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SEC Alleges HealthSouth Faked $1.4 Billion in Profits

Agency Says CEO Scrushy Ordered Accounting Entries That Were False

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Staff Reporters of THE WALL STREET JOURNAL

Eight days ago, the former chief financial officer of **HealthSouth** Corp. approached federal prosecutors in Alabama and told them something shocking: Senior executives at the health-care giant had been falsifying financial results for more than five years.

HealthSouth and some of its officials were already under investigation by three federal agencies for possible insider trading. But Weston L. Smith's statements to the U.S. attorney in Birmingham went far beyond that. He said HealthSouth's founder, chairman and chief executive, Richard Scrushy, met regularly with him and an another executive and told them to inflate earnings to meet Wall Street estimates.

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THE ALLEGATIONS

• See the full text of the SEC's charges against HealthSouth and its CEO[5], by arrangement with FindLaw (www.findlaw.com[6]).

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The get-togethers were known as "family" meetings, Mr. Smith said in a plea agreement, and bogus accounting entries were known as "dirt" to fill a "gap" or a "hole" in the numbers.

Wednesday, the Securities and Exchange Commission accused HealthSouth and Mr. Scrushy of "massive accounting fraud," alleging in a civil case that they had overstated earnings by a total of $1.4 billion since 1999. Mr. Smith pleaded guilty to four federal criminal charges and was released on bond. He was CFO until last August, when he took a different corporate role.

Mr. Scrushy had returned to the HealthSouth CEO post only two months ago, after a six-month period during which a law firm's inquiry found the insider-trading questions groundless. The onetime gas-station attendant had made a fortune by targeting a health-care niche and shrewdly riding trends in demographics and Medicare reimbursement. His outpatient rehabilitation and surgery-services business, founded in 1984, made HealthSouth into a kind of McDonald's of outpatient care. In his native Alabama, the 50-year-old Selma native was known as a colorful entrepreneur who had spread his vast wealth with contributions to local charities.

Mr. Scrushy took a personal role in building HealthSouth's brand, singing with his country-music band, the Dallas County Line, at health-care conventions and charity functions. The board rewarded him well: He earned a salary of nearly $4 million and a $6.5 million bonus in 2001, according to a proxy statement.

According to the SEC, Mr. Scrushy "has personally profited from the scheme to artificially inflate earnings." It said Mr. Scrushy had sold at least 7.8 million shares of HealthSouth since 1999 and got a $6.5 million bonus that was based on the company's false profits.


Richard Scrushy

An spokesman for the company said it would comment "within an appropriate amount of time." Mr. Scrushy couldn't be reached Wednesday. During the insider-trading probes, which involved the Federal Bureau of Investigation as well as the SEC and Justice Department, Mr. Scrushy has asked the board to place him on administrative leave and reassign his responsibilities, his lawyers said, so he can concentrate on responding to the allegations and the company can continue to cooperate with authorities. "Mr. Scrushy was shocked and surprised at the unexpected actions taken by the government over the past two days," said the lawyers, William Clark and Mark White, who said both the company and its chairman had long been cooperating with the SEC investigation. During the insider-trading probe, which also involved the Federal Bureau of Investigation, Mr. Scrushy said all of his trading was proper.

"HealthSouth's fraud represents an appalling betrayal of investors," said the SEC's enforcement director, Stephen M. Cutler. The "standard operating procedure," he said, "was to manipulate the company's earnings to create the false impression that the company was meeting Wall Street's expectations." (See a related article[1].)

In the fall of 1997, the SEC said, company accounting personnel appealed to Mr. Scrushy to end the earnings manipulation. The agency said Mr. Scrushy refused. According to the SEC, he said, "Not until I sell my stock."

The SEC halted trading in HealthSouth's shares, citing "materially misleading information in the marketplace." HealthSouth's most recent SEC filing had what the agency considers false information, meaning the fraud was continuing, say individuals familiar with the matter. Before the halt, HealthSouth stock traded at $3.91 a share, down four cents. Its 52-week high is $15.69 and all-time high, in 1998, was $30.56. The company's market value has fallen to $1.55 billion from a high of nearly $12 billion.

