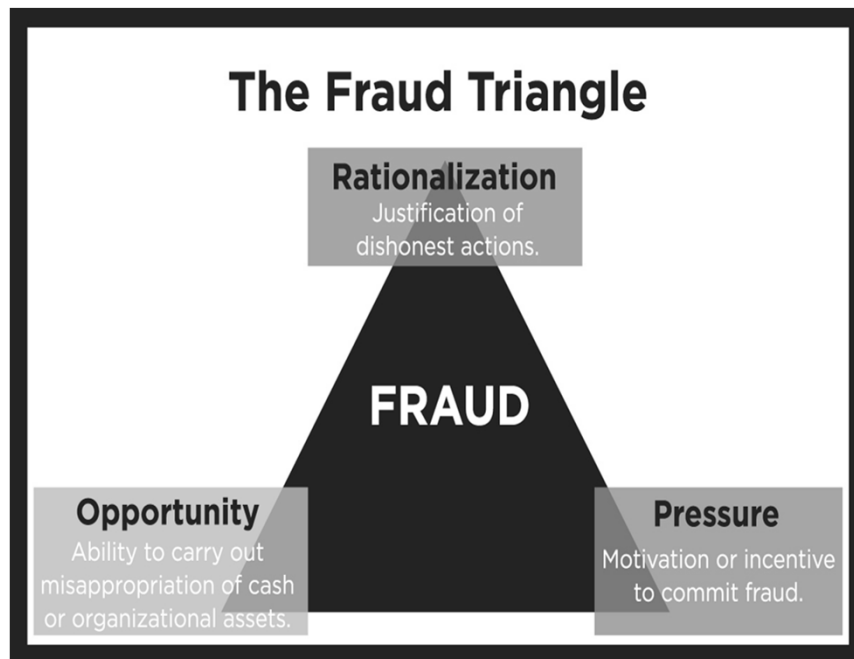




## **“Gate Keeper” Failures Analyzed Under the Fraud Triangle**



# ***“Reputational Intermediaries”***

**Auditors  
Corporate Compliance  
Governance**

- **Background on the Business**
- **Accounting – Aggressive →→→ Fraud**
- **Gatekeeper Failures Contributed to Fraud**
- **Impact of Failures: Investigations/Litigation**

