

**IN THE UNITED STATES DISTRICT COURT  
FOR THE NORTHERN DISTRICT OF ALABAMA**

**SOUTHERN DIVISION**

<b>UNITED STATES OF AMERICA</b>	)	
	)	
<b>v.</b>	)	<b>DRAFT MARCH 31, 2003</b>
	)	<b>11:30 a.m.</b>
<b>KENNETH K. LIVESAY,</b>	)	
<b>Defendant</b>	)	

**INFORMATION**

The United States Attorney charges, that at all times material to this Information:

**Count 1**  
**Conspiracy to Commit Wire Fraud, Securities Fraud and False Books and Records**  
**Title 18, United States Code, Section 371**

**INTRODUCTION**

1. Defendant **KENNETH K. LIVESAY** (“LIVESAY”) was employed at HealthSouth Corporation (“HealthSouth”) beginning in 1989 and continuing to 1999 as Assistant Controller. In November 1999 he was promoted to the position of Chief Information Officer.
2. HealthSouth was a corporation organized under the laws of the State of Delaware with its headquarters in Birmingham, Alabama. HealthSouth claims to be the nation’s largest provider of outpatient surgery, diagnostic imaging and rehabilitative healthcare services with approximately 1800 locations in all 50 states, Puerto Rico, the United Kingdom, Australia, and Canada. At all times relevant to this Information, HealthSouth's common stock was listed on the New York Stock Exchange.
3. HealthSouth is an issuer of a class of securities registered under Section 12 of the Securities Exchange Act of 1934 (“the Act”). To sell securities to members of the public and

maintain public trading of its securities in the United States, HealthSouth was required to comply with the provisions of the federal securities laws, including Section 13(a) of the Act (Title 15, United States Code, Sections 78m(a) and 78o(d)) and the regulations promulgated thereunder, that were designed to ensure that the company's financial information was accurately recorded and disclosed to the public.

4. Under provisions of the federal securities laws and the provisions promulgated thereunder, HealthSouth was required, among other things, to (a) file with the SEC annual financial statements audited by an independent accountant; (b) file with the SEC quarterly updates of its financial statements that disclosed its financial condition and the results of its business operations for each three-month period; (c) make and keep books, records, and accounts that accurately and fairly reflected the transactions and dispositions of the company's assets; and (d) devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances that – (i) the company's transactions were recorded as necessary to permit preparation of financial statements in conformity with generally accepted accounting principles (“GAAP”) and other criteria applicable to such statements and to maintain the accountability of assets; and (ii) the recorded accountability for assets was compared with the existing assets at reasonable intervals and appropriate action was taken with respect to any differences.

5. From 1986, when HealthSouth issued its initial public offering, it filed quarterly reports, such as Form 10-Q, and annual reports, such as Form 10-K, with the United States Securities and Exchange Commission (“SEC”), which is located in Washington, D.C. HealthSouth's quarterly and year-end financial statements were transmitted directly and indirectly from HealthSouth's offices in Birmingham, Alabama to the offices of RCI Group, Inc. in

Washington, D.C., a filing agent that assists companies in electronically filing periodic reports with the SEC, and were thereafter transmitted electronically to and filed electronically with the SEC.

### **CERTAIN RELEVANT ACCOUNTING PRINCIPLES**

6. Public companies, such as HealthSouth, typically report the financial results of their operations in financial statements that include both an Income Statement and a Balance Sheet. A company's Income Statement reports, among other things, revenue recognized, expenses incurred, and income earned during a stated period of time – usually for a fiscal quarter or fiscal year. Within an Income Statement, expenses are generally subtracted from revenues to calculate net income. A company's Balance Sheet reports, among other things, the assets and liabilities of a company at a point in time, usually at the end of a fiscal quarter or the end of a fiscal year.

7. In preparing and maintaining the company's books and records, HealthSouth's accounting staff employed certain accounting principles and financial statement line items specific to healthcare services providers. One such Income Statement line item was "contractual adjustments." The contractual adjustments account is a revenue allowance account that estimates the difference between the gross amount charged to the patient and the amount that various healthcare insurers will pay for a specific treatment. HealthSouth deducted this amount from gross revenues to derive net revenues, which were reported on HealthSouth's periodic reports filed with the SEC. Since GAAP generally require that any increase in revenue or decrease in expenses be matched with either an increase in assets or decrease in liabilities on the Balance Sheet, any manipulation of the contractual adjustment account resulting in an increase in

revenues would require a corresponding entry on the Balance Sheet.

