterhouseCoopers is the new independent auditor for the company. HealthSouth has avoided bankruptcy by consolidating operations and working to convince customers, employees, and creditors that they have a corporate governance policy in place to prevent frauds from happening again. Barbara Patton is no longer employed at HealthSouth Corporation, but her contribution to the understanding of HealthSouth's fraudulent actions cannot be overlooked.

HEALTHSOUTH CORPORATION CASE

TEACHING NOTES

Case Objectives:

HealthSouth Corp., one of the nation’s largest healthcare providers, was the first company charged under the provisions of the Sarbanes-Oxley Act. HealthSouth’s CEO, Richard Scrushy, and sixteen of HealthSouth’s executives were indicted for allegedly using a sophisticated scheme to overstate its earnings by as much as $2.7 billion over the period from 1986 to 2002. The primary objective of the case is to provide students with an opportunity to confront ethical issues that face practicing accountants on a daily basis. The case has been used in several undergraduate and graduate accounting classes and has helped students become more ethically conscious. Specifically, it helps students become familiar with the major provisions of the Sarbanes-Oxley Act (in part 1 of the case), helps students reflect on management accountants’ ethical dilemma and independent auditors’ fraud detection responsibility (in part 2), and provides students with an opportunity to see the consequences of fraudulent reporting (in part 3).

Classroom Use Of The Case:

This case is designed to be used primarily in financial accounting classes at both principles and intermediate levels. However, it has also been used effectively in an auditing class. The case should also fit well into a MBA-level financial accounting course.
Teaching Methodology:

It is recommended that the three parts of the case be administered in three 15-20 minutes sessions. We found it particularly effective to divide the class into groups of four to five students to discuss the case for the first half of the 20 minutes session before the case is discussed in front of the entire class. We found that the small group discussion allows students to express their views more freely and helps students better formulate their ideas.

As with any ethical cases, all the questions are open-ended, and there is no right or wrong answers.

The remainder of the notes consists of suggested discussion questions for each part of the case and some teaching notes we took in administering the case together with some additional information to facilitate class discussions.

Part I

Suggested discussion questions:

1. What are the major provisions of the Sarbanes-Oxley Act?
2. Is it fair to hold a corporate executive personally responsible if the company’s financial statements are found fraudulent?

Part I Notes:

1. What are the major provisions of the Sarbanes-Oxley Act?

Most students in class knew little about the provisions of the Sarbanes-Oxley Act. This part of the case should motivate students to learn more about the Act. The instructor can go over the major (or selected) provisions of the Act by either using a transparency or a class handout. Information that the instructor may need in preparing the handout is presented below.

The U.S. Congress presented the Act to the president on July 26, 2002, after passage in the Senate by a 99-0 vote and in the House by a 423-3 margin. President George W. Bush signed the Sarbanes-Oxley Act (Public Law 107-204) on July 30, 2002. As enacted, the law will directly impact the following groups:

- CPAs and CPA firms auditing public companies;
- Publicly traded companies, their employees, officers, and owners;
- Attorneys who work for or have as clients publicly traded companies; and
- Brokers, dealers, investment bankers, and financial analysts who work for these companies.

Specific requirements for each of the groups are highlighted below.

Requirements for CPA firms:

- The law establishes a five-member accounting oversight board that is subject to Securities and Exchange Commission (SEC) oversight.
- Most Consulting is Banned for Audit Clients. Title II of the Act prohibits most “consulting” services outside the scope of practice of auditors. Prohibited services include, but are not limited to, bookkeeping and related services, design and implementation of financial information systems, appraisal or valuation services, actuarial services, internal audit outsourcing, services that provide any management or human resources, and legal and “expert services unrelated to the audit.”
- Audit Reports Require Concurring Partner Review. Requires a concurring or second partner’s review and approval of all audit reports and their issuance.
“Revolving Door” Employment of CPAs with Audit Clients Is Banned. A registered CPA firm is prohibited from auditing any SEC registered client whose chief executive, CFO, controller or equivalent was on the audit team of the firm within the past year.

Audit Partner Rotation Required. Audit partners who either have performed audit services or been responsible for reviewing the audit of a particular client must be rotated every five consecutive years.

CPA Firms Are Required to Report Directly to the Audit Committee.

Corporate and Criminal Fraud Accountability. Changes to the securities laws can penalize anyone found to have destroyed, altered, hid, or falsified records or documents to impede, obstruct, or influence an investigation conducted by any federal agency, or in bankruptcy, with fines or up to 20 years imprisonment, or both.

