The Sarbanes-Oxley Act of 2002: Ethics, Executive Compensation and HealthSouth Corp.

Ida Robinson-Backmon
University of Baltimore

Betty L. Brewer
North Carolina A&T State University

This is a scenario case, describing a recent series of events in the legal and corporate environments. Financial scandals involving large market capitalization firms induced Congress to enact the Sarbanes-Oxley Act of 2002. This legislation affects a range of corporate activities, including accounting practices, financial statement preparation, corporate governance, and executive compensation. HealthSouth Corp., which had grown rapidly in the 1990s through numerous acquisitions, became the target of an SEC investigation in 2003. Subsequently, five financial officers of the company plead guilty to falsifying financial statements and implicated Richard Scrushy, HealthSouth's founder and CEO, in the fraudulent activities. Mr. Scrushy was indicted on 85 criminal counts and was awaiting trial. Mr. Scrushy contended that his subordinates acted independently and without his knowledge to inflate the reported profits of HealthSouth by more than $2.7 billion. His attorneys were expected to challenge the relevance of these indictments under the Sarbanes-Oxley Act.

CHARGES OF FRAUD

In 1997, Congress enacted legislation that slashed Medicare spending by more than $100 billion. HealthSouth's chief executive officer, however, commented that although Medicare was one of HSC's largest revenue sources, the Congressional cuts, which would occur over the next five years, would not impact company profits. In spite of his public comments that the effects would be minimal for the company, Scrushy initiated the sale of his HealthSouth stock. The stock price of HealthSouth rose continuously through the latter half of 1998. However, once analysts' earnings forecasts were not met for 1998 and 1999, stock prices plunged significantly.

In July, 2002 Scruschy negotiated a sale of 2.5 million shares of his HealthSouth stock. After missing stock analysts' earnings projection for several quarters, Healthsouth announced in August 2002 that 2003 earnings projections were being lowered, based on $175 million effect of Medicare reimbursement changes. Scrushy was proposing a spinoff of its more profitable outpatient surgery centers. He was giving up the post of CEO and would become Chairman of the spinoff operation. Shareholders initiated lawsuits contending that Scrushy had engaged in insider trading and in providing misleading information and financial reports. Following on the heels of this announcement was an announcement that the Securities and Exchange Commission was investigating Healthsouth.

Scrushy returned to HealthSouth as CEO in January 2003. In March 2003, he was ousted again when the SEC filed a civil complaint against him and other officers, charging them with overstating earnings and earnings manipulation. Subsequently five of fifteen indicted former financial officers of the company agreed to plea bargains, including testimony about Scrushy's role in promoting the fraudulent reporting. In November Scrushy was indicated on 85 counts including conspiracy, securities fraud, mail fraud, money laundering and false certifications of reports to the SEC. He became the first CEO to be indicted under the Sarbanes-Oxley Act. Scrushy immediately responded by proclaiming his innocence and blaming the entire financial debacle on his subordinates. His attorneys indicated that part of their defense would be a challenge to the Sarbanes-Oxley Act.

EXECUTIVE COMPENSATION AND PERKS

Following the compensation practices which had become the widespread in the booming economy of the late 1990s, HealthSouth tied financial performance to executive compensation and benefits. Scrushy and his financial and other corporate executives received salaries, bonuses, stock options and other benefits that were linked to the financial performance of the company. Scrushy benefited handsomely during 1996-2002 when he received approximately $267 million in compensation consisting of a base salary ($7.5 million), bonuses ($53 million) and stock options ($204 million, exercise value). Scrushy's personal interest in other ventures prompted HealthSouth to invest in other companies and ventures, including singing groups.

The stock options allowed Scrushy to make handsome profits. He would exercise his options to purchase stock, once the market price increased above the pre-set purchase price, and immediately resell them for a profit. This profit was in addition to company perks which included company loans and the use of airplanes and automobiles.

