

HealthSouth Corp.: The First Test of Sarbanes-Oxley

R. Loring Carlson
John M. Coulter
Thomas J. Vogel*

The accounting fraud at HealthSouth was by any standard both enormous and complex. Its concealment over the course of nearly seven years required considerable effort and, in some cases, luck. For all its size and complexity, however, the fraud shared much in common with other highly publicized earnings overstatement cases, a fact that provided a measure of confidence that significant accounting or reporting misstatements did not escape the Committee's attention.

Stated most simply, the fraud was accomplished by making over \$2.7 billion in false or unsupported entries in the Company's accounting systems. These improper accounting entries, made for the purpose of inflating HealthSouth's earnings, took two principal forms: (1) exaggeration of reported revenue, primarily through reductions to contractual adjustment accounts, and (2) failure to properly characterize and record operating expenses.

Extracted from the "Summary of Conclusions"
Report of the Special Audit Review Committee of
the Board of Directors of HealthSouth Corporation
May 28, 2004

With the issuance of the *Report of the Special Audit Review Committee of the Board of Directors of HealthSouth Corporation*, many issues regarding one of the largest corporate frauds in American history came to light. In a ten-month period from August 2002 to May 2003, HealthSouth Corporation (HS) went from the nation's leader of outpatient surgery and diagnostic services to corporate disaster. Its stock, a listing on the New York Stock Exchange for many years, was delisted and now trading with the pink sheets in the Over-The-Counter market. Fifteen HS employees admitted criminal complicity in accounting abuses. And Richard Scrushy, the

* Dr. Carlson and Dr. Coulter are Professors of Accounting at Western New England College, and Dr. Vogel is Associate Professor of Accounting at Canisius College.

Company's CEO, was indicted by an Alabama grand jury on eighty-five counts of securities fraud and related charges, including two counts under the recently issued Sarbanes-Oxley Act of 2002 (SOX). As such, Scrushy's trial would become the first test of this highly publicized legislation.

Many wondered how a fraud of this magnitude, \$2.741 billion, could have been committed without detection of either or both of the company's internal auditors or external auditors (Ernst & Young, LLP). Others questioned whether SOX will be successful in preventing such frauds from occurring in the future. In particular, the internal control requirements set forth in Section 404 of SOX had not yet been implemented. It is the expectation of many that the reporting requirements mandated by this section for both companies and independent auditors will allow for earlier detection of fraudulent activities in the future.

ACCOUNTING SCANDALS, SOX AND THE PCAOB

In 2001, investor confidence in the financial reporting system was evaporating. The stock market bubble of the 1990s had burst and technology companies lost over 60% of their value from the highs reached in 2000. The tragic events of September 11, 2001 intensified the perception and magnitude of a risk that all investors face - the risk of terrorist attacks.

Over the next twelve months, additional instances of corporate malfeasance were uncovered. Fraudulent financial reporting activities precipitated the need for a number of companies including Enron, Global Crossing, WorldCom, and Adelphia, to file for Federal bankruptcy protection. Andersen, LLP, was forced to disband, eliminating one of the then Big 5 public accounting firms just months after the discovery of the Enron fraud.

Finally, investors had begun to question the usefulness of audit committees. They were in theory the internal financial watchdogs over the financial reporting process, but many who served on the committees of the aforementioned companies lacked the requisite financial expertise needed to perform such duties.

Together, these events created an environment where investors had become extremely reluctant to “take a chance” in the capital markets. Something had to be done to restore investor confidence. Investors demanded more from the financial reporting system including: greater assurance from public accountants, more oversight in corporate governance, and clear evidence of present and functioning internal controls. Responding to the situation, the United States Congress enacted SOX on July 30, 2002. This hallmark legislation set forth a new system of checks and balances in an effort to reduce corporate malfeasance and protect investors.

First, SOX put an end to the era of self-regulation in the accounting environment by creating the Public Company Accounting Oversight Board (PCAOB), which itself reports to the Securities and Exchange Commission (SEC). Responsibility for the development of standards for the auditing of publicly traded companies now rests with the PCAOB. The board is funded through fees charged to public companies and accounting firms that audit public companies. Inspections of audit firms conducted by the PCAOB also mean scrutiny of a larger number of individual auditing engagements, improving upon the peer review system that had been in place. This increased scrutiny has the potential to lead to second opinions on audit decisions and to even tougher audits.

But the impact of SOX was expansive and created new responsibilities for company executives and boards of directors in addition to those for the external auditors. Of primary importance in this case are the requirements set forth in SOX Sections 302 and 404. Section 302 creates new responsibilities for company executives. Both the CEO and the CFO of a publicly traded corporation are now required to personally certify, under threat of criminal liability:

- The signing officers have reviewed the reports
- The report does not contain any material untrue statements or material omission or be considered misleading
- The financial statements and related information fairly present the financial condition and the results in all material respects

- The signing officers are responsible for internal controls and have evaluated these internal controls within the previous ninety days and have reported on their findings
- A list of all deficiencies in the internal controls and information on any fraud that involves employees who are involved with internal activities
- Any significant changes in internal controls or related factors that could have a negative impact on the internal controls (<http://www.soxlaw.com/s302.htm>)

SOX Section 404 establishes the responsibility of the external auditor to provide an independent opinion to shareholders and the board of directors both on management's assertion on the effectiveness of the company's internal control over financial reporting, and of the effectiveness of those internal controls – in addition to the traditional financial statement audit opinion. Prior to SOX, an explicit opinion on internal control over financial reporting was outside the scope of the financial statement audit opinion. This may have contributed to the expectation gap between what an auditor's report was perceived to encompass and what it actually delivered. In some cases, investors believed that an unqualified opinion on the financial statements also indicated that the company was well controlled by management. Now, management's assertion (Section 302) and the related auditor's report on internal control over financial reporting (Section 404) should create much greater transparency for investors about the effectiveness of management's own systems and processes.

