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See No Evil; Hear No Evil; Speak No Evil: Ernst & Young's Ethical Responsibility for the HealthSouth Fraud

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Ernst & Young Meets "The King of Health Care"

Richard Scrushy, the reputed "king of health care" in the late 1990s, used money invested by business associates and a venture capital firm to found HealthSouth Corporation in Birmingham, Alabama, in 1984. Thanks to guaranteed payments from Medicare and Medicaid, HealthSouth was able to report a respectable $20 million in revenues by 1986. Scrushy knew he had created a highly profitable business model for outpatient health care services, but he needed to make HealthSouth a publicly traded company to finance its future growth. In accordance with Securities and Exchange Commission (SEC) regulations, he hired the accounting firm of Ernst & Young LLP to audit the company's financial statements and supporting records in preparation for the initial public offering (IPO) of HealthSouth's stock. Among other tasks, Ernst & Young investigated HealthSouth's senior managers to ensure their assertions concerning the company's financial condition could be trusted. Thus began a 17-year relationship between Ernst & Young and "the king of health care."

Ernst & Young Ignores Early Signs of Trouble

HealthSouth's profits increased steadily over the next 10 years. By 1994, the company's revenues had topped the billion-dollar mark, and HealthSouth was the acknowledged industry leader for rehabilitative health care services. (Heylar 2003, 83–84) As HealthSouth's independent auditor throughout this period, Ernst & Young always gave the company a clean bill of financial health. Despite the audit firm's vote of confidence in its client's financial statements, documents exist that prove the health care giant was committing fraud as early as 1993. Many critics argue that Ernst & Young's failure to act on early signs of trouble enabled the HealthSouth accounting fraud to continue for years, eventually costing investors at least $2.7 billion.

According to a lawsuit filed by the Retirement System of Alabama (RSA), G. Marcus Neas, Ernst & Young's partner in charge of HealthSouth's 1993 financial audit, knew that the company had overstated its earnings by $27 million. Neas used his knowledge to force a HealthSouth executive to accept his guidance on how to account for a $3 million investment banking fee. Neas allegedly told the executive: "Don't question me on this; I turned my head on the $27 million" (U.S. District Court, Northern District of Alabama, Southern Division 2004a, 5–6, 191) If the allegation is true, it means that Ernst & Young knew HealthSouth was committing fraud as early as 1993 but did nothing to stop it.

Like all accounting firms, Ernst & Young reviewed its relationship with its audit clients on an annual basis to determine whether it should retain those clients for another year. Such reviews are designed to reduce the likelihood of retaining high-risk, fraud-prone clients that may expose the audit firm to costly lawsuits. As part of the client retention process, Ernst & Young hired the Center for Financial Research & Analysis (CFRA), a Maryland-based company, to assess the quality of HealthSouth's earnings in 1993 and 1994. The CFRA report was initially sent to James Conley, Ernst & Young's professional practice director, at the firm's national headquarters in New

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York City. After reading the report's disturbing findings, Conley forwarded the document to Neas with the following note: "*Please do not copy or send the report to the client.* Please review the comments in this report, investigate them as you deem appropriate, and prepare a written report to me by April 19" (Center for Financial Research and Analysis 1995, 1). No one at Ernst & Young knows what actions Neas took, if any (U.S. House of Representatives 2003, part II, 104). He may have done nothing at all.

Perhaps the most prescient, and damning, part of the report was the CFRA assessment of HealthSouth's weak control environment (i.e., its operating philosophy, policies, and standards of conduct that set the ethical tone for the entire organization). Often referred to as "the tone at the top," the control environment reflects management's attitudes and core values. According to the CFRA, the weaknesses in HealthSouth's control environment were rooted in systemic problems with the board of directors, a critical corporate governance safeguard against fraud:

> In general, we feel that the outside members of a public company's Board of Directors should lack any significant affiliation with either [*sic*] the company, its executive officers, or the other Board members outside of their service as directors and their ownership stake in the Company. We also advocate that the Board should be comprised of individuals with a diverse set of experiences and perspectives. Furthermore, we feel that a public company should avoid engaging in any significant related-party transactions with either its directors or officers, or with any relatives of such directors or officers…*HEALTHSOUTH's Board appears lacking with regard to such criteria.* (Center for Financial and Research Analysis 1995, 6; emphasis added)

