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Sniffing for Cooked Books

Trend and Ratio Analysis

BY ROBERT TIE



In June, Alton Sizemore Jr., CFE, CPA, sat down for a conversation with someone he had met before – one of the primary architects of the \$2.7 billion financial statement fraud at HealthSouth Corporation, headquartered in Birmingham, Ala. William Owens was president and chief operating officer of the massive conglomerate when the fraud was discovered in 2003 – an astonishing 17 years after it began.

The two men had first become acquainted during the investigation. At the time, Sizemore was the Birmingham FBI office's assistant special agent in charge, and he managed the HealthSouth case.

MANY CHANGES

Seven years later, Owens had lost his license to practice accounting before the U.S. Securities and Exchange Commission (SEC) and was an ex-convict and an ex-CPA who'd served a five-year prison term for securities fraud. Numerous other executives also were convicted of taking part in the fraud, and the former CEO was in prison for bribing a past governor of Alabama in a corruption case unrelated to the HealthSouth financial statement fraud.

Owens shared the gritty story of how and why he took part in the scheme on a pro-bono basis with the business community and others. And he encouraged auditors, investigators, and fraud examiners to resist the intimidation and other tactics he used to hide the HealthSouth fraud.

After a 25-year FBI career, Sizemore is now director of investigations for Forensic Strategic Solutions, a forensic accounting firm with offices in Birmingham, Dallas, and Washington, D.C.

"Twenty-one people pleaded guilty in that case including every CFO who had been with HealthSouth from the time it went public," he said. "The company's internal controls were virtually nonexistent."

In this article, Sizemore supplies simple but powerful analytic techniques that fraud examiners could have used to find red flags in HealthSouth's financial statements and possibly prevent this devastating scheme.

These techniques (among many) include:

- Trend analysis, which measures changes over time in a company's financial statements
- Ratio analysis, which can compare different items in a single company's current financials or contrast them with analogous items in the financials of competitors or other companies operating in similar industries

Experienced auditors and fraud examiners rely on these techniques to expose and highlight inconsistencies and variations that could be signs of fraud and indicate a need for further investigation.

OUT OF CONTROLS

HealthSouth's history had once been inspiringly positive. The company was the nation's largest provider of health-care services, with more than 48,000 employees and nearly 1,700 facilities throughout the 50 states and abroad, according to Congressional testimony by the interim chairman appointed to head HealthSouth's board of directors when the fraud was discovered in 2003.

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Tragically, numerous avoidable lapses in corporate governance and auditing unnecessarily jeopardized the firm's success and cost investors \$6.9 billion in lost share and bond value, according to an **SEC estimate**.

HealthSouth's management had been able to falsify its financial statements since the company went public in 1986 because it had overridden most internal controls and intimidated the external auditors. When the fraud was uncovered in 2003, investigators found that HealthSouth management had **overstated earnings by at least \$2.7 billion** over a 17-year period.

However, before the scheme was exposed, members of senior management had been quietly selling their shares as quickly as they dared and falsely reporting that HealthSouth had billions of dollars in assets that didn't exist.

In August 2002, investors had heard enough when **CEO and Chairman Richard Scrushy sold \$25 million worth of his company shares** just weeks before HealthSouth announced that cuts in Medicare reimbursements would reduce its pretax profits by \$175 million. The company also said it wouldn't issue earnings guidance for the remainder of 2002. HealthSouth common shares **immediately tumbled from \$11.97 to \$6.71**.

The sudden and steep decline in the company's stock attracted the SEC's attention. Company insiders told the agency that **the Medicare payment reduction actually was \$20 million at most**, and that management was using the additional \$155 million in supposed reimbursement cuts to make up for reported earnings that never existed.

ENTER THE FEDS

As a result, the SEC charged numerous HealthSouth executives with insider trading and other violations of securities laws. **The FBI, armed with search warrants, raided the company's Birmingham headquarters** to look for evidence corroborating company informants' reports of the fraud. Their efforts paid off.

"During that raid, we confiscated a terabyte of digital data and three van-loads of paperwork documenting how the financial statements had been falsified," Sizemore recalled. "We were fortunate to have several cooperating witnesses from inside the organization."

Sizemore and his team had planned to search primarily for evidence of insider trading. But their informants raised the stakes when they said that the company also was committing financial statement fraud.

"They told us where to look for proof of falsified financials, and they were right," Sizemore said. "We found it."

The HealthSouth case was like many other financial statement frauds Sizemore has investigated. "Of course, management wants the company to meet analysts' expectations," he said. "But if reality doesn't cooperate, some executives will, for example, inflate their sales numbers and offset them with phony assets."

Such cases that show continuing fraud due to weak internal controls and/or ineffective audit procedures are very common despite widespread press coverage, Sizemore said. But auditors and fraud examiners are more likely to find red flags when they use the right analytical tools to assess the consistency and reasonability of financial statement data.

HEED SAS 99

Statement on Auditing Standards No. 99, "**Consideration of Fraud in a Financial Statement Audit**," provides guidance on identifying signs of fraud such as those in the HealthSouth case.