THE EVENTS AT HEALTHSOUTH, INC.

HS is a leading provider of outpatient surgery, outpatient diagnostic and rehabilitative healthcare services. These services are provided through a national network of inpatient and outpatient healthcare facilities, including inpatient and outpatient rehabilitation facilities, outpatient surgery centers, diagnostic centers, medical centers and other healthcare facilities. The company's goal is to provide patients, physicians and payers with high-quality healthcare services at

significantly lower costs than traditional inpatient hospitals. Additionally, its national network, reputation for quality, and focus on outcomes enabled the company to secure contracts with national and regional managed care payers. At December 31, 2001, HS operated approximately 1,900 locations in all 50 states, Puerto Rico, the United Kingdom, Canada and Australia.¹

HS had exhibited strong financial performance for a number of years. As Exhibit 1 shows, income and asset growth had been trending upwards, at least through 2000. Richard Scrushy, the company's CEO, was considered the engine driving this success. Indeed, the company's 2001 proxy statement filed with the SEC noted that:

In the period since 1993, HealthSouth, under Mr. Scrushy's leadership, has grown from the fourth-largest provider of rehabilitative services to the largest provider, and since 1995 has established itself as the nation's largest provider of outpatient surgery services and outpatient diagnostic services.

To comply with the provision of SOX that 2001 financial statements be certified by August 15, 2002, HS filed an 8-K with the SEC. This filing made on August 14, 2002 contained certifications of the CEO and CFO for the 2001 financial statements and all subsequent quarterly financial statements. Exhibit 2 contains Scrushy's certification for the 2001 financial statements (See Appendix A, Exhibits 1 and 2).

Shortly after this point, however, financial uncertainties began to surface. Within a year, HS would become known for having committed one of the largest frauds in corporate history.

Presented below is a short chronology of the events as they unraveled²:

- | | |
|---------|---|
| 8/14/02 | HS files 8-K for 2001 financial statements with SEC, including CEO and CFO certifications (see Exhibit 2 for Scrushy certification). |
| 8/27/02 | HS announces a Medicare ruling will reduce claims for outpatient therapy reimbursements, reducing earnings by as much as \$175 million. To counteract this, the company planned a spin-off of its surgery center division into a new publicly traded company. Scrushy would serve as Chair of the board of the new company. In order to allow Scrushy to focus on this, William T. Owens assumes the CEO position of HS. After releasing this information, HS share prices fell almost 60% within two days. |

¹ Company information outlined in this section was obtained from the company website in 2003.

² Unless specified otherwise, information discussed on these dates was obtained from 8-K and 10-Q reports filed by the company with the Securities and Exchange Commission.

- 10/16/02 HS announces the suspension of the surgery center vision spin-off plans.
- 11/14/02 HS files 10-Q for third quarter ending 9/30/02. Owens certifies report as HS CEO.
- 1/6/03 HS announces that Scrusby will resume as CEO and Owens will resume his former role as CFO. In announcing the changes, Scrusby states “Our board of directors and I believe the changes we are announcing today will enable us to provide stronger and more effective leadership in the finance area in response to today’s demanding environment.” Owens added, “When Richard and the board asked me to take over the CFO role again, I was honored to take on this new challenge. I have been involved in finance and accounting for HS for nearly 17 years, and I believe that this is the area in which I can make the greatest contribution to the continuing success of our company.”
- 2/6/03 HS receives subpoena from United States Attorney’s Office seeking production of various documents related to transactions by individuals in HS common stock.
- 2/26/03 HS confirms the SEC has issued a “formal order of investigation.”
- 3/18/03 Agents from the FBI serve a search warrant at HS company headquarters and are provided access to a number of current and historical financial records and other materials. The agents also serve an additional grand jury subpoena on HS on behalf of the United States Attorney’s Office.
- 3/19/03³ SEC accuses Scrusby of “massive accounting fraud,” alleging in a civil case that HS had overstated earnings by a total of \$1.4B since 1999. The SEC also halts trading in HS common shares, citing “materially misleading information in the marketplace.” The SEC asserts that each quarter, Scrusby and senior executives would pick a “desired” earnings per share number, and the company’s accounting staff would then meet to devise ways to inflate earnings and meet the goal. To manufacture income, HS capitalized operating expenses and overestimated reimbursements from health care insurers.
- 3/20/03 HS board places both Scrusby and Owens on administrative leave.
- 3/24/03 HS announces that, in light of SEC and Department of Justice investigations, previously issued financial statements should no longer be relied upon. HS also announces that it has engaged the forensic auditing services of PricewaterhouseCoopers to fully investigate all issues related to allegations concerning the company’s previous financial reports.
- 3/25/03 The New York Stock Exchange applies to the SEC to have HS shares delisted from the exchange. Market makers independently begin to make a market in the company’s common stock on the OTC pink sheets under the name “HLSH.”
- 3/31/03 HS board, by unanimous vote of outside directors, declares employment agreement with Scrusby to be null and void.
- 4/3/03⁴ A former HS assistant controller alleges that the accounting fraud went back to 1997 and 1998 when pretax income was inflated by \$1.1B. Combined with the alleged fraud from 199 to 2002, the total of fraudulent earnings reaches \$2.5B.
- 5/28/04 PricewaterhouseCoopers issues its forensic audit report, documenting fraudulent journal entries made during the period 1996 to 2002 that inflated income by a total of \$2.74B. Exhibit 3 summarizes the