The CFRA report criticized HealthSouth for maintaining a combined audit and compensation committee at a time when most public companies separated these functions to avoid potential conflicts of interest. Not surprisingly, HealthSouth's audit and compensation committee met just once in 1993, even though similar committees in other public corporations usually met several times per year. The report also expressed concern over Richard Scrushy's extraordinarily generous compensation package as chief executive officer (CEO) and noted the growing shareholder unrest at the board's willingness to increase his stock options:

> It also deserves noting that HEALTHSOUTH had planned last year to implement a new, more generous executive stock option plan—but suffered the indignity of seeing the proposal voted down at a shareholder meeting in December 1994. While we consider it encouraging that the stockholders took this bold step in preventing what they considered an unwarranted transfer of investors' future wealth into certain executive officer pockets, *we are nevertheless troubled by HEALTHSOUTH's attempt to implement a plan that insti-*

tutional investors (who reportedly led the charge against the stock option plan) would consider out of bounds. (Center for Financial and Research Analysis 1995, 7; emphasis added)

When Ernst & Young's representatives were questioned about this report during congressional hearings in November 2003, they could not explain why no one objected to retaining HealthSouth as an audit client (U.S. House of Representative 2003, part II, 104). Neas, the partner who handled the HealthSouth audit in 1993, was long retired.

More Red Flags

From 1995 to 1997, Cahaba Government Benefits Administration, a division of Blue Cross Blue Shield of Alabama, served as HealthSouth's fiscal intermediary. While processing HealthSouth's Medicare claims in 1996 and 1997, Cahaba noticed certain irregularities and started an investigation (U.S. District Court, Northern District of Alabama, Southern Division 2004a, 109). Cahaba determined that HealthSouth had violated Medicare regulations by submitting claims for services provided by unqualified personnel (i.e., support staff) and billing at an individual rate rather than the lower group rate. Ernst & Young should have been suspicious of HealthSouth's billing policies and the management team that put those policies in place, but it was not.

Like many public corporations, HealthSouth has been the subject of several lawsuits over the years. One such suit filed by Dewayne Manning, a former employee, accused the company of improper billing practices and other illegal acts dating back to 1996. In April 1998, a former HealthSouth patient named James Devage sued HealthSouth for overbilling Medicare. Mark Mandel and John Darling, two other patients, filed similar suits, and the federal government eventually joined both of these suits (U.S. District Court, Northern District of Alabama, Southern Division 2004a, 108, 111–112). Even though these suits and the government's participation were a matter of public record, Ernst & Young never considered dropping HealthSouth as a high-risk audit client.

Regulatory Changes Affecting HealthSouth and the Health Care Industry

In addition to ignoring the significance of multiple lawsuits against its audit client, Ernst & Young failed to consider how regulatory changes in the health care industry increased HealthSouth's risk of fraud. In 1997, President Clinton signed the Balanced Budget Act (BBA), a landmark piece of legislation that cut back Medicare payments to companies like HealthSouth by $115 billion over a 5-year period (Haddad, Weintraub, and Grow 2003, 71). This bill triggered a dramatic decrease in revenues throughout the health care industry.

At first, Richard Scrushy, HealthSouth's CEO, insisted that the BBA would have no effect on his company's bottom line. But in September 1998, he suddenly issued a profit warning to HealthSouth's investors and Wall Street analysts (Abelson and Freudenheim 2002). The company's net income plunged 86%, from $330 million in 1997 to $46 million in 1998, and its stock price fell from its previous high of $30.56 on April 20, 1998, to $8.31 on October 7, 1998 (U.S. District Court, Northern District of Alabama, Southern Division 2004b, 6, 8). Many analysts suspect that this setback forced the HealthSouth fraud into high gear. By 2000, the company reported net income of $278 million (HealthSouth Corporation 2001, 26) when, in fact, it should have reported a net loss of $364 million (HealthSouth Corporation 2005, 66).

In 2000, *Modern Healthcare,* a major health care industry journal, surveyed 105 post acute-care providers, including HealthSouth, to determine how these companies were doing financially 3 years after implementation of the BBA (*Modern Healthcare* 2000, 20) The journal found that, except for HealthSouth, the largest health care companies tended to have the worst outcomes. HealthSouth's remarkable profitability at a time when its major competitors were struggling to recover from record losses should have triggered alarm bells at Ernst & Young, but the audit firm made no effort to conduct more extensive audit procedures to determine whether its client was committing fraud.