**AMCARE**



**HEALTHSOUTH**  
Rehabilitation Corporation <sup>SM</sup>

**Aaron Beam**  
Chief Financial Officer

**Anthony Tanner**  
Administration

**Gene Smith**  
Operations

**Richard M. Scrusby**  
CEO

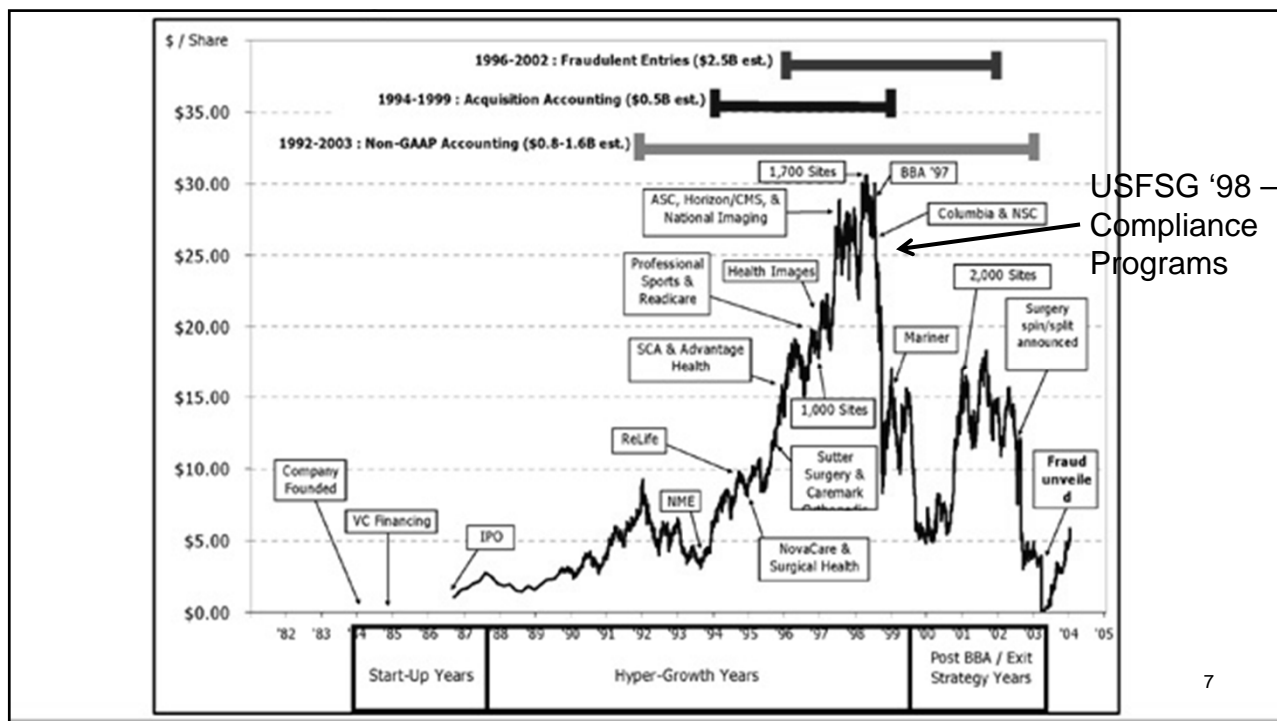


5

Shades of Gray

1986-1996

6



## HealthSouth

- Heavily regulated industry
- 52,000 employees
- 2,000+ facilities
- 50 states, 5 countries
- Largest provider of IP & OP rehab, diagnostic & surgery centers in US
- \$4.5B NYSE listed
- 3<sup>rd</sup> largest healthcare company in the world!



# Accounting Fraud

1996-2003

## HealthSouth Key Officers



**Richard Scrushy**  
CEO/Chairman  
(except 8/02-01/03)



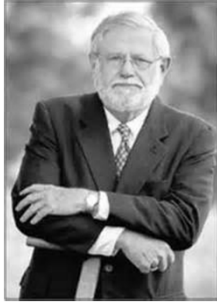
**Aaron Beam**  
CFO  
Founder-3Q97



**Bill Owens**  
E&Y Auditor '81-86  
Controller '86-'00  
CFO 2000-8/2001  
Pres/COO 8/01-8/02  
CEO 8/02-01/03  
CFO 2003



**Ken Livesay**  
Accounting



2Q96

Miss expectations by a penny (\$7.5M in revenue)



“Fix it”

~1,500 Fraudulent entries made by Controller Bill Owens and Ken Livesay, Accountant overnight



11



3Q97

Beam – co-founder and CFO 1984-1997 resigns

\$7.5M increased to \$300M in 6 quarters

**Mike Martin**  
outside banker '83-'89 in healthcare lending for AmSouth  
Joined HS in '89 as Treasurer  
EVP – Finance & Treasurer '94  
CFO 10/97 – Resigned 2000

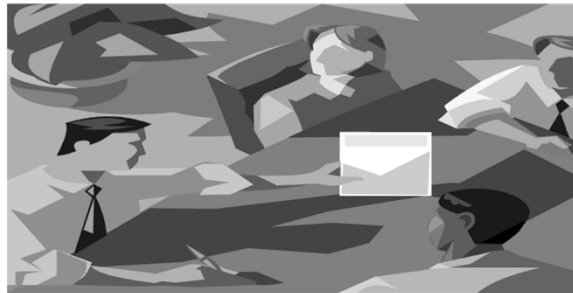


December 31  
HealthSouth's Reported Earnings are Overstated by More Than \$300 Million

12

4Q97

**“ Hit EPS” & “Keep stock price up”**



13



**Key Executive's – Structure of  
Employment Agreements'  
Compensation & Benefits**

**4 Components:**

- o Base Salary
- o Annual Target Bonus
- o Management Bonus Pool
- o Stock Options

14



## Salaries

1996-2003

<b>Scrushy</b>	<b>\$ 7,517,052</b>
<b>Beam</b>	<b>\$1,084,138</b>
<b>Martin</b>	<b>\$1,633,709</b>
<b>Owens</b>	<b>\$1,612,021</b>
<b>Smith</b>	<b>\$1,175,290</b>
<b>McVay</b>	<b>\$922,902</b>

15



## CEO's Annual Target Bonus

- Payable if annual performance standard in business plan met (defined as meeting/exceeding "earnings per share" projected to Wall Street analyst)
- Earned \$200,000/month payable within 5 days following the date "...the Company's internal monthly financial statements have been completed" if monthly standard in "Business Plan met"
- If any Monthly Target Bonus is "missed" it is available for payment if the Company attains its annual performance standard for such calendar year
- "Opportunity to earn" 2X base salary or \$2.4M

