Internal Control and Fraud Considerations

Client HEALTHSOUTH Corporation

Subsidiary or Division

Audit Date 12/31/02

Completed or Updated by	Date	Reviewed and Approved by	Date
See AWS		See AWS	

General

This questionnaire assists us in gaining an understanding of and assessing internal control at the entity level and in assessing the risk of fraud. This questionnaire provides us with only a portion of the understanding about an entity's internal control that we are required to obtain to plan the audit (e.g., make our preliminary combined inherent and control risk assessments) and to determine the nature, timing, and extent of our audit procedures. We also are required to obtain information about internal control at the individual application/process level.

This questionnaire has been designed to be completed/updated electronically or manually. To complete/update the questionnaire electronically, click in the appropriate box to the right of the risk factor. Clicking in the box will enter an "X," clicking again will remove the "X."

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We complete this questionnaire for each of the five components of internal control (i.e., the control environment, the client's risk assessment process, information and communication, control activities, and monitoring) for the entity as a whole. In addition, for multilocation engagements, we complete the applicable sections of the questionnaire and make our assessments for those locations (e.g., subsidiaries, divisions) at which we perform full-scope procedures. For example, at a large subsidiary where we perform full-scope procedures, we would prepare/update the questionnaire as it relates to that subsidiary. However, certain sections (e.g., "Board of Directors and/or Audit Committee Participation in governance and oversight") may not be applicable and need not be completed. The partner in charge of the audit determines whether some or all of the questionnaire should be completed at locations where we do not perform full-scope procedures. In making this determination, the partner in charge of the audit considers such factors as the materiality of the location; the nature and extent of our procedures at the location; the nature and extent of the location's operations and the similarity of its operations, systems, and procedures to those at other locations; the degree of operating autonomy granted the location; whether the internal auditors have completed (and we have reviewed) a similar questionnaire for the location; our understanding of the business and financial statement risks associated with the location; the client's expectations; and concerns about internal control or fraud resulting from our prior experiences.

The questionnaire should be completed/updated by those on the engagement team with sufficient experience and knowledge of the client to know, with a high degree of confidence, whether the risk factors in the questionnaire are present and whether additional risk factors should be considered. Further, those same individuals ordinarily are involved in making our assessments of the effectiveness (ineffectiveness) of internal control at the entity level and the risk of fraud.

Because the process of completing/updating the questionnaire frequently will require input from more than one team member, the process ordinarily can be accomplished in a more effective and efficient manner when the engagement team (including the partner) discusses, early in the engagement, which individual(s) will be responsible for completing/updating which sections of the questionnaire. For example, the partner or senior manager (who ordinarily have interaction with the board of directors and/or the audit committee) normally are the only members of the engagement team with sufficient knowledge to respond to the items in the section entitled "Board of Directors and/or Audit Committee Participation in governance and oversight," while the manager and senior (when they have worked on the engagement before) ordinarily will have sufficient knowledge of the client and its business to complete/update most of the remainder of the questionnaire, with input as necessary from others on the engagement team.

The first time the questionnaire is completed (whether for a first-year or recurring audit) the executive in charge of the audit reviews and approves it. In subsequent years, at least a manager reviews and approves the questionnaire.

Each year a copy of the "Summary and Conclusions" page(s) of this questionnaire is attached to the Audit Strategies Memorandum.

We also review and update this questionnaire during our annual client continuance process whenever we assess our risk relating to the client as "other than low" on Form U574, "Evaluation of Audit Clients—Risk Assessment." In such situations, we attach a copy of the updated questionnaire to Form U575, "Audit Client Continuance Form."

Risk Factors

This questionnaire contains lists of risk factors that are relevant to internal control at the entity level and/or the risk of fraud. However, the lists are not necessarily all inclusive. Based on our understanding of the client and its business and industry, we may identify other risk factors that should be considered and documented in the questionnaire.

The relative importance of the risk factors varies among engagements from critical to insignificant. Some of the factors will be present in clients where the specific conditions do not present a weakness in internal control at the entity level or present a risk of fraud, while in other situations, they may. Accordingly, we exercise considerable professional judgment when considering the risk factors individually and in combination. When considering the presence of risk factors, we consider whether there are other factors or specific controls that mitigate or exacerbate the risk factors we have identified.