Requirements for Corporations, Their Officers and Board Members:

- No Lying to the Auditor. The act makes it unlawful for an officer or director or anyone acting for a principal to take any action to fraudulently influence, coerce, manipulate or mislead the auditing CPA firm.
- Code of Ethics for Financial Officers. The SEC is mandated to issue rules adopting a code of ethics for senior financial officers.
- Financial Expert Requirement. The SEC is required to issue rules requiring a publicly traded company’s audit committee to be comprised of at least one member who is a financial expert.
- Audit Committee Responsible for Public Accounting Firm. The Act vests the audit committee of a publicly traded company with responsibility for the appointment, compensation and oversight of any registered public accounting firm employed to perform audit services.
- Audit Committee Independence. Requires audit committee members to be members of the board of directors of the company, and to otherwise be independent.
- CEOs & CFOs Required to Affirm Financials. Chief executive officers (CEOs) and CFOs must certify in every annual report that they have reviewed the report and that it does not contain untrue statements or omissions of material facts.
  (a) Penalty for Violation. If material noncompliance causes the company to restate its financials, the CEO and CFO forfeit any bonuses and other incentives received during the 12-month period following the first filing of the erroneous financials.
- CEOs & CFOs Must Enact Internal Controls. CEOs and CFOs will be responsible for establishing and maintaining internal controls to ensure they are notified of material information.
- Penalties for Fraud. The Act also has stiffened penalties for corporate and criminal fraud by company insiders. The law makes it a crime to destroy, alter, or falsify records in a federal investigation or if a company declares bankruptcy. The penalty for those found guilty includes fines, or up to 20 years imprisonment, or both.
- No Listing on National Exchanges for Violators.
- No Personal Loans.

Requirements for Analysts:

- No Retaliation against Analysts for an adverse, negative or unfavorable research report on a public company.
- Conflict of Interest Disclosures. Securities analysts and brokers or dealers are required to disclose conflicts of interest.

Requirements for Attorneys:

- Requirement on Attorneys to Report Violations: (a) Requiring attorneys employed by a public company to report to the chief counsel or CEO of the company, evidence of a “material” violation of securities law, breach of fiduciary duty, or similar violations by the company or its agent; (b) Once reported, if the counsel or CEO does not appropriately respond to the evidence, the attorney must report the evidence to the board of directors or its audit committee.
Enhanced Criminal Penalties*

<table>
<thead>
<tr>
<th>Behavior</th>
<th>Sentence</th>
</tr>
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<tbody>
<tr>
<td>The alteration, destruction, concealment of any records with the intent of obstructing a federal investigation.</td>
<td>Fine and/or up to 10 years imprisonment.</td>
</tr>
<tr>
<td>Failure to maintain audit or review “workpapers” for at least five years.</td>
<td>Fine and/or up to 5 years imprisonment.</td>
</tr>
<tr>
<td>Anyone who “knowingly executes, or attempts to execute, a scheme” to defraud a purchaser of securities.</td>
<td>Fine and/or up to 10 years imprisonment.</td>
</tr>
<tr>
<td>Any CEO or CFO who “recklessly” violates his or her certification of the company’s financial statements. If “willfully” violates.</td>
<td>Fine of up to $1,000,000 and/or up to 10 years imprisonment.</td>
</tr>
<tr>
<td>Two or more persons who conspire to commit any offense against or to defraud the U.S. or its agencies.</td>
<td>Fine and/or up to 10 years imprisonment.</td>
</tr>
<tr>
<td>Any person who “corruptly” alters, destroys, conceals, etc., any records or documents with the intent of impairing the integrity of the record or document for use in an official proceeding.</td>
<td>Fine and/or up to 20 years imprisonment.</td>
</tr>
<tr>
<td>Mail and wire fraud. Violating applicable Employee Retirement Income Security Act (ERISA) provisions.</td>
<td>Increase from 5 to 20 years imprisonment.</td>
</tr>
<tr>
<td></td>
<td>Various lengths depending on violation.</td>
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</tbody>
</table>

*Source: Sarbanes-Oxley Act of 2002

2. Is it fair to hold a corporate executive personally responsible if the company’s financial statements are found fraudulent?

The Sarbanes Oxley Act requires that chief executive officers (CEOs) and CFOs must certify in every annual report that they have reviewed the report and that it does not contain untrue statements or omissions of material facts, and are personally responsible for any misstatements. Given the Enron scandal not so long ago, students generally agree with the Act which holds CEOs and CFOs personally responsible for the company’s financial statements. However, a small minority of students felt that it’s unfair to hold the CEOs and CFOs personally liable if they did not know or participate in the fraud. They argue that one of the benefits of a corporation is its “corporate veil.” The corporate veil, in general terms, exists to protect corporate officers from liability caused by the corporation. Some instructors may feel it is inappropriate to have students question the Act, and simply choose to skip this discussion question.

**Part II**

Suggested discussion questions:

1. Should manual entries be allowed in computerized accounting systems? If manual entries are allowed, what control measures should the company take to ensure proper control?
2. What would you do if you were invited to one of those “family meeting?”
3. Should Ernst & Young’s auditors have detected the earnings overstatement regardless of the level of management participation in perpetrating the fraud?
Part II Notes:

1. Should manual entries be allowed in computerized accounting systems? If manual entries are allowed, what control measures should the company take to ensure proper control?

   This question is appropriate when the case is used in an upper level accounting class, particularly in an auditing class. Students generally felt that while a computerized accounting system eliminates some of the traditional control risks, it creates some new risks of its own. Most students also agree that there are circumstances that would justify entering manual entries in a computerized accounting system. As to the question of what can be done to enhance control when manual entries are allowed, there are usually a variety of suggestions from students. For example, some students suggest having the computer print a special report of all the manual entries and making the special report available to both internal auditors and the independent auditors.

