Name: Alert ID: TMML2024036793211 The 1960s found 17-year-old Richard Scrushy pumping gas in Selma, Alabama, thinking of better opportunities. With his then-wife pregnant, Scrushy found his first real job working alongside his mother as a respiratory technician. 5 After graduating from the University of Alabama, Scrushy was hired at an entry-level position at Lifemark Corp, a Houston-based health-care company. 5 He worked his way up the ladder and, in no time, was running the company's pharmacy, physical rehab, and merger departments. 5 In 1984, Scrushy received a $1 million loan from Citicorp Venture Capital to start his own company, HealthSouth, Inc. 5 HealthSouth, the first national chain of orthopedic hospitals and outpatient centers, quickly became one of United States' largest owners and operators of inpatient rehabilitative hospitals. 1,5 By 1996, when Scrushy took his company public, HealthSouth had a massive market value of over $12 billion. 2 However, in retrospect, HealthSouth's growth, market value, and financial statement values were not nearly what they appeared to be, as HealthSouth executives had perpetrated an upwards of $2.7 billion of accounting fraud. 3 The HealthSouth fraud occurred during an interesting period of economic growth and lackadaisical regulations, which made committing accounting fraud much easier. The 1990s saw investors and lenders who were less focused on profitability and more so on revenue. 4 When looking for capital as a company, growth was key. This pressured CEOs, like Scrushy, to continue growing their companies and meeting analyst expectations quarter after quarter. Combined with this increased pressure of growth was an environment of strange legalism. 4 If accounting procedures and policies did not directly violate Generally Accepted Accounting Principles (GAAP), then they were considered legal, and in turn, morally and ethically adequate. 4 This allowed Scrushy and HealthSouth to meet analyst expectations for 40 consecutive quarters, using creative accounting methods and ultimately fraudulent accounting. Driven by this thirst to hit analyst expectations, Scrushy and HealthSouth's "financial family" (Scrushy and five HealthSouth CFOs) altered their earnings numbers; explained as: plugging "holes" in the balance sheet with "dirt." 1 The fraud, which included improperly capitalizing expenses, overestimating insurance reimbursements, overvaluing fixed assets, and using faulty reserve accountings, went undetected until 2003, when former HealthSouth CFO, Weston Smith, revealed the fraud to federal investigators. 1 Despite seemingly being the obvious mastermind behind HealthSouth's accounting fraud, Scrushy denied (and still denies to this day) that he was involved in any way. 5 Scrushy claimed that the other executives took part in the fraud, and kept it hidden from him completely. 5 Despite his expressed innocence, Scrushy was convinced for accounting fraud and served a five-year sentence. 5 Business Model Upon the founding of HealthSouth, Scrushy saw healthcare as a no-lose business under the premise that large government reimbursements would continue to grow and to always be available to hospitals operators. 5 Scrushy saw two trends occurring in the United States: injuries to feet, knees, and hips were becoming more frequent as the population grew older, and more people were exercising later into life. 5 This lead to a large percentage of HealthSouth pateints being eligible for Medicare, and because government was in fact giving large health-care subsidies to hospitals, Scrushy used this financing to engage in aggressive acquisition of competing companies, with the plan of receiving more and more of the government's money. 5 His strategy, initially, worked flawlessly, with HealthSouth posting yearly double-digit profit increased and stock growth of 31% per year on average between 1987 and 1997. 5 Scrushy was able to use HealthSouth stock as currency to further expand on his core business of rehabilitation, moving into outpatient surgery, occupational medicine, and hospital sectors. 5 However, in 1997 government cut Medicare reimbursements to hospitals, which took a huge toll on HealthSouth's margins. 5 With Medicare at the time accounting for 37% of HealthSouth's revenues, HealthSouth's business immediately felt the effects of the subsidy cuts. 5 With HealthSouth no longer able to grow via acquisition, many of its flaws in operations began to show. Scrushy tried to keep his company profitable off operations alone by upping the amount of patients at each of his facilities, but HealthSouth still took an 86% hit to net income in 1998. 5 Yet HealthSouth "magically" found new life over the next few years. Although sales only grew by 5% from 1999 to 2001, HealthSouth's net income inconceivably rose almost 500%. 1 At the time, Scrushy explained this rebound occurred from lowering costs while raising revenues through increased efficiency in each hospital, but we now know that these magical earnings numbers were magical for a reason: because they were almost completely fictitious. Accounting Fraud How did HealthSouth get away with a fraud so big for so long? Their executives followed three basic steps while committing the fraud: 1) Company officials compared their internal financial statements to see if they would meet analyst expectations. 