³ Information obtained from “HealthSouth Faked Profits, SEC Charges --- A \$1.4 Billion Overstatement Cited as CEO is Accused of Ordering ‘Massive Accounting Fraud’” by Deborah Solomon, Ann Carms, and Chad Terhune, published in the *Wall Street Journal* on March 20, 2003.

⁴ Information obtained from “HealthSouth Case Unveils a Shock Strategy --- U.S. Prosecutors Announce Round of Guilty Pleas in Investigation; New Scrusby Team Denies Charges” by Ann Carrns, Carrick Mollenkamp, Deborah Solomon, and John R. Wilke, published in the *Wall Street Journal* on April 4, 2003.

various categories of fraudulent activity identified. The report also documents examples where the committee “identified other accounting issues and transactions which, while not necessarily the result of intentional fraud, nevertheless were sufficiently aggressive or questionable to warrant discussion.” These accounting issues and transactions, totaling \$632M, are summarized in Exhibit 4.

(See Appendix A, Exhibits 3 and 4).

THE TRIAL

The Federal criminal trial of Mr. Scrushy began in January 2005 and on June 28, 2005, he was acquitted of all remaining 36 counts related to the HS fraud, including one count under SOX (falsely certifying a report with the SEC). After the trial, many jurors discussed that the government’s case was hindered by the credibility of key witnesses such as William T. Owens, former chief financial officer of HS. Mr. Owens was one of 15 HS employees who had pleaded guilty to federal criminal charges related to the fraud. In addition, he was delinquent in filing federal tax returns for nine years and had lied about a \$1.3 million loan from HS.

After the trial, Mr. Scrushy remained the largest individual shareholder of HS with 3.7 million shares. But the any efforts to remain on the board would be challenged by the company. Bob May, HS Chairman, stated “The new board and new management team remain appalled by the multibillion-dollar fraud that took place under Mr. Scrushy’s management and the environment under which such fraud could occur.”⁵

DISCUSSION QUESTIONS

1. Under the requirements of Section 404 of the SOX and PCAOB Auditing Standard No. 5 (AS 5), *An Audit of Internal Control Over Financial Reporting That is Integrated with An Audit of Financial Statements*, a public accounting firm is to issue a written report on its assessment of the internal controls of its registered publicly traded clients.

a) How specifically does the evaluation of a client’s internal control as required by AS 5 differ from what the evaluation of internal control that is required in order to perform a financial statement audit alone? The standard may be obtained at:

http://www.pcaob.org/Rules/Rules_of_the_Board/Auditing_Standard_5.pdf

⁵ Quote of Mr. May obtained from “HealthSouth’s Scrushy is Acquitted” by Dan Morse, Chad Terhune, and Ann Carns, published in the *Wall Street Journal* on June 29, 2005.

b) Based on your answer to part a) above, how do you think an audit of HS' internal control over financial reporting might have helped to prevent the fraud?

2. Part of complying with AS 5 involves the identification of what are termed significant deficiencies and judging whether or not they aggregate into what may be termed a material weakness in the client's system of internal controls. What are the definitions of the terms 'significant deficiency' and 'material weakness' as they apply to this standard? What practical difficulties do you see with the implementation of this process and the determination of such a judgment?

3. PWC was hired to perform a special audit of HS in order to help determine the specific nature and extent of the fraud. A summary description their findings as filed with the SEC may be found at: <http://www.sec.gov/Archives/edgar/data/785161/000095017204001357/ex99-1hsc.txt> Obtain and review this report. Identify the significant deficiencies in HS's internal control that enabled the perpetration of the fraud. Do you believe that these significant deficiencies aggregate to a material weakness? Explain.

4. Assume that there was indeed a material weakness in HS's system of internal control, and that HS management had previously indicated to its public accounting firm that it felt its system of internal control over financial reporting was effective. Draft a report that expresses an adverse opinion both on management's assessment of the system of internal control and of the effectiveness of internal control over financial reporting itself. Be sure to include at least one of the specific significant deficiencies identified in Question 3 (whether you considered it to be a material weakness in answering that question or not) in drafting your report. Use your auditing textbook and the guidance available at http://www.pcaobus.org/Rules/Rules_of_the_Board/Auditing_Standard_5.pdf to assist you.