16





## Management Bonus Pool

1996-2003

<b>Scrushy</b>	<b>\$39,500,000</b>
<b>Beam</b>	<b>\$650,000</b>
<b>Martin</b>	<b>\$3,250,000</b>
<b>Owens</b>	<b>\$5,050,000</b>
<b>Smith</b>	<b>\$1,175,000</b>
<b>McVay</b>	<b>\$360,000</b>

17



## Stock Option Sales

1996-2003

<b>Scrushy</b>	<b>\$206,479,628</b>
<b>Beam</b>	<b>\$9,681,245</b>
<b>Martin</b>	<b>\$12,821,925</b>
<b>Owens</b>	<b>\$9,681,245</b>
<b>Smith</b>	<b>\$4,716,471</b>
<b>McVay</b>	<b>\$ 865,910</b>

18

**HEALTHSOUTH**  
 Corporation

Quarter to Date: March 31, 1998

Report ID: CORNDEL  
 Operator ID: 18DZED

Run Date: 04/14/98  
 Run Time: 1:07

Street Variance

	CORPORATE and SPT	MEDICAL CENTERS	INPATIENT	OUTPATIENT	SURGERY CENTERS	IMAGING	HOME HEALTH	OCCUPATIONAL MEDICINE	Eliminations	COMBOLATED	Street	Variance
Net Revenues	7,238,626.31	41,337,450.24	413,078,134.18	147,334,193.12	144,864,223.19	34,402,914.18	24,634,494.82	17,833,222.90	0.00	899,163,100.34	909,878,000.00	(9,714,899.74)
Operating Expenses	39,419,741.96	47,243,234.28	318,734,298.44	123,811,498.12	90,886,733.24	34,013,213.98	13,884,734.19	18,299,998.48	0.00	708,413,732.82	747,382,000.00	(38,968,267.18)
Provision for Doubtful Accounts	0.00	3,122,872.76	3,854,218.81	5,876,217.39	2,349,249.79	3,033,479.77	438,453.77	143,619.51	0.00	19,732,800.19	20,000,000.00	(267,199.81)
EBITDA	(32,381,083.65)	(12,144,379.64)	90,233,298.71	17,803,187.71	23,409,450.56	13,334,318.18	11,122,127.12	(6,000,187.09)	0.00	182,994,497.53	300,797,000.00	(117,802,502.47)
Depreciation & Amortization	29,314,646.24	4,431,419.81	21,488,196.13	14,222,294.56	10,441,978.49	6,463,794.41	397,249.02	1,294,493.23	0.00	72,341,468.33	78,344,000.00	(6,002,531.67)
Interest Expense	9,231,232.03	2,619,782.22	14,383,298.38	44,478.49	398,866.38	337,849.47	6,672.74	294.13	0.00	26,315,442.95	30,119,000.00	(3,803,557.05)
Income Before	(3,147,498.39)	(1,802,469.85)	(1,847,373.02)	(6,473.83)	(643,126.10)	(47,886.37)	8.00	(1,087,493.09)	0.00	(1,146,847.76)	(1,027,000.00)	(119,847.76)
Income Before Minority Int & Income Taxes	(3,867,864.63)	3,182,960.03	40,339,479.23	22,904,247.33	41,831,241.89	13,880,242.17	(81,119.41)	(1,891,242.97)	0.00	84,418,241.48	193,214,000.00	(108,795,758.52)
Minority Income	0.00	0.00	(1,833,847.87)	(926,133.33)	(1,263,213.97)	(1,983,813.20)	308,243.97	0.00	0.00	(6,831,473.90)	(1,877,800.00)	(4,953,673.90)
Income Before Income Taxes	(3,867,864.63)	3,182,960.03	38,505,631.36	21,978,114.00	39,568,027.92	11,896,428.97	119,144.34	(1,891,242.97)	0.00	77,586,767.58	171,336,200.00	(93,749,432.42)
Provision for Income Taxes	0.00	0.00	0.00	3,081.71	472.43	0.00	0.00	0.00	0.00	13,834,479.89	13,834,479.89	0.00
Income Before VC Charge	(3,867,864.63)	3,182,960.03	38,505,631.36	21,981,195.71	39,568,500.35	11,896,428.97	119,144.34	(1,891,242.97)	0.00	91,421,247.47	187,501,720.11	(96,080,472.64)
InterCompany Interest	(26,009,311.04)	1,740,148.81	3,187,299.00	8,979,408.17	4,433,799.33	1,334,021.99	347,742.00	884,298.00	0.00	(16,288,332.32)	0.00	(16,288,332.32)
InterCompany Management Fees	(19,364,800.00)	3,109,964.35	38,648,249.93	14,464,033.37	4,924,271.13	323,443.17	3,962,298.00	0.00	0.00	(14,488,122.02)	0.00	(14,488,122.02)
	(19,374,117.06)	3,830,034.34	31,234,208.93	27,324,271.49	11,348,270.27	1,679,483.26	3,114,132.08	884,298.00	0.00	(10,728,833.32)	0.00	(10,728,833.32)
<b>NET INCOME (LOSS)</b>	<b>(25,188,130.43)</b>	<b>1,313,993.47</b>	<b>21,448,124.43</b>	<b>(1,412,860.93)</b>	<b>18,409,237.18</b>	<b>13,217,045.31</b>	<b>(1,337,088.72)</b>	<b>(1,777,649.97)</b>	<b>0.00</b>	<b>(25,743,713.54)</b>	<b>46,344,813.74</b>	<b>(72,091,527.28)</b>
Weighted Average Shares Outstanding Basic	398,496,389.00	398,496,389	398,496,389	398,496,389	398,496,389	398,496,389	398,496,389	398,496,389	398,496,389	398,496,389	398,496,389	398,496,389
Earnings Per Share - Basic	(63.22)	3.30	53.81	(3.55)	46.19	33.17	(3.36)	(4.46)	0.00	(64.61)	116.31	(113.01)
Weighted Average Shares Outstanding Diluted	413,233,281	413,233,281	413,233,281	413,233,281	413,233,281	413,233,281	413,233,281	413,233,281	413,233,281	413,233,281	413,233,281	413,233,281
Earnings Per Share - Diluted												
Add back for Akkod EPS - earnings												



