



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

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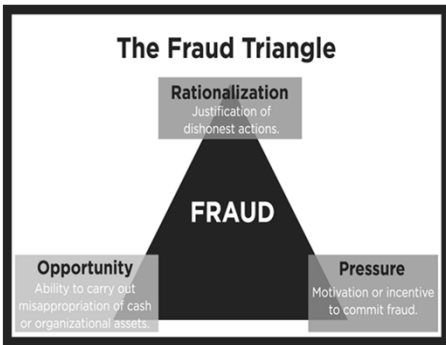
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***“Reputational Intermediaries”***

**Auditors  
Corporate Compliance  
Governance**

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

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<b>Aaron Beam</b> Chief Financial Officer
<b>Anthony Tanner</b> Administration
<b>Gene Smith</b> Operations
<b>Richard M. Scrusby</b> CEO

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Shades of Gray  
1986-1996

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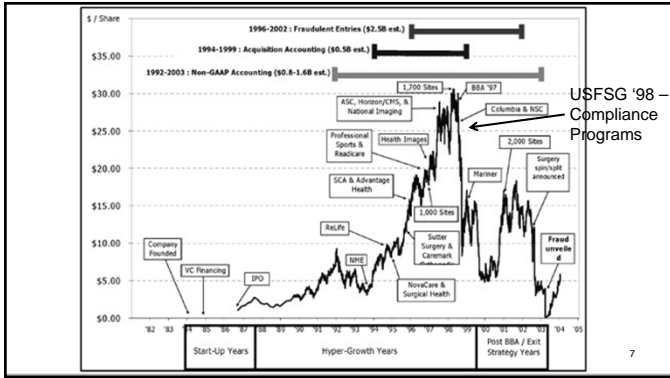
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USFSG '98 - Compliance Programs

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## 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!




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## Accounting Fraud

1996-2003

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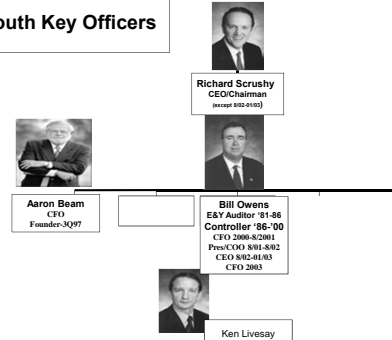
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**HealthSouth Key Officers**



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

**Aaron Beam**  
CFO  
Founder-3Q97

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

**Ken Livesay**  
Accounting

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**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



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**3Q97**

**Beam – co-founder and CFO 1984-1997 resigns**



**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

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

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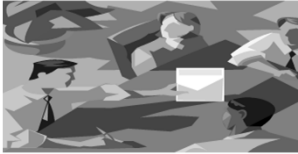
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4Q97

“ Hit EPS” & “Keep stock price up”



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**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

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**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>

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### 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

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### 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>

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### 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>

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**HEALTHSOUTH**  
 HealthSouth Financials  
 Quarter 4 Year 1998

Street Variance

Account	1998	1997	1996	1995	1994	1993	1992	1991	1990	1989	1988	1987	1986	1985	1984	1983	1982	1981	1980
Operating Revenue	1,024,200	924,200	877,200	800,000	700,000	600,000	500,000	400,000	300,000	200,000	100,000	50,000	20,000	10,000	5,000	2,000	1,000	500	200
Operating Expenses	(800,000)	(750,000)	(700,000)	(650,000)	(600,000)	(550,000)	(500,000)	(450,000)	(400,000)	(350,000)	(300,000)	(250,000)	(200,000)	(150,000)	(100,000)	(50,000)	(20,000)	(10,000)	(5,000)
Operating Profit	224,200	174,200	177,200	150,000	100,000	50,000	0	0	0	0	0	0	0	0	0	0	0	0	0
Income Tax Expense	(80,000)	(70,000)	(70,000)	(70,000)	(70,000)	(70,000)	(70,000)	(70,000)	(70,000)	(70,000)	(70,000)	(70,000)	(70,000)	(70,000)	(70,000)	(70,000)	(70,000)	(70,000)	(70,000)
Net Income	144,200	104,200	107,200	80,000	30,000	0	0	0	0	0	0	0	0	0	0	0	0	0	0

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**HEALTHSOUTH**  
 HealthSouth Financials  
 Quarter 4 Year 1998