### **HEALTHSOUTH'S COMMUNICATIONS WITH INVESTORS**

8. The management of many public companies including HealthSouth provided "guidance" to the investing public regarding anticipated earnings per share for upcoming reporting periods. Relying in part on a company's "guidance," many professional securities analysts then disseminated to the public their own estimates of the company's expected performance. These "earnings estimates" or "analyst expectations" were closely followed by investors. Often, if a company announces earnings that fail to either meet or exceed analyst expectations, the price of the company's securities will decline.

9. Numerous analysts of major Wall Street investment firms followed HealthSouth's performance and issued "guidance" estimates regarding its expected earnings. These analysts considered, among other things, HealthSouth management's "guidance" concerning estimated revenue, income and earnings per share, to gauge HealthSouth's performance, financial condition, and to predict HealthSouth's expected earnings. Similarly, market participants and members of the investing public considered and relied upon HealthSouth's periodic financial statements and guidance concerning actual operating results.

### **HEALTHSOUTH'S EARNINGS SHORTFALLS**

10. Beginning at least in or about 1997, a group of HealthSouth's senior officers, which included the then Chief Executive Officer (the "CEO"), and officers who would become the Chief Operating Officer (the "COO"), the Chief Financial Officer (CFO), (collectively, the "Senior Officers") and others, recognized that HealthSouth's financial results were failing to produce sufficient earnings per share to meet or exceed Wall Street "earning expectations" or

"analyst expectations." The difference between HealthSouth's true and correct earnings per share and the Wall Street expectations was referred to internally at HealthSouth as the "gap" or the "hole." The Senior Officers and others recognized that the earnings shortfall created a substantial risk that, unless HealthSouth's earnings per share were artificially inflated, HealthSouth's earnings would fail to meet analyst expectations and the market price of HealthSouth's securities would therefore decline.

### **THE CONSPIRACY**

11. Beginning at a time at least as early as 1996, and continuing until approximately November, 1999, within the Northern District of Alabama and elsewhere, the defendant, **KENNETH K. LIVESAY**, knowingly and willfully conspired and agreed with other persons, to commit an offense against the United States, to wit:

(1) to devise and attempt to devise a scheme and artifice to defraud and to obtain money and property by means of material false and fraudulent pretenses, representations and promises and to knowingly transmit and cause to be transmitted, by means of wire communication, in interstate and foreign commerce, writings, signs, signals and sounds for the purpose of executing such scheme and artifice in violation of Title 18, United States Code, Section 1343;

(2) to willfully and knowingly make and cause to be made false and misleading statements of material fact in applications, reports and documents required to be filed under the Securities and Exchange Act of 1934 and the rules and regulations thereunder in violation of Title 15, United States Code, Sections 78m(a) and 78ff and Title 17, Code of Federal Regulations, Section 240.13a-1; 13a-13 and 13b2-2; and

(3) to willfully and knowingly falsify books, records and accounts of HealthSouth in violation of Title 15, United States Code, Sections 78m(b) (2) (A) & (B), 78m(b) (5) and 78ff and Title 17, Code of Federal Regulations, Section 240.13b2-1.

### **THE PURPOSE OF THE CONSPIRACY**

12. The purpose of the conspiracy was for the defendant, **KENNETH K. LIVESAY**, the Senior Officers, and others to fraudulently enrich themselves by inflating artificially HealthSouth's publicly reported earnings and earnings per share and by fraudulently enhancing its reported financial condition.

### **THE MANNER AND MEANS OF THE CONSPIRACY**

The manner and means by which the defendant and others sought to accomplish the conspiracy included, among other things, the following:

13. It was part of the conspiracy that the Senior Officers, defendant **LIVESAY** and others, would engage in an illegal scheme to inflate artificially HealthSouth's publicly reported earnings and earnings per share and falsify reports of HealthSouth's financial condition.

14. It was further part of the conspiracy that defendant **LIVESAY** and others would provide the CFO and the COO with monthly and quarterly preliminary reports showing HealthSouth's true and actual financial results and that these reports would be provided to the CEO.

15. It was further part of the conspiracy that after reviewing the preliminary reports on HealthSouth's actual monthly and quarterly earnings numbers, the Senior Officers would direct defendant **LIVESAY** and other members of HealthSouth's accounting staff to find ways to ensure that HealthSouth's earnings per share number met or exceeded Wall Street analyst

expectations.

