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## SEARCHING FOR THE RED FLAGS

### EXPERT DETAILS HEALTHSOUTH SCANDAL CLUES

*ROY L. WILLIAMS News staff writer*

As investigators dig into evidence that Birmingham's HealthSouth Corp. faked \$2.5 billion in profits, one question lingers: How could the scheme have gone undetected for so long?

It's hindsight now, but Craig Greene, a certified fraud examiner from Chicago who has investigated accounting scandals nationwide, says the government's lawsuit against HealthSouth points to many red flags in the company's financial statements that he believes auditor Ernst & Young "should have picked up on."

According to a government lawsuit, HealthSouth officials manipulated revenue figures, created phony invoices and inflated the value of assets to overstate earnings by \$1.4 billion between 1999 and mid2002. Last week, a HealthSouth executive said the company faked another \$1.1 billion in profits in 1997 and 1998.

The Securities and Exchange Commission says the fraud likely dates back to 1986, the year HealthSouth first sold shares to the public.

Greene has studied SEC and HealthSouth documents and identified details in the company's financial reports that should have set off alarm bells.

One example: HealthSouth reported net income rose almost 400 percent from 1999 to 2000, yet cash on hand increased only 40 percent. "The old story is follow the money," said Greene, a partner at McGovern & Greene LLP. "Was cash really tracking earnings?"

Greene also noted HealthSouth reported a \$342 million adjustment in 1999 to an allowance for doubtful accounts, followed by only \$98 million in 2000. "I believe this is the account that was manipulated for revenues," Greene said. "Why such a drastic change?"

Moreover, HealthSouth reported significant capital expenditures from 1998 and 2001, but that did not translate into additional sales, as one might expect, he said. "That is more equipment and property to treat more patients, which results in more revenue," Greene said.

Yet another red flag: The U.S. economy began to sour at the end of 1999, yet HealthSouth's books showed strong profit growth in 2000 and 2001.

Officials at Ernst & Young, which was fired March 31 as HealthSouth's auditor, have said auditors at the firm were duped by company officials - a key reason the fraud went undetected for so long.

Catherine Svoboda, spokeswoman for Ernst & Young in New York, declined comment on the investigation into HealthSouth's accounting practices. She said the firm is cooperating with federal investigators.

Federal prosecutors have said HealthSouth finance officials - including the Chief Finance Officer William Owens - faked invoices and exaggerated asset values in a way calculated to deceive the

auditors.

"It's important to note that Owens, the CFO, had previously worked for Ernst & Young as an accountant," Greene said. "Thus it may be inferred that he may have had knowledge of E&Y's audit procedures."

Owens pleaded guilty to fraud last week.

Another HealthSouth finance official, Emery Harris, the former assistant controller who has been described as a "mechanic" of the fraud, has agreed to help outline the company's accounting tricks to the FBI.

Officials from PricewaterhouseCoopers, hired by HealthSouth's board to conduct a forensic accounting investigation and determine the company's true financial picture, declined comment for this report. The New York-based accounting firm is led by Birmingham native Sam DiPiazza.

### Snooping

Accounting fraud is not new, but it has been pushed into the spotlight by high-profile cases that led to bankruptcies at Enron Corp. and WorldCom Inc. The Association of Certified Fraud Examiners estimated that fraud cost U.S. businesses 6 percent of their revenue last year - about \$600 billion, or \$4,500 per employee.

These cases also have cast light on a little-known aspect of accounting - forensic accounting, which involves snooping for the details of fraud in income statements and balance sheets.

The PricewaterhouseCoopers forensic accountants will examine in detail the company's records, ledgers, subledgers and journal entries, focusing on the legitimacy of the entries and supporting documentation. They'll also interview employees.

"In a case like HealthSouth where there are allegations that documents have been falsified, that is a challenge in itself," said Jim Hart, managing partner for Birmingham's Dent Baker & Co. LLP, who has conducted forensic investigations for more than two decades.

The findings of this investigation will be important to the efforts to salvage HealthSouth, which was once valued at more than \$12 billion on Wall Street and has more than 50,000 employees across the nation.

"Shareholder groups, lending institutions, employee groups and retirement participants all have a clear vested interest in the outcome," said Mike Mason, who heads Consilium Forensic Accounting LLC in Birmingham.

As they go about their work at HealthSouth, the forensic accountants already have a roadmap to guide them in the SEC lawsuit that describes the fraud scheme. Additional details have emerged in plea agreements.

The SEC says each quarter, HealthSouth senior officials gave CEO Richard Scrusby the company's actual unreported earnings for comparison against Wall Street analysts' estimates. If earnings fell below expectations, the SEC charges, Scrusby ordered managers to "fix it" by recording false earnings.

HealthSouth senior accountants held what the SEC called "family meetings" to discuss false entries that could be made to inflate the company's earnings.

One way they did this, the SEC says, was by reducing the "contractual adjustment account," which estimates the difference between the amount billed to the patient and the amount insurance will pay. The SEC charges that officials doctored the balance sheet and falsified fixed-

asset accounts to match the fictitious adjustments made to the company's income statement.

Accountants used HealthSouth's property, plant and equipment account to artificially inflate the company's assets, making thousands of phony asset entries, the government says. Fictitious entries were often listed under the category "AP Summary," employees have told investigators.

To conceal their fraud from auditors they knew would question large additions to asset accounts, they kept the bogus additions below a certain threshold, the SEC charges.

Greene said the scheme outlined by the SEC reminds him of techniques used by Mississippi-based WorldCom to dress up its financial results. Similar allegations of manipulation of cash, balance sheet items and reserves got executives at Cendant Corp. in trouble for fraud in 1999, he said.

"Much of the fraud used journal entries as a tool," Greene said. "It accomplishes several things: reducing current expenses and ultimately amortizing the fraud off the books. In my opinion if the auditors don't catch it when it occurs, they will never catch it in the future years as they would not focus on auditing the purchase of previously procured assets."

He said journal entries appear to have been designed to limit the number of people who had knowledge of the fraud. "These entries, I assume, were made directly by the upper level finance and accounting staff," Greene said.

So far, eight HealthSouth employees - two finance chiefs and so-called "family members" - have pleaded guilty to fraud in Birmingham.

Mason said the speed at which top executives are admitting to wrongdoing is surprising.

"It is most unusual to see top level executives come forward as material witnesses in the early stages of a fraud investigation," he said.

**Illustration:**A Newsgraphic titled 'How HelathSouth cooked the books' accompanied this article.

"The old story is follow the money. Was cash really tracking earnings?" Certified fraud examiner Craig Greene