While a "yes" response to a risk factor does not necessarily mean that internal control at the entity level is ineffective or there is a risk of fraud, a "yes" response (particularly when there are multiple "yes" responses) to a risk factor should heighten our awareness, and we give it (them) due consideration.

In instances where a risk factor is not applicable, mark the "No" column for the risk factor and discuss why that particular risk factor is not applicable in space provided below the risk factors. In addition, risk factors known to the engagement team but not included in this questionnaire should be added to the applicable sections.

Considerations for Smaller Entities

Our evaluation of the risk factors in this questionnaire should consider the unique circumstances, as well as the size and complexity, of smaller entities. For example, an entrepreneurial client may not have a written code of conduct or formally documented corporate policies and procedures. In these instances, we pay particular attention to the "tone" set by management in its own actions, as well as its efforts to communicate to employees the company's policies and values and the importance of integrity and ethical behavior. Similarly, an entrepreneurial client may not have an independent or outside member on its board of directors. If so, we consider the degree of diligence exhibited by management and the board of directors in executing their corporate governance responsibilities. These conditions may not negatively affect our assessment of control risk or of the risk of fraud. We recognize that entrepreneurial entities, by nature, will have varying degrees of internal control. As a result, judgment is involved in determining the effects of internal control at the entity level on our audit approach.

Control Environment

The control environment sets the tone of an organization, influencing the control consciousness of its people. It is the foundation for all other components of internal control, providing discipline and structure. We obtain sufficient knowledge of the control environment to understand management's and the board of directors' attitudes, awareness, and actions concerning the control environment, considering both the substance of controls and their collective effects.

The control environment consists of the following factors:

- Integrity, ethical values, and behavior of key executives.
- Management's control consciousness and operating style.
- Management's commitment to competence. Board of directors and/or audit committee participation in governance and oversight.
- Organizational structure and assignment of authority and responsibility.
- Human resource policies and practices.

When gaining an understanding of the control environment, we consider each of these factors and their interrelationships. In particular, we recognize that significant deficiencies in any one of the factors may undermine the effectiveness of the others.

Integrity and Ethical Values, and the Behavior of Key Executives

The effectiveness of controls cannot rise above the integrity and ethical values of the people who create, administer, and monitor them. Integrity and ethical values are essential elements of the control environment, affecting the design, administration, and monitoring of key processes. Integrity and ethical behavior are the product of the client's ethical and behavioral standards, how they are communicated, and how they are monitored and enforced in its business activities. They include management's actions to remove or reduce incentives and temptations that might prompt personnel to engage in dishonest, illegal, or unethical acts. They also include the communication of the entity's values and behavioral standards to personnel through policy statements and codes of conduct, and by the examples set by the executives.

Are the following risk factors present?	Yes	No
• Lack of policies regarding the client's values and behavioral standards and lack of codes of conduct.	☐	☒
• Ineffective means of communicating and supporting the client's values or ethics.	☐	☒
• Management does not attempt to remove or reduce incentives and temptations that might prompt personnel to engage in dishonest, illegal, or unethical acts.	☐	☒
• Management does not lead by example.	☐	☒
• Management does not take appropriate action in response to departures from approved policies and procedures or the code of conduct.	☐	☒

Indicate other risk factors considered:

Management's Control Consciousness and Operating Style

Management's control consciousness and operating style have a pervasive effect on internal control.