GX 019-010  
 CR-03-BE-0530-S  
 01/05/2005

IC062-01S-0039

**HEALTHSOUTH CORPORATION  
 SHORTFALL**  
 (In Thousands, except EPS Calculation)

	Current Estimates				4Q99
	1Q99	2Q99	3Q99	4Q99	Annualized
Pre-Tax Shortfall	-103,250	-138,318	-110,360	-95,626	-382,505
Projected Actual EPS with Operational Synergies Expected/To Be Reported EPS	\$0.10	\$0.08	\$0.13	\$0.16	\$0.65
Earnings Shortfall	\$0.26	\$0.27	\$0.28	\$0.29	\$1.18
	-\$0.16	-\$0.20	-\$0.15	-\$0.13	-\$0.52
Earnings as a Percent of Total	62%	72%	54%	45%	45%
Accumulated Accounting Issue	-103,250	-\$241,568	-\$351,928	-\$447,554	-\$382,505
<b>Fraudulent</b>					
Pre-Tax Shortfall	-103,250	-129,098	-50,448	-12,587	-50,346
Projected Actual EPS with Operational Synergies Expected/To Be Reported EPS	\$0.10	\$0.08	\$0.13	\$0.16	\$0.65
Earnings Shortfall	\$0.26	\$0.25	\$0.20	\$0.18	\$0.72
	-\$0.16	-\$0.18	-\$0.07	-\$0.02	-\$0.07
Earnings as a Percent of Total	62%	70%	34%	9%	9%
Accumulated Accounting Issue	-103,250	-\$232,348	-\$282,796	-\$295,383	-\$50,346

+ 50mm carry-over from 1998.



GX 13K  
 CR-03-BE-0530-S  
 01/05/2005

1B157-HS-V-0045

# HealthSouth Key Officers



**Richard Scrushy**  
CEO/Chairman  
(except 8/02-01/03)



**Aaron Beam**  
CFO  
Founder-3Q97



**Mike Martin**  
AmSouth lender  
Treasurer '89  
Finance & Treasurer '94  
CFO 1997-2000



**Bill Owens**  
E&Y Auditor '81-86  
Controller '86-'00  
CFO 2000-8/2001  
Pres/COO 8/01-8/02  
CEO 8/02-01/03  
CFO 2003



**Ken Livesay**  
Accounting



**Emory Harris**  
Accounting

# "the family"



"dirt" – fraudulent numbers



"hole" – short fall in EPS

Internal Controls: an "Effective" Compliance Program –  
7 elements U. S. Sentencing Guidelines

- |                              |  |
|------------------------------|--|
| 1. Standards & Procedures    | 1. Few   |
| 2. Oversight                 | 2. Audit & Compliance Committee<br>CO  |
| 3. Education & Training      | 3. Education   |
| 4. Monitoring & Auditing     | 4. 1.5 FTE Compliance<br>2.0 FTE Internal Audit                              |
| 5. Reporting & Investigating | Audits – "white glove" audits E&Y;<br>advance notice, no access/independence |
| 6. Enforcement & Discipline  | -no risk assessments, FCPA   |
| 7. Response & Prevention     | 5. Answering machine – designed to alert<br>fraudsters                       |
|                              | 7. "Henze" story   |