16. It was further part of the conspiracy that after the Senior Officers issued instructions as to the desired earnings per share number, members of HealthSouth's accounting staff would meet to discuss ways to inflate artificially HealthSouth's earnings in order to meet the Wall Street earnings expectations. These meetings were known as "family" meetings and the attendees were known as the "family." At the meetings the "family" members discussed how members of the accounting staff would falsify HealthSouth's books to fill the "gap" or "hole" and meet the desired earnings. The fraudulent postings used to fill the "gap" or "hole" were referred to as the "dirt."

17. It was further part of the conspiracy that defendant **LIVESAY** made and caused to be made false and fraudulent entries in HealthSouth's books and records for the purpose of inflating artificially HealthSouth's revenue and earnings per share. Methods for artificially inflating HealthSouth's revenue and earnings per share included over booking reserve accounts, sometimes referred to as "socks" which could later be bled out into revenue, creating fictitious entries in the fixed assets system known as "AP Summaries," and overstating intangible assets (good will) accounts. After manipulating these accounts and other expense accounts to artificially inflate revenue on the Income Statement defendant **LIVESAY** and others made and caused to be made corresponding fraudulent adjustments to increase assets and decrease liabilities shown on HealthSouth's Balance Sheet. Thus, false and fraudulent entries were made to accounts in HealthSouth's books and records including, but not limited to, the: (1) Property, Plant and Equipment ("PP&E") account; (2) cash account; (3) inventory account; and (4) intangible asset (goodwill) accounts. Each of these accounts was reported in HealthSouth's

Balance Sheets. As defendant **LIVESAY** and his co-conspirators well knew, there was no justification in fact, or under GAAP, for these entries.

18. It was further part of the conspiracy that defendant **LIVESAY** and his co-conspirators, acting at the direction of the Senior Officers, would falsify HeathSouth's books and records by making thousands of phony entries to various HealthSouth accounts involving over a thousand HealthSouth facilities. In some cases, when these facilities were sold, defendant **LIVESAY** and his co-conspirators, in order to continue the scheme, moved hundreds of millions of dollars of fraudulently created assets to other hiding places on HealthSouth's books and records including the cash account.

19. It was further part of the conspiracy that defendant **LIVESAY** and other HealthSouth accounting personnel designed the fictitious accounting entries to avoid their detection. For example, if the accounting staff decided to increase inventories, it would increase inventory accounts at various HealthSouth facilities by different false amounts because they knew that if amounts were increased uniformly, suspicions of the auditors might be raised. In addition, since the HealthSouth accounting staff knew that auditors questioned additions to the PP&E account which exceeded a certain threshold, the bogus additions to PP&E at a particular facility were kept below the threshold.

20. It was further part of the conspiracy that defendant **LIVESAY** and his co-conspirators created and caused to be created false and fictitious documents to be provided to HealthSouth's auditors for the purpose of concealing the massive accounting fraud. The names of fraudulently enhanced property accounts were changed to make the false accounts appear routine.



21. It was further part of the conspiracy that defendant **LIVESAY**, the Senior Officers and their co-conspirators made and caused to be made the false and fraudulent journal entries in HealthSouth's books and records knowing, and intending (1) that such journal entries would ultimately be reflected in HealthSouth's financial statements and public filings with the SEC; (2) that HealthSouth's financial statements and public filings would falsely overstate HealthSouth's revenue, earnings per share; and assets (3) that the investing public would rely upon such fraudulently overstated earnings and earnings per share.

22. It was further part of the conspiracy that the Senior Officers, defendant **LIVESAY**, and others caused HealthSouth to file publicly with the SEC annual reports and quarterly reports that materially misstated, among other things, HealthSouth's net income, revenue, earnings per share, assets, and liabilities during the period of **LIVESAY'S** involvement in the conspiracy from at least 1996 until in or about November, 1999. As a result of the scheme, HealthSouth's revenue and earnings were inflated by hundreds of millions of dollars on publicly filed reports.

### **OVERT ACTS**

23. In furtherance of the conspiracy and to achieve the objects thereof, defendant **LIVESAY**, the Senior Officers and others committed and caused to be committed the following overt acts, among others, within the Northern District of Alabama and elsewhere:

(a) In or about the third week of the last month of each fiscal quarter, defendant **LIVESAY** and others prepared a report showing HealthSouth's actual consolidated operating results and provided the report to the CFO.