Are the following risk factors present?	Yes	No
• Management is dominated by one or a few individuals without effective oversight by the board of directors or audit committee.	☐	☒
• Management lacks a proven track record in this or other businesses.	☐	☒
• Nonfinancial management's excessive participation in, or preoccupation with, the selection of accounting principles or the determination of significant estimates.	☐	☒
• Management's excessive interest in maintaining or increasing the client's stock price or earnings trend.	☒	☐
• Management's failure to give appropriate attention to internal control, including the effects of information systems processing.	☐	☒
• Management's failure to correct known reportable conditions on a timely basis.	☐	☒
• Management sets unduly aggressive financial targets and expectations for operating personnel.	☐	☒
• A significant portion of management's compensation is derived from bonuses, stock options, or other incentives, the value of which is contingent upon the entity achieving unduly aggressive targets for operating results or financial position.	☐	☒
• Management is aggressive in selecting accounting principles and determining estimates.	☐	☒
• Management commits to analysts, creditors, and other third parties to achieve what appear to be unduly aggressive or unrealistic forecasts.	☐	☒
• Management does not consult us on significant matters relating to internal control and accounting issues or there are frequent disputes regarding them (or for initial engagements, there were disputes with the predecessor auditors).	☐	☒
• Management displays a cavalier attitude toward, and inadequate monitoring of, significant business risks.	☐	☒

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- Management displays significant disregard for regulatory authorities. ☐ ☒
- There is a history of securities law violations or claims against the client or its management alleging fraud or violations of securities laws. ☐ ☒
- Management displays significant disregard for the audit. ☐ ☒
- Management is domineering in dealing with us. ☐ ☒
- Management attempts to reduce the scope of the audit (directly, for example, by limiting access to people or information, or indirectly, for example, by unreasonable fee or time constraints) or imposes unreasonable deadlines. ☐ ☒
- Management attempts to limit our ability to communicate effectively with the board of directors or the audit committee. ☐ ☒

Indicate other risk factors considered:

Management's Commitment to Competence

Management's commitment to competence includes management's consideration of the competence levels for particular jobs and how those levels translate into requisite skills and knowledge. Among the many factors that should be considered by management are the nature and degree of judgment to be applied to a specific job and the extent of supervision that will be provided.

Are the following risk factors present?	Yes	No
• The accounting, finance, and IT personnel do not have the competence and training needed to deal with the nature and complexity of the entity's business.	☐	☒
• Lack of commitment by management to provide sufficient accounting and financial personnel to keep pace with the growth and/or complexity of the business and the demands of the stakeholders.	☐	☒

Indicate other risk factors considered:

See risks associated with the internal audit function.

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Board of Directors and/or Audit Committee Participation in Governance and Oversight

The client's control consciousness is influenced significantly by the board of directors and/or audit committee. The board of directors, through its own activities and supported by an audit committee or an equivalent function, is responsible for overseeing the client's accounting and financial reporting policies and procedures.

Are the following risk factors present?	Yes	No
• Board of directors does not have a charter or objectives for the audit committee.	☐	☒
• Inadequate communications among the board, audit committee, and external and internal auditors.	☐	☒
• Audit committee members are not appropriately experienced or qualified.	☐	☒
• Board of directors or audit committee is not sufficiently independent of management.	☐	☒
• Inadequate number of meetings or the matters discussed are not appropriate.	☐	☒
• Board of directors and audit committee do not adequately scrutinize activities—difficult questions are not raised and pursued with management.	☐	☒
• Board of directors and/or audit committee are not adequately involved in the financial reporting process.	☐	☒
• Board of directors and/or audit committee do not give adequate consideration to monitoring business risks affecting the organization and management's risk assessment processes.	☐	☒
• High turnover of board members.	☐	☒

Indicate other risk factors considered:

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Organizational Structure and Assignment of Authority and Responsibility

The client's organizational structure provides the framework within which its activities for achieving entity-wide objectives are planned, executed, controlled, and monitored. Establishing a relevant organizational structure includes considering key areas of authority and responsibility and appropriate lines of reporting. The client should have an organizational structure that is suited to its needs. The appropriateness of the client's organizational structure depends, in part, on its size and the nature of its activities. The assignment of authority and responsibility pertains to how operating activities are assigned and how reporting relationships and authorization hierarchies are established. It also includes policies relating to appropriate business practices, knowledge and experience of key personnel, and resources provided for carrying out duties. In addition, it includes policies and communications directed at ensuring that all personnel understand the entity's objectives, know how their individual actions interrelate and contribute to those objectives, and recognize how and for what they will be held accountable.