5. In spite of the massive fraud that took place while he was the CEO of HS, Scrushy was acquitted of criminal charges related to it. How do you think this may affect investor perceptions of the effectiveness of SOX? Was this a case of the prosecution being ineffective, or is the legislation not as strong as it needs to be? Scrushy then asked to have his old job back—discuss the implications for HS if they had agreed to this. Would you have hired him back?

Appendix A

EXHIBIT 1

Selected Financial Statement Information for HealthSouth

(all figures for full year except 2002 is first nine months ending 9/30; net income and total assets in thousands)

	1998	1999	2000	2001	2002
Net Income for year (to 9/30 for 2002)	\$46,558	\$76,517	\$278,465	\$202,387	\$135,704
Total Assets (12/31 all years except 9/30 for 2002)	\$6,778,209	\$6,890,484	\$7,380,440	\$7,579,237	\$7,930,465
EPS	\$0.11	\$0.19	\$0.72	\$0.52	\$0.34

EXHIBIT 2
CEO Certification
Abstracted from Form 8-K filed with Securities and Exchange Commission

STATEMENT UNDER OATH OF PRINCIPAL EXECUTIVE OFFICER AND PRINCIPAL FINANCIAL OFFICER REGARDING FACTS AND CIRCUMSTANCES RELATING TO EXCHANGE ACT FILINGS

I, Richard M. Scrushy, Chairman of the Board and Chief Executive Officer of HEALTHSOUTH Corporation, state and attest that:

(1) To the best of my knowledge, based upon a review of the covered reports of HEALTHSOUTH Corporation, and, except as corrected or supplemented in a subsequent covered report:

- o no covered report contained an untrue statement of a material fact as of the end of the period covered by such report (or in the case of a report on Form 8-K or definitive proxy materials, as of the date on which it was filed); and*
- o no covered report omitted to state a material fact necessary to make the statements in the covered report, in light of the circumstances under which they were made, not misleading as of the end of the period covered by such report (or in the case of a report on Form 8-K or definitive proxy materials, as of the date on which it was filed).*

(2) I have reviewed the contents of this statement with HEALTHSOUTH Corporation's audit committee.

(3) In this statement under oath, each of the following, if filed on or before the date of this statement, is a "covered report":

- o the Annual Report on Form 10-K for the year ended December 31, 2001 of HEALTHSOUTH Corporation;*
- o all reports on Form 10-Q, all reports on Form 8-K and all definitive proxy materials of HEALTHSOUTH Corporation filed with the Commission subsequent to the filing of the Form 10-K identified above; and*
- o any amendments to any of the foregoing.*

/S/ RICHARD M. SCRUSHY

Signature

Richard M. Scrushy

Printed Name

Date: August 14, 2002

EXHIBIT 3
Categories of Fraudulent Entries
Abstracted from the Forensic Audit Report

	Increase in <u>Income</u> ⁶
Reduction of contractual allowances or expenses	\$2,203
Acquisition accounting	421
Bonus accounting	52
Investment accounting	17
Facility contractual accounting	19
Third-party transaction accounting	<u>29</u>
Total	<u>\$2,741</u>

⁶ Income reported is in millions and represents income before minority interest and taxes.

EXHIBIT 4
Other Potential Accounting Misstatements
Abstracted from the Forensic Audit Report

	Increase in <u>Income</u> ⁷
Capitalization:	
Operating expenses and start up costs	\$156
Inventory/supplies	49
“Borrowed” depreciation	8
Assets at closed facilities	62
Leased assets	82
Audit adjustments	53
Facility contractual accounting:	
Reported under reserve	49
Recalculated reserve	155
Employee and other loans	<u>18</u>
Total	<u><u>\$632</u></u>

⁷ Income reported is in millions and represents income before minority interest and taxes.

CASE OBJECTIVES AND USE

This case introduces students to the requirements of the Sarbanes-Oxley Act of 2002 (SOX), arguably the most important legislation impacting financial reporting since the Federal Securities Acts of 1933 and 1934. Students are provided information surrounding the events that led up to an accounting fraud at HealthSouth Corporation (HS) where income was overstated in excess of \$2.7 billion. Also provided are excerpts from a special forensic audit report concerning HS, which highlights many deficiencies in their financial reporting processes. Using this information, students gain exposure to parts of the Act designed to prevent such abuses in the future.

In addition, this case affords students the opportunity to identify significant deficiencies in internal controls over financial reporting and to consider the extent to which these deficiencies create a material weakness that will necessitate the rendering of an adverse opinion on controls consistent with Section 404 of SOX. The case is useful in expanding auditing students' understanding of SOX.

HEALTHSOUTH CORP.: THE FIRST TEST OF SARBANES-OXLEY

Teaching Notes

Summary

This case allows students to explore the effects of the implementation of PCAOB Auditing Standard No. 5 *An Audit of Internal Control Over Financial Reporting That is Integrated with An Audit of Financial Statements*. Its major objectives are to introduce students to the specifics of the implementation of the Sarbanes-Oxley Act (SOX) and its impact on audit reporting. One question explores the similarities and differences between the examination of a client's internal control in an integrated audit, as opposed to a purely financial statement audit. Another looks at some of the terms that are involved in the application of Section 404 of SOX with regard to assessment of a client's evaluation of its internal control. There is also a question directing the student to review the SEC filing associated with PricewaterhouseCoopers' special audit undertaken to identify the extent and magnitude of the fraud at HS. The fourth question asks the student to draft an integrated audit report incorporating specific findings from the special audit undertaken by PricewaterhouseCoopers. The final has students assess the perceived effectiveness of SOX and whether HS should have considered returning Mr. Scrushy to the CEO position after his acquittal. The case is designed for use in an introductory auditing class, offering a specific example of fraud in an audit client and the potential implications of SOX to prevent such fraud in the future.