Whistleblowers on the Internet

HealthSouth's financial reports and industry journals were not the only sources of red flags with regard to HealthSouth's extraordinary profitability. The anonymity of the Internet offered disgruntled HealthSouth employees a relatively safe outlet for their concerns. Between July and October 1998, Peter Krum, a former HealthSouth food service manager, posted a number of defamatory messages on Yahoo! concerning the company, CEO Richard Scrushy, and Scrushy's wife, Leslie (Gibb 1998). Using the screen name, "I Am Dirk Diggler," a not so subtle reference to a porn-star character in the 1997 movie *Boogie Nights,* Krum accused Scrushy of "bilking taxpayers by sapping Medicare reimbursement." He also described the company's managers as "egotistical yahoos" and warned readers that "this house of cards was starting to collapse." Krum, however, proved to be his own worst enemy. In addition to accusing Scrushy of Medicare fraud, Krum claimed that he and Scrushy's wife had an extramarital relationship. HealthSouth's legal department promptly sued Krum for libel and forced him to post an Internet message retracting his claims. Krum's references to Scrushy's wife destroyed his credibility, but it seemed that he knew more about HealthSouth's accounting gimmicks than Ernst & Young knew or admitted knowing.

Another HealthSouth employee, Kimberly Landry, also posted messages about HealthSouth on a Yahoo! bulletin board in the late 1990s (Moss 1999). She changed the spelling of Richard Scrushy's surname to "Screwshe," labeled him a "crook" and a "megalomaniac," and warned readers that HealthSouth's stock was about to fall because the company paid too much money to acquire some of its facilities. In an interview with the *New York Times,* she accused HealthSouth of "keeping the numbers up" by accepting certain Medicare-eligible patients even though it could not provide adequate care for them (Abelson and Freudenheim 2003). HealthSouth initially responded by suing Landry for defamation, but it later dropped the suit citing "an inappropriate use of its resources." No one knows if Ernst & Young read the Internet messages posted by Peter Krum and Kimberly Landry. If the audit firm had read them, it chose not to investigate them.

Notes from a Knowledgeable Shareholder: Smoke and Mirrors

In November 1998, 2 months after HealthSouth warned investors that it would miss the earnings targets that management had earlier projected, an anonymous individual identified only as "Fleeced Shareholder" sent a rather remarkable memo to the following recipients: Ernst & Young's chairman, the American Institute of Certified Public Accountants (AICPA), the Health Care Financing Administration (HCFA), *Business Week,* Morgan Stanley (a nationally known investment bank), Milberg Weiss (a law firm specializing in securities fraud and investor rights), and the SEC's Division of Enforcement.

Unlike the average investor, Fleeced Shareholder obviously knew a great deal about accounting and the "smoke and mirror" gimmicks that accountants sometimes use to cook their books. He began, quite appropriately: "You bring the smoke, I'll bring the mirrors. At least the market has shown the wisdom to devalue HS [HealthSouth] stock. Wish I got out in time." The writer then challenged the propriety of some of HealthSouth's accounting practices. Although the memo contained multiple addressees, Fleeced Shareholder's anger was directed primarily at Ernst & Young:

> How can the HS outpatient clinics treat patients without pre-certification, book the revenue, and carry it after being denied payment?
> How can the company carry tens of millions of dollars in accounts receivable that are well over 360 days?

> How did the E&Y [Ernst & Young] auditors in Alabama miss this stuff?
> Are these clever tricks to pump up the numbers, or something that a novice accountant could catch?
> How is it that a year ago Vencor [a HealthSouth competitor] announced that the BBA [Balanced Budget Act] would have a major impact on its Tefra [Tax Equity and Fiscal Responsibility Act of 1982] reimbursement, but HS management, similarly affected by BBA cutbacks in all divisions, was mute? They were busy though, cashing out before the big hit.
> Does anyone really believe that nonsense about managed care pressure? It's the Medicare, stupid.
> If the accounting is slick, what do the cost reports look like?"
> You people and I have been hoodwinked. This note is all that I can do about it. You all can do much more, if all you do is look into it to see if what I say is true. (Fleeced Shareholder Memo 1998)

Ironically, Fleeced Shareholder alerted several corporate governance watchdogs to HealthSouth's fraud almost 5 years before the fraud was exposed. Unfortunately, none of these watchdogs, not even Ernst & Young, bothered to connect the dots. Ernst & Young did assign two auditors who were not involved with HealthSouth's financial audits to investigate the allegations, but they concluded, quite erroneously, that the problems described by Fleeced Shareholder "had no impact on [HealthSouth's] financial statements." Based on those findings, the audit firm decided not to inform HealthSouth's audit committee or its board of directors about Fleeced Shareholder's allegations. Five years later, however, Fleeced Shareholder was fully vindicated.