2) If earnings appeared to be short, managers were told to fix them and manipulate the results in any way necessary. 3) False documents were created to conceal the false entries added to the financial statements. 4 HealthSouth's executive "family" happened to be made up of many former Ernst & Young (E&Y;) auditors, which was the public assurance firm auditing HealthSouth, and thus were especially well-positioned to keep the fraud from the public by deceiving the audit engagement team. 1 For example, management knew that E&Y;'s materiality threshold for examining fixed-asset additions was $5,000. 1,4 This meant that as long as HealthSouth employees only moved amounts of money less than $5,000 at a time, the fictitious transactions would not be picked up in E&Y;'s auditing procedures. 1 However, this required a massive amount of work. With an average fictitious journal entry of $2,500, in order to overstate income by $2.7 billion, it would take over one million separate transactions. Not only did HealthSouth employees have to create each individual journal entry, false documentation and fixed-asset ledgers were created to show auditors in order to further conceal the fraud. 1 The volume of work that was required to pull off this fraud displays just how widespread the knowledge and participation of the fraud was throughout HealthSouth. 4 HealthSouth employees went above and beyond to conceal the fictitious entries from the auditors, which was what allowed the fraud to exist for so long. The organizational culture at HealthSouth also played a huge role in allowing the fraud to take place for such a long period of time. Scrushy was clearly a CEO with an overbearing presence at the top of his company. In their preliminary audit work papers, E&Y; noted about HealthSouth that: "management is dominated by one or a few individuals without effective oversight by the board of directors or audit committee, management displays a cavalier attitude toward, and inadequate monitoring of, significant business risks," and "management has excessive interest in maintaining or increasing the client's stock price or earnings trend." 1 These qualities of management all combine to create an environment at the top that is obsessed with earnings and that has the power over their employees to allow a fraud of this size to occur. Scrushy had complete control over his company; even going as far as to have security cameras installed throughout headquarters to keep watch on his employees. 3 As in most cases of fraud, greed also was a significant motive for HealthSouth management to inflate earnings. By manipulating earnings and stock price, Scrushy was able to secure stock options for himself on the lowest trading day of HealthSouth stock, netting him the highest profit possible. Both Scrushy and Michael Martin, HealthSouth's treasurer and CFO for three years, engaged in large stock sales which provided them with plenty of motive to raise the company's stock price. 3 In 1997, Martin sold $3 million worth of HealthSouth shares while Scrusy sold a hefty $100 million. 3 While testifying in regards to this sale, Martin stated, "Even though we knew we were committing fraud, we felt it was important to keep the stock price up for at least a year." 3 HealthSouth executives were also very closely knit, which reinforced group loyalty over that of the general public. 3 HealthSouth's executive "family" found it much easier to deceive and hurt a nameless mass of investors than the other members of their internal group. 3 Scrushy exploited the psychological desire to help those you know over those you do not. For example, he told one of his CFOs: "if you want to go public with all this, get ready to get fired, and everyone goes down with you." 3 This created a culture at the top of HealthSouth where every executive was pressured to keep quiet for fear of bringing down their close colleagues with them. There were also characteristics of HealthSouth on the structural level which allowed for the accounting fraud to occur. Proper checks and balances were not in place at HealthSouth, with Scrushy making a large amount of the company's decisions on his own. For example, HealthSouth's accounting systems did not sync properly with the corporate enterprise-resource-planning software. 3 This meant that results had to be consolidated by hand by executives, and allowed for an easy way to manipulate earnings figures. 3 The internal audit committee was also sneakily kept from doing their duties, and E&Y; noted that "the internal audit-function was understaffed, undertrained, and lacking in independence." 3 Fraud Discovery While the fraud was occurring at HealthSouth, there were multiple warnings from outside sources to auditors that should have tipped them off to the fraud's existence. Michael Vines was a bookkeeper at HealthSouth who oversaw the purchase of equipment. 4 After his warnings to several members of management went unnoticed, Mr. Vines left his position at HealthSouth for another job. 4 Upon leaving HealthSouth, Mr. Vines sent a letter to the E&Y; auditors which read: "I know that HealthSouth based out of Birmingham, AL has severe problems in the Accounting Department. In December 2001, HealthSouth moved expenses to capital accounts. The following accounts need to be look at as of 12-31-2001: 7000, 7200 and 7995." 