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# 'Audit-Related Fees' to Ernst Were for Janitorial Inspections

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Ernst & Young LLP collected \$2.6 million from HealthSouth Corp. for conducting janitorial inspections of the health-services company's facilities in 2000 and 2001 and advised it to classify the payments as "audit-related fees," leading HealthSouth to make inaccurate public disclosures about Ernst & Young's fees for nonaudit services.

The brainchild of former HealthSouth Chairman and Chief Executive Richard Scrushy, the inspections were part of a program HealthSouth called "Pristine Audits." Despite the name, these reviews had nothing to do with Ernst's audits of the company's financial statements. Rather, the primary purpose of the inspections was to check the cleanliness and physical appearance of HealthSouth's approximately 1,800 surgical and rehabilitation facilities.

Under the program, Ernst made unannounced visits to each facility once a year, using dozens of junior-level accountants who were trained for the inspections at HealthSouth's Birmingham, Ala., headquarters. The accountants carried out the reviews armed with a 50-point checklist designed by Mr. Scrushy. The checklist included seeing if magazines in waiting rooms were orderly, the toilets and ceilings were free of stains, and the trash receptacles all had liners. HealthSouth paid Ernst more money to inspect its facilities than it did to audit its books.

An Ernst spokesman, Donald Howarth, says: "E&Y believes that HealthSouth's fees were properly classified." He declined to comment when asked how the pristine audits were related to HealthSouth's financial-statement audits. HealthSouth's new management team takes a different view. "HealthSouth relied on Ernst & Young to classify the audit- and nonaudit-related fee information," says Andrew Brimmer, a HealthSouth spokesman. "We do not consider the pristine audit work to be related to the financial audit."

The wording of the disclosures, contained in HealthSouth's two most recent proxy statements, came amid widespread investor criticism over hefty fees auditing firms receive from corporate clients for nonaudit services. Since 2000, when the Securities and Exchange Commission began requiring auditor-fee

## PRISTINE FACTOR

See the "Pristine Factor" checklists Ernst & Young used to audit HealthSouth's [Inpatient](#)<sup>1</sup> and [Ambulatory Services](#)<sup>2</sup> divisions.

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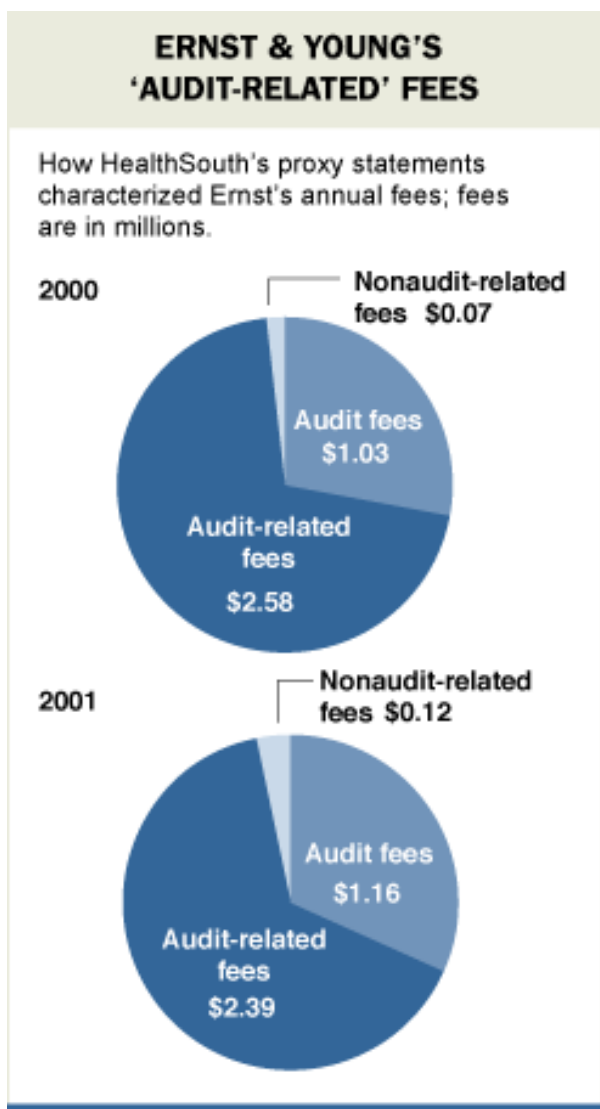
## HEALTHSOUTH SAGA

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disclosures, audit fees at large companies typically have been about one-third the size of the fees paid to auditors for other services. The disclosures have prompted many investors to complain that accountants might not be impartial and independent in audits with so much other business at stake.

Many companies, encouraged by their auditors, have tried to allay such concerns by voluntarily disclosing how much of their fees for "other" services are "audit-related." The SEC's 2000 rules didn't envision this practice or define the term "audit-related." But it would be considered improper for a proxy to use the term "audit-related" in a false and misleading way. More-common examples of audit-related services include pension-plan audits and consultations on accounting rules. "Pristine audits" previously had been unheard of, according to accounting-industry executives.

HealthSouth's April 2001 proxy, filed with the SEC, said the company paid Ernst \$1.03 million to audit its 2000 financial statements and \$2.65 million of "all other fees." The proxy said the other fees included \$2.58 million of "audit-related fees," and \$66,107 of "nonaudit-related fees." In its April 2002 proxy, HealthSouth said it paid Ernst \$1.16 million for its 2001 audit and \$2.51 million for "all other fees." The proxy said the other fees included \$2.39 million for "audit-related fees" and \$121,580 for "nonaudit-related fees."