Epilogue

On April 13, 2005, the U.S. Securities and Exchange Commission hosted a roundtable discussion on the implementation of Section 404 requirements during the first year. As discussed in the Commission's Statement (2005-74) dated May 16, 2005, two outcomes were evident. "First, compliance with Section 404 is producing benefits, including a heightened focus on internal controls at the top levels of public companies. We hope that this focus will produce better financial

reporting. Second, implementation in the first year also resulted in significant costs. While a portion of the costs likely reflect start-up expenses from this new requirement, it also appears that some non-trivial costs may have been unnecessary, due to excessive, duplicative or misplaced efforts. As a result, we heard the implementation process needs to be improved going forward, so that it is more effective and efficient.” Estimates of the costs of implementation do indeed appear to be substantial. For example, the Financial Executives Institute estimates that “companies will spend an average of \$3 million apiece to comply with the rule. Companies with more than \$5 billion in revenue are expected to spend about \$8 million on average, while companies with less than \$100 million in revenue are expected to spend about \$550,000 on average.”⁸

As of the writing of this case, there were 2,963 accelerated filers with completed Section 404 audits. Independent auditor reports on internal controls noted material weakness(es) for 363 (12.25%) of these companies. Material weakness disclosures for these firms include the following as the most common *general* areas of concern: adjusting journal entries, restatement of financial statements, and inadequate resources and expertise in the accounting function to perform the tasks assigned. The most common financial statement issues resulting in material weakness(es) include income tax, revenue recognition, leases, and inventory/cost of sales.

Meanwhile, on December 5, 2005, Mr. Scrusy announced that he would resign as a director of HS. “I recognize that I will not be part of the Board or the management team of HealthSouth. Still, I built the company and remain a major shareholder for the company and regardless of what anyone says, I want the best for HealthSouth.”⁹ On December 15, 2006, Mr. Scrusy sued HS for firing him seeking \$70 million for accrued pay, bonuses, unreimbursed business expenses, and severance pay.

⁸ “Accounting Rule Exposes Problems but Draws Complaints About Costs,” *Wall Street Journal*, March 2, 2005.

⁹ Quote of Mr. Scrusy obtained from “Scrusy to Quit HealthSouth Board” by Evan Perez, published in the *Wall Street Journal* on December 6, 2005.

But Mr. Scrushy's legal fortunes ended on June 29, 2006 when he was convicted of paying \$500,000 in bribes in return for a spot on a state regulatory panel. This loss in federal court could lead to 20 years of jail time. Meanwhile the lawsuits between Mr. Scrushy and HS continued. On August 25, 2006, Mr. Scrushy was ordered to repay \$47.8 million in bonuses he received during the years the fraud occurred. Then on September 13, 2006, HS was ordered to pay \$17 million for the legal defense team of Mr. Scrushy in the original criminal trial. These final two claims were settled on November 29, 2006 without the final terms being disclosed.

The company spent years re-examining their records and restating results. After filing these restatements and catching up on current SEC filings, the company rejoined the New York Stock Exchange on October 26, 2006 with the ticker symbol HLS.

Answers to Discussion Questions

1. Under the requirements of Section 404 of the SOX and PCAOB Auditing Standard No. 5 (AS 5), *An Audit of Internal Control Over Financial Reporting That is Integrated with An Audit of Financial Statements*, a public accounting firm is to issue a written report on its assessment of the internal controls of its registered publicly traded clients.

a) How specifically does the evaluation of a client's internal control as required by AS 5 differ from what the evaluation of internal control that is required in order to perform a financial statement audit alone? The standard may be obtained at:
http://www.pcaob.org/Rules/Rules_of_the_Board/Auditing_Standard_5.pdf

b) Based on your answer to part a) above, how do you think an audit of HS' internal control over financial reporting might have helped to prevent the fraud?

a) Prior to the issuance of SOX and AS 5, an auditor was only required to obtain an understanding of a client's system of internal control, and to document this understanding in the working papers. Past that point, an auditor was faced with a choice between what has been termed a substantive strategy vs. a reliance strategy (e.g., Messier, Glover and Prawitt, 2008). If the auditor believed that testing of controls was not cost effective in terms of being able to lower assessed

control risk and thus perform reduced substantive testing, then control risk could be assessed at maximum and a strategy based on extensive detailed substantive testing would be pursued. If, on the other hand, the auditor believed that important controls over financial reporting could be identified and tested to ensure their functioning, then such testing would be performed. If controls were indeed functioning as intended then control risk could be reduced and less detailed substantive testing could be performed, allowing the audit to be completed with lesser expenditure of resources.