1 Mr. Vines identified three specific accounts for the auditors to look at to discover the fraud. However, instead of investigating the e-mail on their own, E&Y; called the CFO of HealthSouth who claimed Mr. Vines was just a disgruntled employee and he was making his allegations up. 4 The auditors believed this explanation and never looked into the accounts Mr. Vines identified. E&Y; also received an e-mail from "Fleeced Shareholders" expressing concern about fraud within HealthSouth. The e-mail read: "You bring the smoke, I'll bring the mirrors. At least the market has shown the wisdom to devalue HS stock. Wish I got out in time. I have a list of questions, which I hope might interest you. How can the HS outpatient clinics treat patients without precertification, book the revenue, and carry it after being denied payment? How can the company carry tens of millions of dollars in accounts receivable that are well over 360 days? How can some hospitals have NO bad debt reserves? How did the E&Y; auditors in Alabama miss this stuff? Are these clever tricks to pump up the numbers, or something that a novice accountant could catch? You people have I have been hoodwinked. This note is all that I can do about it. You all can do much more, if all you do is look into it to see if what I say is true." 1 Despite these multiple, specific warnings about the fraud at HealthSouth, E&Y; still failed to bring the fraud to light. It took a former HealthSouth CFO to come forward with information for the fraud to be discovered. In 2003, Weston Smith, a former CFO, tipped off federal investigators to the HealthSouth fraud. 1 Soon after, many other employees who had participated in the fraud turned themselves in as well. 1 Ethical Implications Had any of the HealthSouth executives been acting under any sort of ethical framework, it is hard to believe that this level of fraud would have occurred within the company. The deontological framework requires decisions to be made based on what is "right" in a broad sense, valuing principals such as honesty, promise keeping, fairness, loyalty, justice, and respect for others. 7 HealthSouth executives clearly held none of these values in high regard. Anytime a corporate fraud is committed, there needs to be a disregard for moral values in favor of wealth and greed. While some of the employees involved may have succumbed to intense pressure from Scrushy or justified their actions by thinking it would only be a one-time occurrence, it is clear that Scrusy and a majority of his executive family were well-aware of the wrong-doing they were participating in. It is also easy to see the ethical implications of the HealthSouth fraud when looking at it through a Utilitarian framework. Utilitarianism states that an ethical decision should maximize benefits to society and minimize harms. 7 The HealthSouth accounting fraud did just the opposite. HealthSouth executives put their own wealth and well-being before the rights of their shareholders and creditors to have legitimate and trustworthy company financial data. Scrushy kept his entire executive team close and exploited the psychological desire to help those you know over those you do not. The E&Y; auditors on the HealthSouth account also failed to provide the public with independently qualified financial statements. Although it can be argued that HealthSouth was exceptionally skilled in deceiving the audit team, there were many instances and red flags that should have led the auditors to discover the fraud. The audit team did not thoroughly consider the ethical implications of their negligence on the public, and overlooked an enormous, long-lasting accounting fraud that was right under their noses. Once the accounting scandal went public, HealthSouth's share price tanked to as low as $0.35 a share, costing their shareholders millions. Lawsuits were filed by shareholders against HealthSouth, Scrushy, and E&Y.; Although found not guilty on criminal charges, Scrushy paid $81 million to the SEC to settle civil charges related to the fraud and in 2009 as rule to owe almost $3 billion to shareholders in a class action lawsuit. 1 E&Y; also settled the shareholders' class action lawsuit for $109 million, reaffirming their gross negligence in their audit of HealthSouth. 1 Many lessons can be learned from the accounting scandal at HealthSouth. Accounting scandals of this scale do not just occur on their own; they require multiple people to orchestrate. When the tone at the top of a company deviates away from any sort of ethical framework, it should be a red flag to other members of the company, to auditors, and to the public that fraud is more likely to occur. Had Scrushy or any of his CFOs thoroughly thought about the long-term implications and consequences for themselves, their company, and the public, the HealthSouth fraud may never have occurred. Although it is easy to get caught in the pressure of corporate fraud, one cannot let themselves blindly follow a CEO and be ethically deficient in their actions. As Scrushy himself said, "The CEO is just a human; the mind can only absorb so much." 5

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