23

## Henze -



- VP – Accounting Systems & Controls
- 1998 – odd jump in net income; told Livesay looked suspicious
- Not satisfied with explanation
- Spring 1999 – back from maternity leave saw \$60M jump in net income for boost of 14 cents EPS
- Called Compliance
- Passed over for promotion

24

# Corporate Compliance

- 1.5 FTE
- Unmanned 'hotline'
- No access to General Ledger
- No direct access to Board
- No experience in compliance
- Oversight by EVP-  
Administration/Director/Secretary/Founder
- 4Q – Henze Complaint



25

## INTERNAL AUDIT CONTROLS

### Independent Auditor – E & Y

- No rotation of engagement partner
- No change in audit protocol
- Not allowed to use proprietary software – not reported to Audit Committee
- Allowed HS to keep \$500M of overvalued AR owed by financially distressed health care IT firms
- “Audit Related Fee” –consulting contracts

### Corporate Internal Audit

- 2 FTE
- 1-2 weeks notice before an audit
- No access to General Ledger
- No expertise – no background with audit firms
- No line of report to Board
- No meetings with Audit & Compensation Committee/Board

26

# BOARD GOVERNANCE

## Audit & Compensation Committee

- Experience
- Reporting structure
- “Executive Session”
- “Minutes” – timeliness
- Access to records
- Compensation structure

## Independence of Directors

- Stock options
- Access to records for review before meetings
- 3<sup>rd</sup>-party related transaction

## HealthSouth Key Officers



**Richard Scrushy**  
CEO/Chairman  
(except 8/02-01/03)



**Aaron Beam**  
CFO  
Founder-3Q97



**Mike Martin**  
AmSouth lender  
Treasurer '89  
Finance & Treasurer '94  
CFO 1997-2000



**Bill Owens**  
E&Y Auditor '81-86  
Controller '86-'00  
CFO 2000-8/2001  
Pres/COO 8/01-8/02  
CEO 8/02-01/03  
CFO 2003



**Weston Smith**  
Former E&Y Auditor  
CFO  
2001-2002



**Tadd McVay**  
CFO  
2002 (5 months)  
Demoted to Treasurer



**Ken Livesay**  
Accounting



**Emory Harris**  
Accounting

## 3Q02

- Sarbanes Oxley passed
- 8/5 Weston Smith refuses to sign
- 8/6 Smith offered a “clean” Company position
- 8/7 Smith signs the SOX certification
- 8/27 Announce split surgery center & T1783 Impact
- Owens CEO, Scrusby Chairman, McVay CFO  
(5<sup>th</sup> since 1997)
- Class Action Civil Suits Filed
- 8/28 SEC Begins investigation
- USAO opens insider trading investigation



29

## Risk & Relationships

Sage Givens,  
Larry Striplin Jr.,  
John Chamberlin,  
Charles Newhall III  
George Strong



30

### PIVOTAL DATES

HealthSouth's daily closing stock price



Source: Thomson Datastream

31



### Total Base → Total Earnings\*

1996-2003

<b>Scrushy</b>	<b>\$ 7,517,052 → \$ 267,900,000</b>
<b>Beam</b>	<b>\$1,084,138 → \$ 11,200,000</b>
<b>Martin</b>	<b>\$1,633,709 → \$ 17,600,000</b>
<b>Owens</b>	<b>\$1,612,021 → \$ 16,400,000</b>
<b>Smith</b>	<b>\$1,175,290 → \$ 7,000,000</b>
<b>McVay</b>	<b>\$ 922,902 → \$ 2,100,000</b>

\* estimates

32



# At the end of the day ...

USAO: 17 criminal convictions  
 5 year CIA with HealthSouth (ended 12/04)  
 \$325M paid on FCA qui tam settlement

HealthSouth: 15 months to reconstruct 'financial statements'  
 \$445M civil settlement paid by HS for civil lawsuits (2006)  
 \$100M to the SEC  
 D & O litigation payouts  
 Paid \$100+M in attorney, accounting, turn-around costs  
 Relisted on NYSE (2006); trading as \$37+ as of October 2014 with \$3.28B market cap

Scrushy: \$2.88B civil verdict [appeals exhausted]  
 \$88M paid to SEC  
 SEC sanctions remain in place against him serving in a public company

**Directors: D & O maximum paid by several companies who had stacked policies; personal payouts (amounts undisclosed); resigned from Board positions on other companies & yet to 'recover' that standing**

## Fraud Triangle