For audits performed of non-SEC clients, this is still the minimum level of evaluation of internal control that must be performed. Section 404 of SOX, however, requires that management of large public companies (currently, those worth over \$75 million, and for all publicly traded firms for fiscal years ending on or after June 15, 2010. See <http://www.sec.gov/news/press/2009/2009-213.htm> for further details) must prepare a report on the quality of the internal controls over their financial reporting process. The independent public accounting firm that is auditing the financial statements must also attest to the report on internal control provided by client management. This represents a significant increase in effort and responsibility both for clients and public accounting firms.

The specific steps the auditor must follow in the audit of internal control over financial reporting are to: (1) plan the engagement, (2) evaluate management's assessment process, (3) obtain and document an understanding of internal control, (4) evaluate the design effectiveness of internal control, (5) test and evaluate the operating effectiveness of internal control, (6) test and evaluate the operating effectiveness of internal control, and (7) form an opinion on the effectiveness of internal control (Messier, Glover, and Prawitt, 2008).

b) While student answers are apt to vary to some degree, common elements of a "correct" answer should include a discussion of the increased scrutiny that HS would have received during

the principal years of the fraud if there had been an audit over its system of ICFR, as well as the increased level of responsibility that EY would have felt given that it would have been auditing not only the financial statements of HS, but also management's assertion concerning ICFR as well as the operating effectiveness of HS's ICFR. While there is of course no guarantee that fraudulent misstatements would not be detected by an integrated audit, the instructor can use this question to guide class discussion over whether it at least provides a greater degree of assurance than that provided by an audit solely of the financial statements themselves.

2. Part of complying with AS 5 involves the identification of what are termed significant deficiencies and judging whether or not they aggregate into what may be termed a material weakness in the client's system of internal controls. What are the definitions of the terms 'significant deficiency' and 'material weakness' as they apply to this standard? What practical difficulties do you see with the implementation of this process and the determination of such a judgment?

AS5 defines and provides examples of significant deficiencies and material weaknesses in its Appendix A at http://www.pcaobus.org/documents/rules_of_the_board/Standards%20-%20AS2.pdf :

A **significant deficiency** is a deficiency, or a combination of deficiencies, in internal control over financial reporting that is less severe than a material weakness, yet important enough to merit attention by those responsible for oversight of the company's financial reporting.

A **material weakness** is a deficiency, or a combination of deficiencies, in internal control over financial reporting, such that there is a **reasonable possibility** that a material misstatement of the company's annual or interim financial statements will not be prevented or detected on a timely basis.

Instructors can take the "practical difficulties" in implementation portion of the question in a number of different directions. One of the foremost difficulties will be in the consistent interpretation of many of the uncertainty expressions contained in not only the two terms defined above, but throughout Section 404 of SOX. It is not clear how well individual auditors will be able to map these uncertainty expressions into their judgment and decision-making processes.

Research has shown that auditors' frequency knowledge is affected by a number of factors, including experience (e.g., Nelson, Libby and Bonner, 1995; Bonner, Libby and Nelson, 1996), so until further experience is gained by practitioners in the application of SOX and provisions such as these it is not at all clear how well auditors will be able to interpret events with a low likelihood of occurrence or whether these interpretations will be consistent between clients, industries or across different public accounting firms.

3. PricewaterhouseCoopers was hired to perform a special audit of HS in order to help determine the specific nature and extent of the fraud. A summary description their findings as filed with the SEC may be found at:

<http://www.sec.gov/Archives/edgar/data/785161/000095017204001357/ex99-1hsc.txt>

Obtain and review this report. Identify the significant deficiencies in HS's internal control that enabled the perpetration of the fraud. Do you believe that these significant deficiencies aggregate to a material weakness? Explain.

The instructor should note, as does PricewaterhouseCoopers in its special audit report, that a special audit such as this is not an audit of financial statements conducted in accordance with generally accepted auditing standards, nor is it an examination of a client's system of internal control conducted in accordance with AS 5. It does, however, provide a useful surrogate for the latter insofar as PricewaterhouseCoopers did undertake an examination of HS's controls, and in so doing identified many weaknesses the student can examine for materiality. As page 8 notes, "the fraud was accomplished by making over \$2.7 billion in false or unsupported entries in the Company's accounting systems." Since this amount exceeds the reported retained earnings balance of HS it is hard to see how it could be other than a "material weakness" from any reasonable standpoint, so all students should reach the same conclusion. Among the control weaknesses PricewaterhouseCoopers identified areas follows [note that while this list is representative and detailed, it is not an exhaustive summary of all the weaknesses identified]:

(pages 10-11): “During the second quarter of 1996, HealthSouth began what was to become a systematic pattern of reducing contractual adjustments—i.e., narrowing the gap between standard charges and anticipated reimbursements—even though the applicable contractual adjustments had not actually changed and there was otherwise no support for the reductions. This practice continued without interruption in every reporting period through mid-2002. At the same time, the company reclassified a number of operating expenses to make it appear as if the expenses were never incurred.”

(pages 11-12): “The alteration of HealthSouth’s income statements also required balance sheet manipulations. These manipulations resulted in unsupported entries that affected virtually all of the Company’s balance sheet asset accounts.”