Shareholder Proposals: Calls to Reform HealthSouth's Board of Directors

For most public companies, the board of directors is the first line of defense against frauds perpetrated by management and other employees. If the directors are not completely independent of management, the board may not be able to protect the shareholders' financial interests. Since institutional investors (e.g., pension funds and mutual funds) have more money at risk than the majority of individual investors, they are not shy about calling for corporate governance reforms. HealthSouth's institutional investors were rattled by the dramatic drop in the company's earnings in 1998 and placed much of the blame on a board that was not independent of management.

In 1998, the Iron Workers' Local No. 25 Pension Fund proposed that HealthSouth adopt the Council of Institutional Investors' (CII) criteria for director independence (HealthSouth Corporation 1998a, 10–12). The Iron Workers wanted to prevent the directors on HealthSouth's audit and compensation committee from having any "personal, financial, and/or professional relationships with the CEO or other executive officer." Not surprisingly, the board opposed the Iron Workers' proposal, arguing that HealthSouth's directors already met the New York Stock Exchange (NYSE) criteria for independence. The board also pointed out that adopting the CII criteria for independence would only serve to reduce corporate profits by preventing HealthSouth from appointing the most qualified business leaders as directors.

The Iron Workers' proposal was soundly defeated during the annual shareholders' meeting, receiving less than 20% of HealthSouth's voting shares (HealthSouth Corporation 1998b, 15). In 1999, however, the Longview Collective Investment Fund, another institutional investor, reintroduced the Iron Workers' proposal in a somewhat watered-down form (HealthSouth Corporation 1999a, 11–14). Longview proposed a board in which at least three quarters of the directors would be independent of management. It argued that six of the twelve directors on the then current board lacked independence because they were company insiders or part of an interlocking directorate (a situation in which two boards of directors have at least one director in common). Longview also suggested that the board's lack of independence was responsible for the recent decline in HealthSouth's stock price and Richard Scrushy's overly generous compensation package as CEO:

> Our CEO was recently named as one of ten "executive pay anti-heroes" by Graef Crystal, an expert on executive pay, in a report prepared by the Council of Institutional Investors. Crystal's conclusion was based in part on Mr. Scrushy's drawing a base salary 350% above the market; a salary and bonus 592% above the market; and a total direct compensation that is 225% above the market. (HealthSouth Corporation 1999a, 14)

Once again, HealthSouth's board of directors opposed the proposal, citing the same arguments used in 1998. It also blamed the recent drop in its stock price on an industry-wide decline in earnings and dismissed complaints about Scrushy's compensation as "a gratuitous attack" on HealthSouth's CEO and chairman of the board. Although only 15% of voting shares supported the proposal (HealthSouth Corporation 1999b, 21), the number of company insiders on the board dropped from five to two in 2000. Unfortunately, the problem of close financial ties between certain directors and management remained.

Like other independent audit firms, Ernst & Young was required to read its clients' annual reports, proxy statements, and related reports to ensure such documents did not include misleading or fraudulent financial information. There is no way the audit firm can claim it did not know about the shareholders' concerns. By themselves, these proposals may not have justified conducting a more extensive financial audit at HealthSouth. But when the proposals are considered in conjunction with so many other red flags, a far more intensive audit would have made sense.

HealthSouth's Pristine Audits: Got Toilet Paper?

Even though Ernst & Young was not paying close attention to the cumulative effect of multiple red flags in HealthSouth's finance and accounting departments, it apparently did a very thorough job when performing what was known as "pristine audits." Teresa Sanders, HealthSouth's former chief accounting officer (CAO), testified before Congress that Richard Scrushy ordered her to develop a 50-point checklist known as a "pristine audit" (U.S. House of Representatives 2003, part II, 25, 38). The word "audit," however, is clearly a misnomer because the checklist focused on cleanliness of facilities, maintenance standards for equipment, and similar issues, rather than on the accuracy of financial statements and properly maintained accounting records. Despite Sanders's objections, Scrushy tasked Ernst & Young, rather than HealthSouth personnel, to conduct these pseudo-audits. Ironically, HealthSouth paid Ernst & Young a total of $4 million for pristine audits between 2000 and 2002, but only $3.22 million for SEC-mandated financial audits during the same period (Weil 2003). During the 2003 public hearings on the HealthSouth fraud, Congressman James Greenwood (R-Pennsylvania) suggested the following scenario to explain why Ernst & Young never reported its client's illegal activities:

> And in retrospect, and I am not casting the tiniest dispersion [*sic*] on Ernst & Young when I say this, in retrospect when you see an indictment that says that the fraud began in 1996, *do you wonder whether Mr. Scrushy said to himself: I am about to start cooking some serious books here and I have an auditing company that might find out about this, let me invent a lovely sweetener of the pot?* Has that thought occurred to you? (U.S. House of Representatives 2003, part II, 120; emphasis added)

Richard Dandurand, an Ernst & Young partner, objected strongly to Greenwood's suggestion and insisted that HealthSouth was just one of thousands of his firm's audit clients. Nevertheless, there is no denying the fact that HealthSouth was also Ernst & Young's highest paying client in the state of Alabama.

The Michael Vines e-Mail: Spitting in the Wind

Michael Vines, a former HealthSouth bookkeeper, suspected that his company was committing fraud and tried, albeit unsuccessfully, to expose it (Mollenkamp 2003). Although he lacked a college degree in accounting, Vines worked in HealthSouth's Fixed Asset Management Department from April 1997 until he quit his job in May 2002 (U.S. House of Representatives

2003, part I, 27). He was responsible for processing transactions involving the purchase of major pieces of equipment.

By late 2001, Vines began to suspect that HealthSouth was overstating its reported earnings by transferring income statement expenses to fictitious balance sheet asset accounts in violation of generally accepted accounting principles. When a purchase is recorded as an expense, it is reported on the income statement, and it reduces the company's net income by the entire amount immediately. When, however, it is recorded as an asset, it is reported on the balance sheet (a process called "capitalization") and has no effect on income. The asset's cost is amortized over a period of several years and recorded as an expense each year (a process called "depreciation"). According to Vines, HealthSouth's accountants recorded expenses as assets only if the cost was under $5,000. The accountants, some of whom were former Ernst & Young employees, knew that the audit firm ignored individual expenses below this threshold.

Vines told his boss, Cathy Edwards, that he would not transfer expenses to the balance sheet unless she personally signed off on the accounting entries. (Edwards was one of the many HealthSouth employees who later pleaded guilty to the fraud.) In December 2001, Ernst & Young, as part of its annual financial audit, conducted a routine review of HealthSouth's procedures for depreciating certain balance sheet assets. The review posed a serious problem for Edwards because many assets on HealthSouth's balance sheet were nothing more than expenses that should have been reported on past income statements and that would have reduced net income. The assets did not exist. Because there were no invoices or other documents proving the existence of these assets, Edwards used a computer and scanner to alter the invoices of actual assets, thereby creating the missing documentation. Ernst & Young never realized that at least $1 billion of the assets recorded on the company's balance sheet existed only in Cathy Edwards's fertile imagination.

Aware of the growing public furor over the Enron fraud and the government's plan to increase criminal penalties for corporate fraud, Vines started having second thoughts about working for a Fortune 500 company that was obviously cooking its books. In June 2002, 1 month after he quit his job, he sent an e-mail to Ernst & Young urging the audit firm to review the accounting transactions in three specific accounts: minor equipment, repairs and maintenance, and public information. Unfortunately, Vines never told the auditors to look for transactions below the $5,000 threshold or to verify the existence of certain balance sheet assets. He assumed, incorrectly, that the auditors would examine all transactions in those accounts regardless of the dollar amount. By February 2003, he realized that Ernst & Young had done nothing to stop the HealthSouth fraud. Using the alias "Junior," he posted the following message on Yahoo's bulletin board: "What I know about the accounting at HRC [HealthSouth] will be the blow that will bring HRC to its knees" (Mollenkamp 2003). Unfortunately, no one at Ernst & Young took his allegations seriously until after the SEC charged HealthSouth and its CEO with defrauding investors of billions of dollars. Vines was simply written off as "a disgruntled employee" who was fired for fraternizing with women (U.S. House of Representatives 2003, part II, 96).

Assessing the Likelihood of Fraud at HealthSouth: Ernst & Young's Checklist Mentality

In preparation for public hearings on the HealthSouth fraud, Congress subpoenaed several documents from Ernst & Young's confidential working papers. Congress later posted these documents on the Internet, thereby giving investors and other corporate stakeholders a rare glimpse into the secret world of financial audits. One of the most interesting of the subpoenaed documents was a 2002 checklist entitled "Internal Control and Fraud Considerations." Ernst & Young used it to decide whether or not to retain HealthSouth as a financial audit client.