Are the following risk factors present?	Yes	No
• Overly complex organizational structure involving numerous or unusual legal entities, managerial lines of authority, or contractual arrangements without apparent business purpose.	☐	☒
• Significant bank accounts or subsidiary or branch operations in tax-haven jurisdictions for which there appears to be no clear business justification.	☐	☒
• Lack of appropriate management oversight (for example, inadequate supervision or monitoring of accounting personnel, information systems or remote locations).	☐	☒
• A poor structure for assigning ownership of data, including who is authorized to initiate and/or change transactions.	☐	☒
• Difficulty in determining the organization or individual(s) that control(s) the client.	☐	☒
• High turnover of senior management or legal counsel.	☐	☒
• Lack of appropriate system of authorization and approval of transactions.	☐	☒
• Unclear assignment of responsibilities, including those specific to information systems processing and program development.	☐	☒
• Policies and procedures for the authorization of transactions are not established at the appropriate level.	☐	☒

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Human Resource Policies and Practices

Human resource policies and practices relate to hiring, orienting, training, evaluating, counseling, promoting, and compensating personnel. These policies and practices also relate to remedial actions, such as disciplining and terminating personnel.

Are the following risk factors present?	Yes	No
• Inadequate standards and procedures for hiring, training, motivating, evaluating, promoting, compensating, transferring, or terminating personnel in some or all functional areas (e.g., accounting, marketing, information systems).	☐	☒
• Lack of job applicant screening procedures relating to employees with access to assets susceptible to misappropriation.	☐	☒
• No written job descriptions or reference manuals that inform personnel of their duties (or, in the absence of written documentation, lack of communication of job responsibilities and expectations).	☐	☒
• Inadequate procedures for establishing and communicating policies and procedures to personnel at decentralized locations (including foreign operations).	☐	☒
• Employees with access to cash, securities, and other valuable assets are not bonded.	☐	☒
• Policies and procedures are not clear or issued, updated, or revised timely.	☐	☒
• Lack of mandatory vacation policy for employees performing key control functions or in areas that lack proper segregation of duties.	☐	☒
• Anticipated future employee layoffs that are known to the work force. **(There were layoffs by the Company in the 4th quarter of 2002 – no other layoffs expected)**	☐	☒
• Employees with access to assets susceptible to misappropriation who are known to be dissatisfied.	☐	☒
• Known unusual changes in behavior or lifestyle of employees with access to assets susceptible to misappropriation.	☐	☒
• Known personal financial pressures affecting employees with access to assets susceptible to misappropriation.	☐	☒

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Comments and Additional Information

Provide additional information about the identified risk factors to assist in determining their effects on the assessments of the effectiveness (ineffectiveness) of internal control at the entity level and the risk of fraud. In addition, you may use this space to provide any comments about any of the other risk factors listed above that you believe those making the assessments need to consider.

Overall, we believe that management has designed an environment for success. As a result of this environment, management has designed sufficient controls and oversight functions in order to prevent instances of material misstatement of the financial statements. We believe that management is ethical, competent, and fully aware of all potential business developments. The oversight function of the Company has also been designed to prevent material misstatement of the financial statements. We believe the board of directors and audit committee oversight provides adequate control over management as well as provides adequate direction of the Company. Although Richard Scrushy, CEO, has an overwhelming amount of control over the Company, we feel the results of the Sarbanes-Oxley act have deterred this control through allowing the audit committee more oversight. Note that Mr. Scrushy is not involved with the audit committee.

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The Client's Risk Assessment Process

Risk assessment is the *client's* process for identifying and analyzing the risks (both internal and external) that are relevant to the achievement of its objectives. In addition, a risk assessment process provides the client with a basis for determining how to manage its risks (e.g., the actions to address specific risks or a decision to accept a risk because of cost or other considerations). After indicating the risk factors in this section that we are aware of that are present, we gain an understanding of the client's risk assessment process, specifically as it relates to the financial reporting objective of internal control, and then we determine, generally through inquiry, observation, and inspection of relevant documents, whether the client's risk assessment process has identified and analyzed each of the risks, and if so, whether the client has implemented appropriate steps to mitigate each of the risks.