(pages 12-13): “For the most part, improper accounting entries were made after ‘first run’ consolidation, rather than in conjunction with proper entries made in the ordinary course of the Company’s daily operations. The improper entries shared other characteristics as well. They typically were in large dollar amounts, routinely carried generic, non-descriptive explanations, and often were not accompanied by contemporaneous documentation or other support. Many were extraordinarily long—often exceeding 200 lines—and were entered into the accounting system through external uploads. Improper entries frequently were booked to inter-company and corporate suspense accounts and otherwise affected accounts not normally associated with one another. Many entries self-reversed during successive reporting periods. Finally, many improper entries contained designated letter prefixes, and many of the employees who recorded them were at least generally aware that they were incorrect or unsupported.”

(page 14): “Unexpected or unexplained revenue increases and expense reductions, which improved the earnings of individual facilities, became so institutionalized at HealthSouth that they were referred to by corporate accountants as ‘management entries’ and by operations personnel as ‘gifts,’ ‘pixie dust,’ ‘fairy dust,’ or ‘candy.’”

(page 16): “To account for assets that did not exist, and thus would not have been recorded in HealthSouth’s payable system or processed in its general ledger system in the normal fashion, fictitious assets were added to the fixed asset list during monthly reconciliations.”

(page 17): “Given the method by which non-existent fixed assets were allocated to a particular facility’s books, some AP SUMMARY entries had dollar values exceeding the cost of any asset the facility would have been likely to acquire.”

(page 18): “Concealing the overstatement of HealthSouth’s reported cash balances by approximately \$374 million presented similar challenges. Receipts from the Company’s nearly 2,000 bank accounts were swept daily into a corporate consolidation account, known as the 1015 Account, before being transferred to a corporate disbursement account. Funds swept into the 105 Account were recorded through general ledger entries based on monthly reconciliations prepared by the Company’s cash department. Between 1999 and 2002, a former employee responsible for preparing these reconciliations regularly misstated either the 1015 Account general ledger balance or transactional activity in the 1015 Account.”

(page 22): “Although HealthSouth never established a formal employee incentive compensation plan, it paid discretionary bonuses of more than \$78 million between 1999 and 2002. By means of

improper accounting entries, the Company failed to record nearly two-thirds of its bonus expense, again improving its reported income.”

(page 23): “Between 1993 and 2000 the Company HealthSouth purchased 1.7 million shares of Caremark Rx (‘Caremark’) common stock in the public securities markets. The Company sold its Caremark stock in June 2001, realizing a substantial profit and initially recording some \$19 million in income attributable to the sale. Within days of the sale, however, the Company reclassified this income to contractual adjustments, which were then reduced as if the Company had received \$19 million in additional operating revenue. At the same time, the Company altered its investment accounts to reflect that it still held 1.7 million shares of Caremark, even though it no longer owned, and never reacquired, those shares. One year later the Company again recorded a ‘sale’ of Caremark stock, this time booking income of more than \$17 million attributable to the sale.”

(page 25): “And, while the Company thereafter made timely mark-to-market adjustments of its Healthtronics stock, those adjustments—all of which reflected increases in market value over recorded value—were calculated as if the Company held more than twice the number of shares it actually owned.”

(page 27): “In December 2002, the Company sought to avoid a write-off of the overstatement [of a receivable] by recording an increase of nearly \$29 million in a capital asset account and a corresponding reduction of the Source Medical receivable.”

(pages 27-28): “Between 1998 and 2002, HealthSouth’s reported income was affected by transferring a variety of current expenses to property, plant and equipment accounts, reclassifying those expenses as capital assets, and depreciating them over time. As described below, these policies allowed the Company to defer recognizing over \$200 million in expenses.”

(page 30): “Company accountants...automatically reclassified any expenditure exceeding \$500 as a capital asset. The reclassified assets typically were described only generically—as for example, ‘surgical instruments’ or ‘medical equipment’—and without regard to whether they remained in use at a facility. These wholesale reclassifications almost certainly resulted in capital asset treatment for items that did not qualify for such treatment under Generally Accepted Accounting Principles. Moreover, the Company’s approach provided no means of identifying items that, even if properly classified as capital assets, ultimately were disposed of and thus should not have remained in the Company’s fixed asset listing.”

(page 35): “...the Company’s operating divisions employed no consistent methodology to estimate or establish contractual adjustments and allowances in the first place. Moreover, even if a particular division had adopted a standard policy for determining contractual adjustments, individual facilities at times calculated the adjustments in a manner that departed from that policy, often with the result that earnings were favorably affected.”

Instructors should also refer students to the final three pages of PWC’s special audit report, which outlines over two dozen suggested improvements in HealthSouth’s internal control over its

financial reporting process. They conclude their report by noting that:

“However useful they may be, no accounting procedures or internal control mechanisms can be truly effective in the absence of an appropriate corporate environment. That environment must be one in which there is an explicit commitment by management, the Board, and all others with accounting or financial responsibility to accurate, truthful, and transparent financial reporting. It is an environment in which management and the Audit Committee must be attentive to any sign of unusual or improper activity, and in which there is no tolerance for efforts to manage earnings or otherwise massage financial results. It is an environment in which the Company must swiftly and unequivocally halt any such effort thereby reinforcing a culture in which fidelity to the truth is the foremost objective and financial misreporting is unthinkable.”

This should hopefully go without having to add that such an environment does not exactly describe HS under Scrusby’s leadership.