Current Estimates

Account	1998	1997	1996	1995	1994	1993	1992	1991	1990	1989	1988	1987	1986	1985	1984	1983	1982	1981	1980
Pre-Tax Shortfall	(100,200)	(100,200)	(100,200)	(100,200)	(100,200)	(100,200)	(100,200)	(100,200)	(100,200)	(100,200)	(100,200)	(100,200)	(100,200)	(100,200)	(100,200)	(100,200)	(100,200)	(100,200)	(100,200)
Proposed Actual EPS with Operational Synergies	\$0.18	\$0.18	\$0.18	\$0.18	\$0.18	\$0.18	\$0.18	\$0.18	\$0.18	\$0.18	\$0.18	\$0.18	\$0.18	\$0.18	\$0.18	\$0.18	\$0.18	\$0.18	\$0.18
Proposed Actual EPS with Operational Synergies	43%	70%	94%	97%	97%	97%	97%	97%	97%	97%	97%	97%	97%	97%	97%	97%	97%	97%	97%
Accumulated Accounting Issue	(100,200)	(100,200)	(100,200)	(100,200)	(100,200)	(100,200)	(100,200)	(100,200)	(100,200)	(100,200)	(100,200)	(100,200)	(100,200)	(100,200)	(100,200)	(100,200)	(100,200)	(100,200)	(100,200)

+ 50MM carry-over from 1998.

**Fraudulent**

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**HealthSouth Key Officers**




**Richard Scrushy**  
CEO/Chairman  
(except 1992-1993)




**Aaron Beam**  
CFO  
Founder, 3Q97




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



**Bill Owens**  
E&Y Auditor '81-88  
Controller '88-90  
CFO 2000-2/2001  
Pres/CFO 3/01-3/02  
CEO 3/02-10/03  
CFO 2003



**Ken Livesay**  
Accounting



**Emory Harris**  
Accounting

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**“the family”**




“hole” – short fall in EPS



“dirt” – fraudulent numbers

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**Internal Controls: an “Effective” Compliance Program –  
7 elements U. S. Sentencing Guidelines**

<ol style="list-style-type: none"> <li>1. Standards &amp; Procedures</li> <li>2. Oversight</li> <li>3. Education &amp; Training</li> <li>4. Monitoring &amp; Auditing</li> <li>5. Reporting &amp; Investigating</li> <li>6. Enforcement &amp; Discipline</li> <li>7. Response &amp; Prevention</li> </ol>	<ol style="list-style-type: none"> <li>1. Few</li> <li>2. Audit &amp; Compliance Committee CO</li> <li>3. Education</li> <li>4. 1.5 FTE Compliance 2.0 FTE Internal Audit Audits – “white glove” audits E&amp;Y; advance notice, no access/independence -no risk assessments, FCPA</li> <li>5. Answering machine – designed to alert fraudsters</li> <li>7. “Henze” story</li> </ol>
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**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

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## 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



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## 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

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## 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

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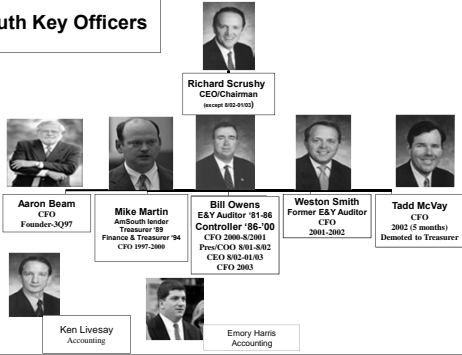
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## HealthSouth Key Officers




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## 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, Scrushy Chairman, McVay CFO (5<sup>th</sup> since 1997)
- Class Action Civil Suits Filed
- 8/28 SEC Begins investigation
- USAO opens insider trading investigation




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## Risk & Relationships

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




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**Total Base → Total Earnings\***

1996-2003

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

\* estimates

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*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**

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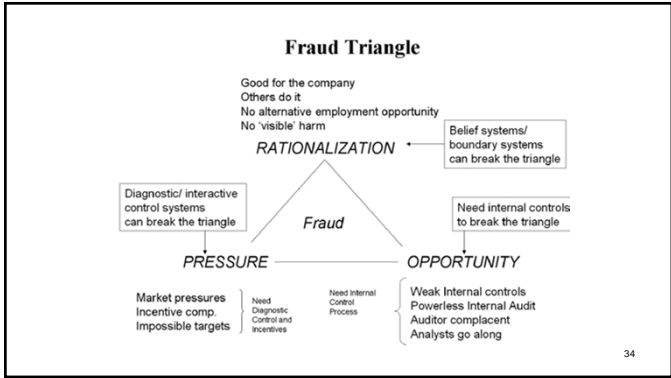
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