Are the following risk factors present?	Yes	No
Business and Industry		
• High degree of competition or market saturation, accompanied by declining margins.	☐	☒
• Declining industry with increasing business failures.	☐	☒
• Rapid changes in the industry, such as significant declines in customer demand, high vulnerability to rapidly changing technology or rapid product obsolescence.	☐	☒
• Unusually rapid growth or unusually high profitability, especially compared with those of other companies in the same industry.	☐	☒
Operations		
• Changes in the entity's operating environment.	☐	☒
• New personnel in key financial or operating positions.	☐	☒
• New or revamped information systems.	☐	☒
• Significant new lines, products, or activities.	☐	☒
• Unrealistically aggressive sales or profitability incentive programs.	☐	☒
• High levels of sales returns.	☐	☒
• Corporate restructuring.	☐	☒
• Especially high vulnerability to changes in interest rates.	☐	☒
• Significant operations in countries where business practices are questionable.	☐	☒
• Small number of transactions that have a material effect on the client.	☐	☒
• Assets susceptible to misappropriation; such as large amounts of cash or assets easily convertible into cash; goods in inventory are small in size, high in value, or high in demand; fixed assets are small, marketable, or lack ownership identification.	☐	☒

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Are the following risk factors present?

	Yes	No
Financial Condition		
• Inability to generate cash flows from operations while reporting earnings and earnings growth.	☐	☒
• Operating losses or significant deterioration in earnings.	☒	☐
• Marginal ability to meet debt repayment requirements (or comply with restrictive loan covenants).	☐	☒
• Ability to raise additional capital is limited (e.g., due to high leverage or an inadequate capital base).	☒	☐
• Severely deteriorating financial condition or liquidity, or threat of imminent bankruptcy or foreclosure (including when management has personally guaranteed significant debts of the client or when the most recent audit report included, or serious consideration was given to including, a disclaimer or an explanatory paragraph describing an uncertainty about the client's ability to continue as a going concern).	☐	☒
Accounting		
• Assets, liabilities, revenues, or expenses are based on significant estimates that involve unusually subjective judgments or uncertainties (e.g., the timing of revenue recognition or the capitalization of costs), or that are subject to potential significant changes in the near term in a manner that may have a financially disruptive effect on the client.	☐	☒
• Significant, unusual, or highly complex transactions or innovative deals (especially those close to year end) that make the determination of their effects on the financial statements difficult or highly subjective or pose difficult "substance over form" questions.	☐	☒
• An extraordinary volume of shipments shortly before or at year end or quarter ends.	☐	☒
• New accounting, statutory, or regulatory requirements that could impair the financial stability or profitability of the client.	☒	☐
• Public criticism or litigation involving accounting, financial reporting, or business practices of the client or of companies in one or more of its industries.	☒	☐
• Restatement of the prior year's financial statements for the correction of an error.	☐	☒
• Adverse consequences on significant pending transactions, such as a business combination, planned debt or equity issue, or contract award, if poor financial results are reported.	☐	☒

Are the following risk factors present?	Yes	No
Related Parties		
• Significant related party transactions not in the ordinary course of business or with related entities not audited or audited by another firm.	☐	☒
• Other auditors involved with related entities (or in the annual audit), or some related entities not audited.	☒	☐

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Indicate other risk factors considered:

Class action lawsuits, as well as SEC investigations, are ongoing.

Does the client have a formal risk assessment process? Yes ☒ No ☐. If not, does the client have an *informal* risk assessment process? Yes ☐ No ☐.

Briefly describe the client's risk assessment process, specifically as it relates to the financial reporting objective of internal control (i.e., preparing financial statements for external purposes that are fairly presented in conformity with generally accepted accounting principles):

On a monthly basis, AR is reconciled to the general ledger and bank reconciliations are prepared and reviewed. On a quarterly basis, AP is reconciled to the general ledger. Also on a monthly basis, Facility Administrators, Department Heads, and Corporate Accounting compare current period revenues/expenses to prior period revenues/expenses and to budget.

The PeopleSoft System is configured to map accounts to financial statement line items. Elimination entries/non-standard journal entries are prepared and reviewed for reasonableness. The controller of the Company reviews the consolidating schedules, ensuring that intercompany account balances reconcile.

The CFO and the Controller review the financial statements in conjunction with the E&Y GAAP Disclosure Checklist.