Ernst & Young was hardly unique in its use of checklists; most audit firms depend on them to document various audit functions. A checklist, however, is a double-edged sword that can cause major problems if it is not used properly. On the one hand, it is a valuable mnemonic aid that ensures the auditor does not skip important steps in the audit process or ignore important information. On the other hand, its overuse can result in a checklist mentality—a form of "tunnel vision" in which the auditor misses the big picture while mindlessly checking off a series of seemingly unrelated items. Unfortunately, Ernst & Young seems to have developed a checklist mentality during its 2002 assessment of HealthSouth's internal controls and risk of fraud.

Dated December 31, 2002, the checklist was completed 3 months after the SEC first announced its investigation into allegations of insider trading by HealthSouth CEO Richard Scrushy. Even though the completed checklist raised several red flags with regard to HealthSouth's management, finance, and accounting functions, the audit firm concluded that its client's internal controls reduced the risk of fraud to an acceptable level. These red flags included, but were not limited to, "management's excessive interest in maintaining or increasing the client's stock price or trend earnings," Scrushy's domineering personality as a CEO "without effective oversight by the board of directors or audit committee," an increase in "public criticism or litigation," and an SEC investigation (Ernst & Young 2002, 5, 10, 12). Ernst & Young erroneously credited HealthSouth's management with creating an effective system of internal controls to prevent and detect fraud:

> Overall, we believe that management has designed an environment for success. As a result of this environment, management has designed sufficient controls and oversight functions in order to prevent instances of material misstatement of financial statements. We believe that management is ethical, competent, and fully aware of all potential business developments. The oversight function of the Company has also been designed to prevent material misstatement of the financial statements. We believe the board of directors and audit committee oversight provides adequate control of management as well as provides adequate direction of the Company. (Ernst & Young 2002, 10)

The audit firm did note certain problems with HealthSouth's Internal Audit Department but, once again, it downplayed the significance of those problems (Ernst & Young 2002, 18). In addition to being poorly trained and severely understaffed (no more than 10 internal auditors to handle up to 2,000 clinics), HealthSouth's internal auditors were denied access to corporate-level accounting data (U.S. House of Representatives 2003, part I, 40–42, 49, 60–62). Scrushy personally tasked his internal auditors to perform operational audits, not financial audits, at various health clinics. Operational audits focused on how personnel performed their duties, whether procedures were followed, and similar matters. They did not include examination of accounting records, the proper recording of cash receipts or disbursement, and other aspects of financial operations. Scrushy did not allow the internal auditors to track the accounting data that the clinics forwarded to corporate headquarters in Birmingham for inclusion in the company's consolidated financial statements. That task he reserved for Ernst & Young. James Lamphron, the Ernst & Young partner who supervised HealthSouth's financial audits in 2000 and 2001, testified before Congress that the audit firm did not care that Scrushy's internal auditors played no role in auditing the company's consolidated financial statements:

> [W]e were not in our audit process going to place much reliance on the work that internal audit did. I mean, let me say that prior to today [November 5, 2003], there was no requirement. Until yesterday, as a matter of fact, that a company has to have an internal audit department…And companies can choose to employ them several ways. They can direct them toward operational auditing or exclusively in operational areas, which we knew that it was they did. And that meant to us that we are not going to place much reliance on their work.…So we put in thousands of hours doing the kind of work that internal audit might do. (U.S. House of Representatives 2003, part II, 106–107)

Lamphron ignored the fact that the head of HealthSouth's Internal Audit Department reported directly to the CEO rather than to the audit committee. According to the Institute of Internal Auditors (IIA), the organization that certifies internal auditors, internal auditors should report a CEO who abuses his or her corporate power to the audit committee. This was not an option at HealthSouth. In addition, Richard Scrushy had personally recruited many of HealthSouth's internal auditors from local colleges, and some lacked the professional training and experience to function effectively as accounting watchdogs. Many of these recruits were extremely loyal to "King Richard," the man who gave them jobs at a Fortune 500 company (Terhune, Mollenkamp, and Carrns 2003). Clearly, Ernst & Young should have asked why HealthSouth was not using its internal auditors to prevent corporate fraud. Considering the prevalence of Medicare and Medicaid fraud in recent years, a prudent company would take advantage of every possible safeguard.