This guidance is especially valuable to auditors and fraud examiners who need to understand the motives and actions of an aggressive executive like Owens, who might be committing and/or hiding fraud.

In particular, the SAS says that "the auditor may identify events or conditions that indicate incentives/pressures to perpetrate fraud, opportunities to carry out the fraud, or attitudes/rationalizations to justify a fraudulent action. Such events or conditions are referred to as 'fraud risk factors.'"

Two such risk factors prevailed at HealthSouth.

First, management believed it had to meet the earnings expectations of debt and equity markets.

"When senior management told Richard Scrushy the company's earnings were less than analysts were expecting, he said, 'Fix it!' They knew what he meant," Sizemore said, "and they acted accordingly."

Second, there was a strained relationship between management and the auditors.

"Owens told me that when the auditors would ask for direct, unfettered access to the general ledger, he would threaten them with finding someone else to do the audit," Sizemore said. Owens told Sizemore the auditors always backed down because they had millions in fees at stake.

CALL TO ACTION

According to the ACFE's **2010 Report to the Nations**, financial statement frauds were the longest in duration (median length: 27 months from inception to discovery) and the most costly (median loss: \$4.1 million) of all those discussed in the report.

Clearly, fraud examiners and auditors should use tools such as the trend and ratio analysis mentioned above to ferret out any red flags of potential financial statement fraud. Following are

examples of what these tools would have revealed, had they been used at HealthSouth.

To illustrate, Sizemore described a vertical analysis comparing data from the financial statements of HealthSouth and one of its major competitors in the 1990s, Tenet HealthCare Corporation, headquartered in Dallas. (See Exhibit 1.)

"This is something that would grab your attention," Sizemore said. "At the end of 1997, 42 percent of HealthSouth's assets were intangible, but only 27 percent of Tenet's were. That's a red flag because intangible assets are inherently difficult to value. It's a part of the financial statements where fraud could be overlooked."

Exhibit 1: Vertical Analysis	HealthSouth Corp.	Tenet HealthCare Corp.
	CYE 1997 (\$000)	FYE 5/31/1998 (\$000)
Intangible Assets	2,243,372	3,417,000
Total Assets	5,401,053	12,833,000
Intangible Assets as % of Total Assets	42%	27%

Data source: EDGAR, www.sec.gov

Sizemore turned to horizontal analysis for a different perspective on this potentially suspicious aspect of HealthSouth's financial statements. (See Exhibit 2.)

"This analysis reveals that the company's already suspiciously high proportion of intangible assets wasn't just a one-year anomaly. It was a disturbing trend of at least three years' duration," he said. "Yet another reason to investigate whether HealthSouth's management was improperly using these intangible asset values to reduce expenses."

Exhibit 2: Horizontal Analysis							
Health South Corp.	CYE 1996 (\$000)	CYE 1997 (\$000)	1996-1997 \$ Change	1996-1997 % Change	CYE 1998 (\$000)	1996-1998 \$ Change	1996-1998 % Change
Intangible Assets	1,094,421	2,243,372	1,148,951	105%	2,959,910	1,865,489	170%

Data source: EDGAR, www.sec.gov

Finally, Sizemore used a ratio analysis to compare HealthSouth's and Tenet's bad-debt write-offs. (See Exhibit 3.) "The less you write off, the higher your income," he said. HealthSouth wrote off only one-third as much in doubtful accounts as Tenet, which faced the same challenges HealthSouth did in collecting receivables. Why was HealthSouth apparently so much better at collections than Tenet? "That's the question this ratio presents," Sizemore said. "It's a red flag that should have been noticed and investigated."

Exhibit 3: Ratio Analysis	HealthSouth Corp.	Tenet HealthCare Corp.
	CYE 1997 (\$000)	FYE 5/31/1998 (\$000)
Provision for Doubtful Accounts	\$71,468	\$588,000
Net Accounts Receivable	\$745,994	\$1,742,000
Doubtful Accounts as % of Net A/R	10%	34%

Data source: EDGAR, www.sec.gov

BOTTOM LINE

Under new management since 2003, HealthSouth has improved controls, cooperated with auditors, and progressed toward recovery.

However, experience shows that the right analytical tools can help auditors, investigators, and fraud examiners shine light and transparency into the dark corners of a potentially fraudulent financial statement.

BEST PRACTICES

- Be mindful that risk factors are detectable now, not just later.

- Gather facts and discover truth; don't make allegations.
- Be professionally skeptical. Thoroughly examine results of trend and ratio analyses.
- Insist on full, authoritative confirmations of data and responses to questions that arise during an audit or investigation.
- Recognize and overcome attempts by management or others to thwart audits and investigations.

RESOURCES

Commercial versions of both trend and ratio analysis software enable users to download data from a financial system for analysis in Excel. Such packages are relatively inexpensive and widely available.

Robert Tie is a New York business writer.

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Reviews



By Wayne



By John



By Richard

More examples of types of analysis would be helpful.



By Daniel

Many of these frauds could have been discovered earlier if the auditors did there job.



By Larry



By Rodney



By Ryan