How well HealthSouth will weather this scandal is unclear, and may depend partly on whether a credible leader can step in for Mr. Scrushy and win the backing of the company's lenders, employees and referring physicians. The health-care giant has valuable facilities in all 50 states and a few overseas. They include 1,229 outpatient rehabilitation clinics, 203 outpatient surgery centers and 117 rehabilitation hospitals, plus 127 diagnostic-imaging clinics -- handling two million patient visits a quarter.

The allegations are a dramatic turn for investors and HealthSouth's board, which in January brought Mr. Scrushy back to his chief executive post. He had stepped down from that position, while remaining chairman, to oversee a spinoff of the surgery-center business, a plan abandoned in October. The moves came amid an investigation by the SEC into the timing of a 2002 profit warning and stock sales by Mr. Scrushy.

On Tuesday night, a fraud SWAT team assembled in Birmingham. Justice Department and SEC officials from the Corporate Fraud Task Force flew in from Washington and, together with the FBI and the Birmingham U.S. attorney's office, searched HealthSouth's offices for evidence of accounting fraud. Armed with a search warrant, the team of about 10 people hauled off paper files, computer hard drives and other items, according to people familiar with the events.

Alice H. Martin, the U.S. attorney in Birmingham, said no date has been set for sentencing of Mr. Smith, the former chief financial officer. He pleaded guilty to conspiracy to commit wire fraud and securities fraud and to making false filings with the SEC.

Among the false filings was a certification of the truth of financial statements HealthSouth sent to the SEC. That violated the Sarbanes-Oxley Act, passed last year to overhaul corporate governance after a wave of corporate financial scandals. The SEC began requiring all finance chiefs and chief executives to attest to the accuracy of their financial reports. Mr. Smith signed his name to a filing in August 2002.

Justice Department officials said this is believed to be the first false-certification criminal charge brought under the law. Mr. Scrushy, who also signed a financial report in August 2002, could face a similar charge, according to people familiar with the matter.

Ms. Martin said Mr. Smith stepped aside as CFO last August to head in-patient operations because "he no longer wanted to file false statements." Mr. Smith's lawyer, David McKnight, said his client has accepted responsibility for his actions. "He is doing the right thing by fully cooperating with the government's investigation. He is trying to do what he can to get HealthSouth back on the right track," Mr. McKnight said.

Investigators stressed that the criminal and regulatory investigations continue. People close to the situation said additional charges are expected. Mr. Scrushy, who hasn't been charged criminally, could face indictment in a matter of weeks, these people said, and is also likely to face additional civil charges from the SEC, possibly including insider trading.

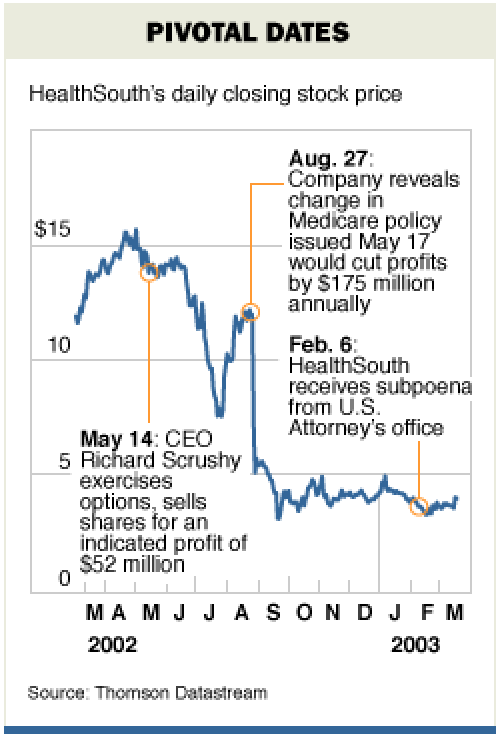
The SEC is looking beyond Mr. Scrushy. "This is not a fraud, given its magnitude, that one or two people can effectuate on [their] own," said Richard P. Wessel, district administrator of enforcement for the SEC in Atlanta. The SEC hasn't brought charges against Mr. Smith.