Neither proxy described in any detail the audit-related or nonaudit-related services for which Ernst was paid. Mr. Brimmer, the HealthSouth spokesman, says the audit-related-fee figures for each year included about \$1.3 million for the pristine audits.

Mr. Scrushy was fired by HealthSouth's board in March, as was Ernst, shortly after the first of 11 former HealthSouth executives pleaded guilty to felony charges over an accounting fraud that overstated profits by \$2.5 billion. In a civil complaint, the SEC has accused Mr. Scrushy of participating in the fraud. Prosecutors are considering whether to file criminal charges against him. Last month, in a victory for Mr. Scrushy, a federal judge denied an SEC request to freeze Mr. Scrushy's assets. Through his attorneys, Mr. Scrushy has denied wrongdoing.

HealthSouth hasn't filed its 2003 proxy or its 2002 year-end financial statements, as a result of the ongoing investigations. Mr. Brimmer said HealthSouth paid Ernst \$5.4 million for 2002, including \$1.1 million for financial-statement audit services and \$1.4 million for the pristine audits. Upon firing Ernst, HealthSouth discontinued the pristine audits.

The government's fraud complaints against former HealthSouth executives haven't cited the pristine audits. But the program illustrates how Ernst had become an instrument of HealthSouth's marketing machine when it was supposed to

be acting as the company's financial watchdog. Mr. Scrushy touted the company's nearly perfect pristine-audit scores at public appearances. Ernst says its auditors had been unaware of HealthSouth's accounting

deceptions.

Describing the pristine audits at a Feb. 3, 2003, investor conference, Mr. Scrushy said: "We believe one of the reasons that we have done so well has to do with the fact that we do audit all of our facilities, 100%, annually. And we use an outside audit firm, our auditors, Ernst & Young. They visit all our facilities, 100%."

On its Web site, HealthSouth said the pristine audit, "administered independently by Ernst & Young LLP ... ensures that all of our patients enjoy a truly pristine experience during their time at HealthSouth. The average score was 98 percent, with more than half of our facilities scoring a perfect 100 percent."

Thomas Sjoblom, an attorney for Mr. Scrushy, says the pristine audits were aimed at providing better care for HealthSouth patients. "The intent was not to use Ernst & Young as part of its marketing program," Mr. Sjoblom says.

Critics question the wording of the proxy disclosures. "E&Y arguing that checking the cleanliness of a facility is 'audit related' goes well beyond the pale of sanity and common sense," says Lynn Turner, the SEC's chief accountant from 1998 until 2001.

Walter Schuetze, another former SEC chief accountant, says Ernst should stop insisting that HealthSouth properly characterized the firm's fees.

"Calling that audit-related is false and misleading," Mr. Schuetze says. "Not only does it fly in the face of facts. 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 Ernst & Young says and does."

The responsibility for the accuracy of proxy disclosures lies with the companies that prepare them. However, Mr. Brimmer points to a March 2002 report by Ernst to HealthSouth's management and board, covering Ernst's services for the fiscal year ended Dec. 31, 2001. The report included an attachment that summarized Ernst's fees and provided a suggested "Proxy Disclosure Format." The attachment shows that Ernst classified the pristine audits as "audit-related services" and the fees for them as "audit-related fees."

Mr. Howarth, the Ernst spokesman, declines to comment on Ernst's proxy-disclosure advice. In a statement, he says Ernst "for the most part" used "audit personnel who were not members of the HealthSouth audit-engagement team" to conduct the pristine audits. Therefore, he says, "the program did not detract from the work done by Ernst & Young on the audits of HealthSouth's financial statements." Mr. Howarth adds: "At the time of HealthSouth's disclosures, there were no SEC rules that defined audit-related services. Describing operational audit procedures as audit-related services was reasonable."

Donald Watkins, a lawyer for Mr. Scrushy, says shareholders could have asked about Ernst's services at HealthSouth's annual meetings, but that SEC rules didn't require the company to describe them in its proxies. "That ain't required by nobody at any time," he says.

Among other items on the 50-point checklist: check the walls, furniture, floors and whirlpool areas for stains; check that the heating and cooling vents "are free of dust accumulation"; that the "floors are free of trash"; and that the "overall appearance is sanitary."

Clean laundry was to be neatly folded and stored, while soiled laundry was to be stored "in a covered container," the checklist said. Ernst accountants also had to make sure the facilities' soft-drink machines distributed Coca-Cola Co. products. In 1997, HealthSouth and Coke signed a five-year, exclusive agreement for Coke to provide its beverages at HealthSouth facilities.

A small portion of the checklist pertained to money matters, though none of it pertained to accounting. Assignments included checking if petty-cash drawers were secure and company equipment was properly tagged. The checklists didn't cover insurance-billing procedures or the quality of the medical treatment.

According to the company's self-published book, "The Story of HealthSouth," Mr. Scrusby got the idea for facility inspections one day in 1996 while lying in bed, worried about keeping HealthSouth's facilities spotless and friendly. He assigned HealthSouth internal auditor Teresa Sanders that year to work out the details, Ms. Sanders testified at a court hearing this spring. Asked by the judge at the hearing whether the pristine audits were related to HealthSouth's audits, Ms. Sanders, who left the company in 1999, said: "No ma'am. This was a totally separate thing."

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