ACCOUNTING PRACTICES AND PROCEDURES

HealthSouth's corporate accounting staff maintained the books and records and all supporting databases at the company's headquarters. The accounting staff prepared all internal reports which reflected the financial position of the company. The reports were delivered and reviewed by Scrushy and his top-executives. Richard Scrushy as CEO was responsible for total management of HealthSouth. According to testimony from former Healthsouth financial executives, from 1996 through 2003 Scrushy directed various senior officers (e.g., President, COO's, CFO's, Controllers) to carry out certain activities designed to inflate corporate earnings through false accounting entries.

The internal reports reflected that the company frequently failed to generate net income to meet quarterly and annual guidelines, market expectations and the company's budgets. Scrushy and other senior executives reportedly believed that communicating actual financial performance to investors and analysts would negatively impact the value of HealthSouth's stock.

Between 1997 and 2000, a typical meeting of the financial executives would involve a discussion of the company profits. Scrushy reportedly directed his finance personnel to "go figure it out" when the profits had not met expectations (Weil, 2003).[1] The attendees would discuss journal entries that could be made and recorded to inflate reported earnings. Entries would be made that reduced the "contractual adjustment"[2] account or expense account with a corresponding decrease in the liability and increase in the asset accounts. The executives would adjust the long-term asset accounts to coincide with the fictitious adjustments to the income statement accounts. They generated periodic reports that were subsequently filed with the SEC and provided to the company's stakeholders. The CEO, CFO and other executives, certified that the filings were representative of the Company's financial position.

The Board of Directors and HealthSouth's external auditor Ernst & Young failed to uncover the fraudulent activity. As early as 1998, an anonymous tip of financial improprieties was sent to Ernst and Young LLP, which determined that "...the issues raised did not affect the presentation of HealthSouth's financial statements." In 2003, a former bookkeeper at HealthSouth also attempted to alert Ernst and Young about questionable activities. In October 2003, several non-officer employees testified before Congress about directions from top management regarding improper entries. As the blame-passing continued, Scrushy was gearing up to challenge the testimonies of former employees and the validity of the Sarbanes-Oxley Act.

Could the federal regulators use the Act against HealthSouth? Can HealthSouth survive the infringements of its top-executives?

Additional Readings

Terhune, Chad, et al. "Close Relations: Inside Alleged Fraud at HealthSouth," The Wall Street Journal, April 3, 2003, A1.

Haddad, Charles et al. "Too Good To Be True: Why HealthSouth CEO Scrushy Began Deep-Frying the Chain's Books," Business Week, April 14, 2003, 70-72.

Colvin, Geoffrey. "History Repeats Itself at HealthSouth," Fortune, May 12, 2003, 40.

HealthSouth Corp. (Chronological)

Terhune, Chad, et al. "Questioning the Books: HealthSouth Suspends 2 Executives," The Wall Street Journal, March 21, 2003, A2.

Mollenkamp, Carrie. "Missed Signal: Accountant Tried in Vain to Expose HealthSouth Fraud," The Wall Street Journal, May 20, 2003, A1.

Farrell, Greg. "From Emperor to Outcast," USA Today, May 29, 2003, 1B.

Taub, Stephen. "Scrushy Lays the Blame on His CFOs," CFO.com, October 15, 2003, 1.

Terhune, Chad, et al. "Scrushy Indicted on Fraud Charges," The Wall Street Journal, November 5, 2003.

Taub, Stephen. "Scrushy to Challenge Sarbox," CFO.com, December 11, 2003, 1.

Sarbanes-Oxley Act

Began Bevan, Philip Ross. "Executive Compensation and Sarbanes Oxley: The Rules Have Changed," Community Banker, November 2003, 66+.

Hall, Steven C. "Sarbanes Oxley Act of 2002," Journal of Financial Service Professional, September 2003, 14+.

Harrington, Cynthia. "The New Accounting Environment," Journal of Accountancy, August 2003, 98+.

Worthen, Ben. "Your Risks and Responsibilities: You May Think the Sarbanes-Oxley Legislation has Nothing to Do With You. You'd Be Wrong," CIO, May 15, 2003, 1+.