(b) In or about the third week of the last month of each fiscal quarter, at the direction

of the Senior Officers, defendant **LIVESAY** and others falsified HealthSouth's revenue numbers to ensure that HealthSouth's earnings per share numbers met or exceeded Wall Street analyst expectations.

(c) In or about the third week of the last month of each fiscal quarter, defendant **LIVESAY** and his co-conspirators in HealthSouth's accounting department artificially inflated HealthSouth's revenue numbers in accord with the instructions of the Senior Officers.

(d) On or about May 15, 1998, the CFO signed HealthSouth's 10-Q for the first quarter of 1998 knowing that it did not fairly present, in all material respects, the financial condition and results of operations of HealthSouth.

(e) On or about August 14, 1998, the CEO signed HealthSouth's 10-Q for the second quarter of 1998, representing that it fairly presented, in all material respects, the financial condition and results of HealthSouth.

(f) On or about August 14, 1998, the CEO caused to be transmitted by wire from Birmingham, Alabama, directly and indirectly, to the SEC, in Washington, D.C., HealthSouth's 10-Q for the second quarter of 1998 signed by the CEO and the CFO.

### **Count 2**

#### **False Books and Records**

**Title 15, United States Code, Sections 78m(b) (2) (A), 78m(b) (5) and 78ff**

**Title 17, Code of Federal Regulations, Sections 240.13b2-1 and**

**Title 18, United States Code, Section 2.**

1. The allegations contained in paragraphs 1 through 10 of Count 1 are repeated and realleged as though set forth in full in this Count.

2. The allegations contained in paragraphs 13 through 23 of Count 1 are repeated and realleged as though set forth in full in this Count as describing the falsification of

HealthSouth's books and records.

3. From at least in or about 1996 until November, 1999, in the Northern District of Alabama, and elsewhere defendant **KENNETH K. LIVESAY** and others, unlawfully, willfully, and knowingly, directly and indirectly, falsified and caused to be falsified, books, records, and accounts which, in reasonable detail, should have accurately reflected the transactions and dispositions of the assets of HealthSouth, to wit: defendant **LIVESAY** made and caused to be made false entries on the books and records of HealthSouth which resulted in the falsification of Cash Flow Statement line items, including: (1) revenue; (2) contractual adjustments; (3) expenses; and (4) earnings per share and Balance Sheet line items, including: (1) PP&E; (2) cash; (3) inventory; and (4) intangible assets (goodwill), which resulted, and were intended to result, among other things, in the filing of false quarterly and annual financial statements with the SEC.

All in violation of Title 15, United States Code, Sections 78m(b) (2) (A), 78m(b) (5), and 78ff, Title 17, Code of Federal Regulations, 240.13b2-1, and Title 18, United States Code, Section 2.

**Count 3**  
**Forfeiture**  
**Title 18, United States Code, Section 981(a)(1)(C) &**  
**Title 28, United States Code, Section 2461(c)**

The United States Attorney further charges:

1. That Counts One and Two of this Information are incorporated by reference herein for the purpose of alleging criminal forfeiture pursuant to Title 18, United States Code, Section 981(a)(1)(C) and Title 28, United States Code, Section 2461(c).

2. As a result of the foregoing offenses alleged in Count One of this Information, the

defendant, **KENNETH K. LIVESAY**, shall forfeit to the United States any property constituting or derived from proceeds traceable to said violations committed by the defendant, **KENNETH K. LIVESAY**. Such forfeitable interests include, but are not limited to, any and all interest and proceeds derived therefrom.

3. If any of the property described above as being subject to forfeiture pursuant to Title 18, United States Code, Section 981(a)(1)(C), and Title 28, United States Code, Section 2461(c), as a result of any act or omission of the defendant, **KENNETH K. LIVESAY** –

- (1) cannot be located upon the exercise of due diligence;
- (2) has been transferred to, sold to, or deposited with a third person;
- (3) has been placed beyond the jurisdiction of the Court;
- (4) has been substantially diminished in value; or
- (5) has been commingled with other property that cannot be subdivided without difficulty;

it is the intent of the United States, pursuant to Title 21, United States Code, Section 853(p), to seek forfeiture of any other property of said defendant, **KENNETH K. LIVESAY**, up to the value of the above forfeitable property.

All pursuant to Title 18, United States Code, Section 981(a)(1)(C) and Title 28, United States Code, Section 2461(c).

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