2. What would you do if you were invited to one of those “family meetings”?

   This is an issue facing many practicing accountants. It’s important for students to realize the inherent dilemma of management accountants (and the accounting profession in general), namely, the conflict of loyalty. Accountants have obligations to both their employer and the general public, duties that are sometimes conflicting. Consequently, management accountants are continuously faced with decisions that have moral and ethical considerations.

   The ethical decisions reached by students in our classes for the above question seemed to be directly related to the ethical models (or approaches) used by students in arriving at their conclusions. Though students may not be aware of the model they used, their discussion regarding how they arrived at their conclusions clearly demonstrated the model(s) they used.

   Students who followed the utilitarian approach generally arrived at the conclusion that, if invited to the “family meetings,” they would not participate in the fraud and would try to stop it by talking to the board of directors, and/or inform the company’s independent auditors. If failed, they’d resign from the company. The utilitarian school of ethics insists that the propriety of one’s action be assessed based on the overall consequences of the action. The analysis goes as follows: if one participated in the scheme to overstate earnings, his/her superior would be pleased. However, the long-run interest of shareholders, investors, creditors, and others who rely on the financial statements would be betrayed by the misstatement. If on the other hand, one fights the misstatement at HealthSouth, his/her superior would be displeased and his/her career advancement with HealthSouth might be hampered, but the public interest would be served.

   Another ethical approach is the deontological approach under which the accountant’s actions, rather than the consequences, become the focus of the inquiry. Under this approach, one would make his/her decisions based on his/her own sense of right or wrong without regards to the consequences of the action. That is, he/she considers his/her professionalism as an accountant and his/her overriding professional duty which is to ensure that financial statements are prepared in accordance with the GAAP. Students following this approach would also arrive at the conclusion that they would fight the earnings overstatement schemes. For these students, they would resign from the job if the overstatement is not corrected because “a job that requires sacrificing personal integrity is not worth keeping.”

   In our opinion, the utilitarian approach is more preferable. We tried to guide students to use the utilitarian approach by asking students to identify the major stakeholders who might be affected by the decision.

   As a final note, very few students followed the ethical egoism approach, which takes a pure self-serving perspective, and concludes that they’d just be a “good soldier.”

3. Should Ernst & Young have detected the earnings overstatement regardless of the level of management participation in perpetrating the fraud?
This discussion question gives students an opportunity to reflect on auditors’ fraud detection responsibility. Students generally arrive at the conclusion that even with due diligence, auditors may not be able to detect all frauds. When a significant portion of the client’s senior accounting personnel participated in the fraud which involves very sophisticated schemes to inflate earnings, it would be very difficult for the auditor to detect such a fraud. That is precisely why the Sarbanes-Oxley Act holds the companies’ CEOs and CFOs responsible for the accuracy of the financial statements and why the Act holds companies’ management responsible for establishing and maintaining proper internal control.

Ernst & Young, the former independent auditor of HealthSouth, is not charged with any wrongdoing related to HealthSouth’s reporting fraud. However, Ernst & Young had some red flags to try to explain away. HealthSouth’s cash amounts were overstated by $300 million at one point, even though cash balances are one of the easiest items for an auditor to verify. From 1999 to 2001, HealthSouth’s net income rose nearly 500 percent even though revenue grew just 5 percent. Ernst & Young also failed to detect the fraud for approximately 17 years, even though an anonymous shareholder had notified the auditor in 1998 and a HealthSouth employee had notified the auditor in 2002 of potential fraud issues in three areas. In addition, one of HealthSouth’s former executives was a former Ernst & Young senior auditor, and some other Ernst & Young senior auditors were also hired by HealthSouth over the years.

Part III

The discussion on Part 3 generally focuses on the relationship between business ethics and business success and between professional ethics and professional success. This discussion usually turned out to be more interesting and fruitful than we had anticipated. Students pointed out many examples of a positive relation between business ethics and business success. With respect to the relationship between accountants’ professional ethics and professional success, many pointed out that the accounting profession’s success is built on its creditability which, in turn, is built on the high ethical principles of its members. Furthermore, it was suggested by some students that holding high ethical standard generally contributes positively to professional success for individual accountants in the long-run. Finally, it was self-evident in Part III of the case that fraud does not pay.

Another way to administer the case would be not to hand out Part 3. Instead, after Part 2, ask students to search the internet and find what happened to the perpetrators of HealthSouth’s fraud. Students will be surprised at the volume of the articles on HealthSouth and the severe consequences of the fraud. When students discuss the case the next class period, there are usually vivid discussions with many interesting insights brought up by students who did extensive readings on HealthSouth.

In summary, as with any other ethical cases, there are no right or wrong solutions to the discussion questions. There were disagreements regarding what constitutes the appropriate ethical decisions even after the class discussion of the case. However, through the discussion in class and the interaction among students, the case has helped many students better understand the Sarbanes-Oxley Act and become more aware of the consequences of their ethical choices.

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