Throughout the year, the HealthSouth Internal Audit Department performs various procedures on the Company's processes. The head of the IA Department reports directly to the HealthSouth Audit Committee.

With respect to the risk factors identified above, has the client's risk assessment process:

- Identified and analyzed each of the risks? Yes ☒ No ☐.
- If yes, has the client implemented appropriate steps to mitigate each of the risks? Yes ☒ No ☐.

Comments and Additional Information

Provide additional information about the identified risk factors (and the effectiveness of the client's risk assessment process in addressing and mitigating each of them) to assist in determining their effects on the assessments of the effectiveness (ineffectiveness) of internal control at the entity level and the risk fraud. In addition, you may use this space to provide any comments about any of the other risk factors listed above that you believe those making the assessments need to consider.

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- Due to clarified Mcare regulations, HRC's earnings experienced a sharp decline in the 3rd and 4th quarter. Their ability to raise additional capital is somewhat limited, due to low stock price and bond rating decline, however, they are still profitable, they have a large amount of cash and they generate significant amounts of operating cash flows.

- During the year, FAS 142 was implemented by the Company. This resulted in a cumulative effect adjustment in the second quarter and will result in an impairment charge at year end due to the decline in operations for the second half of the year as a result of transmittal 1753.

- HRC is involved in multiple shareholder suits related to disclosure of the impact of transmittal 1753 and stock sales by the CEO. In addition, the SEC is also investigating the Company. HRC had a law firm do an investigation stating that their was nothing inappropriate and believe these suits and the investigation by the SEC will find nothing inappropriate

- Other auditors are involved in the audit of the company's insurance captive. The captive liability is immaterial, however, we marked yes because medical malpractice is a significant account.

Control Activities and Information and Communication

Control activities are the policies and procedures that help ensure that necessary actions are taken to address risks to achievement of the entity's objectives. The information system, which includes the accounting system, consists of the methods and records established to record, process, summarize, and report entity transactions (as well as events and conditions) and to maintain accountability for the related assets, liabilities, and equity. Communication involves providing an understanding of individual roles and responsibilities pertaining to internal control over financial reporting. Information and communication is the process of capturing and exchanging the information needed to conduct, manage, and control a client's operations. The quality of the client's information and communication affects management's ability to make appropriate decisions in controlling the client's activities and to prepare reliable financial reports. Information and communication involves capturing and providing information to appropriate personnel so that they can carry out their responsibilities, including providing an understanding of individual roles and responsibilities pertaining to internal control over financial reporting.

Are the following risk factors present?	Yes	No
• Inability to prepare accurate and timely financial reports, including interim reports.	☐	☒
• Planning and reporting systems (such as business planning; budgeting, forecasting, and profit planning; and responsibility accounting) that do not adequately set forth management's plans and the results of actual performance.	☐	☒
• Inadequate methods of identifying and communicating exceptions and variances from planned performance.	☐	☒
• Management's response to reported exceptions and variances is inadequate.	☐	☒
• A low level of user satisfaction with information systems processing, including reliability and timeliness of reports.	☐	☒
• Inadequate policies for developing and modifying accounting systems and controls, including changes to and use of computer programs and/or data files.	☐	☒
• Overall lack of coordination between the accounting and data processing functions.	☐	☒
• Understaffed accounting or information technology department, inexperienced or ineffective accounting or information technology personnel, or high turnover.	☐	☒
• Lack of timely and appropriate documentation for transactions.	☐	☒
• Accounting system is in disarray.	☐	☒

Indicate other risk factors considered:

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Comments and Additional Information

Provide additional information about the identified risk factors to assist in determining their effects on the assessments of the effectiveness (ineffectiveness) of internal control at the entity level and the risk of fraud. In addition, you may use this space to provide any comments about any of the other risk factors listed above that you believe those making the assessments need to consider.

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Monitoring

Monitoring is the process that assesses the quality of the performance of internal control over time. An important management responsibility is to establish and maintain internal control. Management monitors controls to consider whether they are operating as intended and whether they are modified as appropriate for changes in conditions.