Ernst & Young's checklist also contained a summary of the audit firm's discussions with selected members of HealthSouth's management team. Based on interviews with six senior managers, the audit firm concluded that management had not identified "significant instances of fraud. There have been [a] few isolated issues reported through the Corporate Compliance Hotline, but upon follow-up by management, the issues were determined to be minor or not systemic" (Ernst & Young 2002, 21). Ironically, three of the six managers who were interviewed—William Owens, Tadd McVay, and Emery Harris—played key roles in the fraud and lied when interviewed. Unfortunately, Ernst & Young lost its professional skepticism and accepted management's assertions at face value. If the audit firm had pursued even a handful of the red flags it uncovered during its 17-year relationship with HealthSouth, it probably would have uncovered the fraud and saved investors millions, if not billions, of dollars.

Ernst & Young's Victim Mentality

When Lamphron, an Ernst & Young partner, testified before Congress in November 2003, he tried to paint a picture of his firm as just another victim of the HealthSouth fraud:

> [W]e sat down and met with [the Corporate Compliance Department] face-to-face. There were two Ernst & Young partners and another person there. We asked them, tell us about activities in the compliance department. Tell us about everything that has come to your attention, whether resolved or whatever the status. Tell us anything that might have any effect on the financial statements. And they looked us in the eye and lied to us. (U.S. House of Representatives 2003, part II, 117)

Lamphron's version of events at HealthSouth did not mesh with the account given by at least one key witness during CEO Richard Scrushy's criminal trial in 2005. Emery Harris, HealthSouth's vice president of finance, was 1 of 15 employees who pled guilty to participating in the fraud. During his trial, Harris testified that Ernst & Young “had regularly turned a blind eye to material issues during the course of its audits” (U.S. District Court, Northern District of Alabama, Southern District 2004a, 7). He also accused Ernst & Young of giving HealthSouth a clean bill of health on its financial statements even though the auditor “had open audit questions on those financial statements and concerns about the accounting practices being utilized by the company.” According to Harris, Ernst & Young was motivated by its desire to continue “its lucrative relationship with a long-standing client.” But that relationship ended in March 2003 when HealthSouth fired Ernst & Young as its independent auditor. If the audit firm did, indeed, put profit ahead of its duty to protect the investing public, it was guilty of the most serious ethical lapses of all: greed.

Marshalling the Troops: Ernst & Young Gets Back to the Basics

Unlike HealthSouth and its CEO, Ernst & Young avoided indictment by the SEC or the Department of Justice (DOJ) for its role in a $2.7 billion accounting fraud. But the fraud and its aftermath proved to be a major wake-up call for the audit firm’s leadership. On December 1, 2005, James Turley, Ernst & Young’s chairman, gave a landmark speech to the U.S. Chamber of Commerce in Washington, D.C. Although Turley never mentioned HealthSouth by name, he made it clear that the audit firm had learned a number of important lessons since Enron’s fall and the subsequent wave of accounting frauds. He admitted that his firm “has taken some shots from regulators and others over the last several years, and I’m here to tell you that we deserved some of those shots.…The times have taught us the dangers of being arrogant…of not listening.” He also acknowledged the accounting profession’s role as a public servant and financial watchdog: “While the public may not fully know what we do or how we do it, they count on us to help keep the playing field fair and balanced.” But he was probably thinking of HealthSouth and its autocratic CEO Richard Scrushy when he told his audience:

> Let’s stop and remember. It wasn’t long ago that public company auditors were being criticized for being too cozy with clients, for underpricing audit work to sell other services, or simply for not auditing enough.…The public has seen imperial CEOs, since collared and cuffed, acting as if they, and not shareholders, owned the company. Such examples—while clearly exceptions—have broad-brushed the reputations of every corporate leader, myself included. (Turley 2005)

Turley also acknowledged that “[good] auditing is too often not a sufficient defense against the filing of legal claims.” When a public corporation is convicted of fraud, its independent auditor is almost always the target of very costly lawsuits.

Hopefully, the lessons of the HealthSouth fraud have not been lost on Ernst & Young. Perhaps those lessons prompted Turley to reassure his audience that, after much "soul-searching," his firm decided to return to its roots: "We and others got caught up in a '90s-era rush to become one-stop global shops, hoping to provide not only our core services, but also hoping to be the biggest technology consulting firms and even the biggest law firms. Those days are over." Turley even chose an appropriate quote from President Harry Truman to end his speech: "Always do right, it will gratify some people, and astonish the rest."