The SEC asserted that each quarter, Mr. Scrushy and senior executives would pick a "desired" earnings-per-share number, and HealthSouth's accounting staff would then meet to devise ways to inflate earnings and meet the goal. "These meetings were known as 'family' meetings and the attendees were known as the 'family,' " said the Justice Department's complaint against Mr. Smith, filed in federal court in the Northern District of Alabama.

The SEC said the company inflated its earnings by decreasing operating expenses and reducing the amount it estimated it would have to pay to satisfy "contractual adjustments" with health-care insurance providers, such as Medicare.

According to the SEC complaint, the company manufactured more than $800 million of assets to hide real operating expenses. While it's unclear exactly what happened, accounting experts said HealthSouth probably spent money on operating expenses but classified the costs as having paid for fixed assets, such as machinery, which are depreciated over time.

The company also boosted earnings by being overly optimistic about what health-care insurers would pay for treatments. It projected that the gap between what a patient's treatment cost and what an insurer would pay was smaller than it actually was, enabling the company to avoid setting aside a large amount of money to cover uncollectible amounts.



Without this sleight-of-hand, the SEC said, HealthSouth would have reported a loss of $191 million in 1999. Instead, it reported a profit of $230 million. In 2001, the agency alleged, HealthSouth stated its income as $434 million when the actual number should have been $9 million.

To conceal the fraud, according to the SEC, accounting personnel designed false journal entries that they knew would pass muster with outside auditors. The company "knew that its outside auditors only questioned additions to fixed assets at any particular facility if the additions exceeded a certain dollar threshold," so the company was careful not to exceed that dollar amount, the SEC said. When auditors did question an accounting entry, HealthSouth officials created false documents to cover their tracks, according to the SEC.

Ernst & Young, HealthSouth's auditor, said it is cooperating with the SEC's requests for documents. It stated that it appeared HealthSouth's "accounting personnel designed the false journal entries to the income statement and balance sheet accounts in a manner calculated to avoid detection by the outside auditors."

Members of the board's audit committee couldn't immediately be reached for comment. The members for 2001, according to HealthSouth's most recent proxy statement, were investors George Strong and C. Sage Givens, plus Larry Striplin Jr., chairman of Nelson-Brantley Glass Contractors Inc. in Birmingham.

In 2001, HealthSouth agreed to pay $7.9 million to settle Medicare-fraud allegations. The federal government alleged the company overcharged for computers and other equipment bought from a company owned by Mr. Scrushy, his brother and mother.

HealthSouth faced more problems after it said Aug. 27 that a change in payments for outpatient physical therapy from Medicare, the government's health-insurance plan for the elderly, would cut its annual profit by $175 million. Mr. Scrushy and other top company executives said at the time that although Medicare had issued its policy revision on May 17, to take effect July 1, they didn't realize until August the financial impact the change would have on the company.

The disclosure spooked investors, who drove shares down 44% in one day, and led in September to an SEC inquiry into possible insider trading. Mr. Scrushy had exercised options to buy stock on May 14, immediately selling the related 5.3 million shares, for an indicated profit of $52 million. Then, on July 31, he traded 2.5 million shares back to HealthSouth at $10.06 a share to repay a $25 million company loan.

A law firm hired by HealthSouth, Fulbright & Jaworski, said in October that it had conducted a review but found no evidence Mr. Scrushy knew of the impending Medicare change when he made his trades. A spokesman for the law firm declined to comment Wednesday.

To reassure investors worried about close ties between HealthSouth's board and Mr. Scrushy, HealthSouth last fall formed a governance committee and appointed an outside advisory team to recruit three new independent directors. The board named one earlier this month but is still looking for two more.

HealthSouth's future is now uncertain. While HealthSouth had been considered to have valuable assets, particularly its network of surgery centers, potential investors or buyers are unlikely to move anytime soon because of concern over the extent of the alleged accounting fraud.

The spokesman for HealthSouth said that "recent events at HealthSouth's corporate offices do not affect our ability to provide quality patient care. Our operations across the country continue uninterrupted."

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