4. Assume that there was indeed a material weakness in HS’s system of internal control, and that HS management had previously indicated to its public accounting firm that it felt its system of internal control over financial reporting was effective. Draft a report that expresses an adverse opinion both on management’s assessment of the system of internal control and of the effectiveness of internal control over financial reporting itself. Be sure to include at least one of the specific significant deficiencies identified in Question 3 (whether you considered it to be a material weakness in answering that question or not) in drafting your report. Use your auditing textbook and the guidance available at http://www.pcaobus.org/Rules/Rules_of_the_Board/Auditing_Standard_5.pdf to assist you.

As noted in the link referenced in the question, the PCAOB has provided reporting guidance to registered firms for the issuance of an opinion on both internal control over financial reporting and on the financial statements themselves. Auditing textbooks now also include examples of such opinions in their chapters covering the integrated audit. The specifics of a student answers will depend on the material weaknesses they have identified in Discussion Question 3 and then chose to reference in their answer to this question. Instructors should make certain to reinforce to students that this is a dual opinion over both management’s assessment of the system of internal control and of the effectiveness of internal control over financial reporting itself, as noted in the question (See Appendix B, Exhibit TN-1).

AS5 does permit the issuance of an unqualified opinion on the financial statements themselves even when an opinion such as this has been issued regarding internal controls. Instructors may wish to use this as a starting point for classroom discussion about the likelihood of such a combination ever taking place, and the degree of comfort that a public accounting firm might have over issuing a standard unqualified opinion on the financial statements of a large SEC client with one or more material weaknesses in its system of internal control. Another good point to bring up here is that if Ernst & Young had undertaken an examination of controls such as that made by PricewaterhouseCoopers in its special audit, or as mandated by AS5, it seems quite unlikely that the fraud perpetrated by HS would have achieved the duration and/or magnitude that it did.

5. In spite of the massive fraud that took place while he was the CEO of HS, Scrushy was acquitted of criminal charges related to it. How do you think this may affect investor perceptions of the effectiveness of SOX? Was this a case of the prosecution being ineffective, or is the legislation not as strong as it needs to be? Scrushy then asked to have his old job back—discuss the implications for HS if they had agreed to this. Would you have hired him back?

Instructors can use this question as an opportunity to discuss the interaction of investor perceptions, the interests of corporations doing financial reporting, and of legislators charged with ensuring that the public interest is served. That Scrushy was found innocent has generally been seen as an aberration, as many other high-profile executives have been sentenced for their roles in fraudulent financial reporting schemes in the post-SOX era. As of this writing, the PCAOB has modified certain of the provisions the original AS2 with AS5, and within a year, all publicly traded firms will have to comply with the requirements of AS5. There has been no general movement toward the repeal of SOX for its ineffectiveness in improving the quality of internal control over financial reporting.

The primary implications of HS hiring Scrushy back would have revolved around investor and employee perceptions, with likely resulting negative repercussions both for the market value of

the firm's equity and for workplace morale. Further, it would represent a serious threat to an important element of a firm's internal control, its control environment, or the "tone at the top."

Appendix B

Teaching Notes Exhibit TN-1

Report of Independent Registered Public Accounting Firm

We have audited management's assessment, included in the accompanying "Report On Internal Controls Over Financial Reporting", that HealthSouth maintained effective control over financial reporting as of December 31, 2001, based on criteria established in *Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)*. HealthSouth Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management's assessment and an opinion on the effectiveness of the company's internal control over financial reporting based on our audit.

We have conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatement. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

A material weakness is a control deficiency, or combination of control deficiencies, that results in a more than remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected. We have identified the following material weaknesses that have not been identified as material weaknesses in management's assessment:

[Students would list identified weaknesses here, hopefully in very summarized form.]

These material weaknesses were considered in determining the nature, timing and extent of audit tests applied in our audit of the 2001 financial statements, and this report does not affect our report dated February 14, 2002 on those financial statements.

In our opinion, because of the effect of the material weaknesses described above on the achievement of the objectives of the control criteria, management's assessment that HealthSouth Company maintained effective internal control over financial reporting as of December 31, 2001, is not fairly stated, in all material respects, based on the COSO control criteria. Also, in our opinion, because of the effect of the material weaknesses described above on the achievement of the objectives of control criteria, HealthSouth Company has not maintained effective internal control over financial reporting as of December 31, 2001, based on the COSO control criteria.

P. W. Coopers

Gainesville, AL

February 14, 2002

References

- Bonner, S.E., R. Libby, and M. Nelson. 1996. Using Decision Aids to Improve Auditors' Conditional Probability Judgments. *Accounting Review* 71 (April): 221-240.
- Messier, W., S. Glover, and D. Prawitt. 2008. *Auditing and Assurance Services: A Systematic Approach*. McGraw Hill Irwin.
- Nelson, M. , R. Libby, and S. E. Bonner. 1995. Knowledge structure and the estimation of conditional probabilities in audit planning. The *Accounting Review* 70 (January): 27-47.
- Securities and Exchange Commission (SEC). 2009. "Small Public Companies to Begin Providing Audited Assessment of Internal Controls Over Financial Reporting in Nine Months." <http://www.sec.gov/news/press/2009/2009-213.htm>.

The opinions of the authors are not necessarily those of Louisiana State University, the E.J. Ourso College of business, the LSU Accounting Department, or the Editor-In-Chief.