Epilogue: Ernst & Young and the Courts

The SEC never filed suit against Ernst & Young for its role in the HealthSouth fraud, but it did publicly reprimand the audit firm for giving HealthSouth bad advice on how to classify pristine audit fees in its proxy statement. Based on that advice, HealthSouth included the fees paid for pristine audits in its "audit-related fees." Walter Schuetze, a former SEC chief accountant, explained the problem this way: "Calling [pristine audit fees] audit-related is false and misleading. It suggests that Ernst & Young was covering up the facts…When Ernst & Young deliberately misclassifies something that is clearly on its face wrong, that undermines everything that Ernst & Young says and does" (Weil 2003). The audit firm, for its part, rationalized its actions by insisting that "at the time of HealthSouth's disclosures, there were no SEC rules that defined audit-related services." Apparently, a legal loophole is better than no loophole at all.

Another legal loophole was probably the reason Ernst & Young never faced a criminal indictment for the HealthSouth fraud. Section 804 of the Sarbanes-Oxley (SOX) Act of 2002 sets the statute of limitation for securities fraud at "the *earlier* of (1) 2 years after the discovery of the facts constituting the violation; or (2) 5 years after such violation" (emphasis added). As a result, the DOJ was unable to file criminal charges against the audit firm based on allegations that its former partner, G. Marcus Neas, was aware of the fraud in 1993. The SEC did file a civil suit against Ernst & Young in May 2003 to prevent the audit firm from accepting new audit clients for a 6-month period, but that action was the result of an investigation into the firm's relationship with PeopleSoft, Inc. (Bryan-Low and Weil 2003). The SEC "attacked the firm's internal checks as inadequate" and accused it of "violating auditor-independence rules." Although HealthSouth was not mentioned in the suit, it appears that many of the problems plaguing Ernst & Young's relationship with PeopleSoft also played a role in the firm's relationship with HealthSouth.

Ernst & Young may have dodged a bullet with regard to disciplinary action by the DOJ and the SEC, but its legal problems from the HealthSouth fraud are far from over. On March 18, 2005, the firm filed a civil suit against HealthSouth in which it alleged that its former client deliberately concealed evidence of the accounting fraud from its auditor and, as a result, damaged the audit firm's reputation (HealthSouth Corporation 2005, 47). HealthSouth immediately returned the favor by countersuing Ernst & Young for gross negligence in the conduct of its financial audits from 1996 through 2002. Both suits are still pending.

The HealthSouth fraud notwithstanding, Ernst & Young is certainly no stranger to malpractice lawsuits. In 2003, it had the dubious honor of having "paid five of the 13 largest accounting malpractice settlements in history, more than any other firm, according to statistics compiled by Mark Cheffers, CEO of AccountingMalpractice.com" (Kahn 2003, 77). The audit firm must still deal with a major lawsuit filed by the RSA, one of HealthSouth's largest institutional investors.

Conclusion

Ernst & Young survived the HealthSouth fraud, although not without some permanent scars. The firm avoided criminal liability for failing to detect a major accounting fraud, but it will probably spend several years and large sums of money defending itself against civil suits and working to restore the public's trust. Ernst & Young forgot, at least temporarily, what the noted accounting ethicist, Abraham Briloff, calls its unwritten "covenant with society" to protect the financial interests of the investing public (Briloff 2002). The audit firm broke that covenant by failing to investigate thoroughly the many red flags involving fraud in the health care industry and HealthSouth's corrupt corporate governance structure and accounting practices.

Ernst & Young's behavior as HealthSouth's independent auditor calls to mind the old aphorism of the three monkeys: see no evil; hear no evil; speak no evil. Perhaps the audit firm did not want to look too closely for evidence of fraud or material misstatements in HealthSouth's financial statements. If Ernst & Young gave its client an unfavorable audit opinion, it would have risked losing its highest paying client in the state of Alabama. Whether or not the audit firm had a profit motive to overlook so many indicators of fraud, it is guilty of a lack of due diligence in the conduct of HealthSouth's annual financial audits. Ernst & Young was, at a minimum, an enabler of HealthSouth's $2.7 billion fraud. It committed a serious ethical lapse by neglecting its responsibilities as a public watchdog, thus putting the public's financial interests at great risk.

Ernst & Young steadfastly maintained that it was just another victim of HealthSouth's corrupt management. Certainly, only a court of law can convict the audit firm of misconduct. It may be some time before the public accepts the audit firm's opinions on financial statements at face value. Hopefully, as Chairman Turley told his audience, Ernst & Young has learned its lesson and is committed to doing the right thing. Only time will tell. If, however, Turley was merely telling his audience what it wanted to hear, Ernst & Young may yet meet the fate of its former (and now defunct) rival, Arthur Andersen LLP. Doing the right thing may bring in less revenue in the short term, but it is the only sure way to stay in the game for the long haul.

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