

Financial Fraud

Name:

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Date:

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HealthSouth Corporation committed several financial statement frauds. First, HealthSouth overestimated its revenue. The overestimation of earnings was between \$3.8 billion and \$4.6 billion. Second, HealthSouth manipulated its accounts receivables. The allowances established for write-offs did not match the amounts written-off, proving that HealthSouth was using its bad-debt reserves to manipulate earnings. Finally, HealthSouth overestimated the cash collected from sales. The case of HealthSouth raised several red flags. First, it consistently reported earnings that precisely met the expectations of analysts consecutively for 48 quarters (Weld, Bergevin & Magrath, 2004). Additionally, there were correlation failures between balance sheet items and the reserves of HealthSouth, and annual write-offs did not match their allocated allowance. The Corporation's scheme was exposed by one of its employees, Weston Smith, who reported the fraud to the FBI, which then raided HealthSouth offices. Had it not been for Smith, the fraud would, most likely, have continued indefinitely.

For future prevention of such fraud, the auditor needs to examine the earnings of the company compared to the expectations of analysts. Inspecting each accounting disclosure individually can also help detect inconsistencies, such as observed with HealthSouth's bad-debt provision, and accounts receivable. A careful examination of the relationships of financial statement components to each other can provide clarity on how management treats the recording of earnings (Weld, Bergevin & Magrath, 2004). The external auditor for HealthSouth did not detect ongoing fraud. This could have been because of missing information, limited scope of the audit, or ignoring the warning signs.

To conclude, auditors need to be vigilant when examining the relationships between components of the financial statements. They need to identify early warning signs, if any, of abusive earnings management.

Reference

Weld, L. G., Bergevin, P. M., & Magrath, L. (2004). Anatomy of a financial fraud. *The CPA Journal*, 74(10), 44.