Are the following risk factors present?	Yes	No
• Inadequate monitoring of the continued functioning of significant controls.	☐	☒
• Reportable conditions/material weaknesses in internal control (especially when management does not correct them promptly).	☐	☒
• Control-related recommendations from internal and/or external auditors are ignored.	☐	☒
• High level of customer complaints (especially when management does not fix the cause of them promptly).	☐	☒
• Owner/manager not actively involved in the business.	☐	☒
• Significant minority owners (e.g., venture capitalists) and creditors (e.g., banks) do not adequately scrutinize activities.	☐	☒
• Parent company does not adequately scrutinize activities.	☐	☒
• Oversight by applicable legislative or regulatory bodies, such as examinations by bank regulatory agencies, is ineffective.	☐	☒
If the client does not have an internal audit function, check here ☐, skip the remaining risk factors in this section and consider whether the absence of an internal audit function constitutes a risk factor.		
• Internal audit is not adequately staffed or trained, and does not have appropriate specialized skills given the environment.	☒	☐
• Internal audit is not independent (authority and reporting relationships) and does not have adequate access to the audit committee (or equivalent).	☐	☒
• The scope of internal audit's activities is not appropriate (e.g., balance between financial and operational audits, coverage and rotation of decentralized operations).	☒	☐
• Internal audit has limited authority to examine all aspects of the client's operations or fails to exercise its authority.	☒	☐
• Internal audit does not adequately plan, perform risk assessments, or document the work performed or conclusions reached.	☐	☒
• Internal audit does not adhere to professional standards.	☐	☒
• Internal audit has operating responsibilities.	☐	☒

Indicate other risk factors considered:

Comments and Additional Information

Provide additional information about the identified risk factors to assist in determining their effects on the assessments of the effectiveness (ineffectiveness) of internal control at the entity level and the risk of fraud. In addition, you may use this space to provide any comments about any of the other risk factors listed above that you believe those making the assessments need to consider.

Reliance or assistance from the Internal Audit function for HealthSouth does not play an important role in the audit procedures performed by EY. Any information obtained from internal audit is adequately scrutinized and reviewed. We use internal audit assistance in the search for un-entered liabilities, with the FAS 123 calculation, and on site visit procedures.

Fraud Inquiries

Comment below on your findings from your inquiries of selected members of management regarding (1) their understanding of the risk of fraud in the entity, and (2) whether or not they have knowledge of any fraud (other than that which is "clearly inconsequential") that has been perpetrated on or within the entity (these inquiries of management are to be made during the early planning stages of the audit by at least a manager):

Management's understanding of the risk of fraud:

[Indicate the name(s) and level(s) of the members of management with whom the discussions were held as well as the bases for their responses (e.g., what processes do they employ to provide them with reasonable assurance that their risk assessments are appropriate).]

We held discussions with the following individuals:

Bill Owens – Executive Vice President and Chief Financial Officer

Tadd McVay – Treasurer

Brad Hale – Senior Vice President - Administration and Secretary

Bill Horton – Executive Vice President and Corporate Counsel and Assistant Secretary

Susan Smith – Senior Vice President - Reimbursement

Emery Harris – Group Vice President and Assistant Controller

Management is aware of the risk of fraud within the entity and actively searches for any such instances.

Management's knowledge of fraud:

[Indicate the name(s) and level(s) of the members of management with whom the discussions were held as well as the bases for their responses (e.g., what processes do they employ to provide them with reasonable assurance that there are no significant instances of fraud other than those they may have mentioned).]

Management is not aware of any significant instances of fraud. There have been few isolated issues reported through the Corporate Compliance Hotline, but upon follow-up by management, the issues were determined to be minor and not systematic.

Describe any program (not discussed elsewhere in this questionnaire) that the entity may have in place that includes steps to prevent, deter, and detect fraud. If such a program is in place, ask those persons who oversee such program whether the program has identified any fraud or fraud risk factors.

HealthSouth has established an extensive Corporate Compliance Program. Employees are given considerable compliance training. The Company has a "Hotline" available for employees to report fraudulent and/or abusive behavior. The Hotline is monitored by the HealthSouth Internal Audit Department. The Corporate Compliance Officer, Brad Hale, reviews all issues reported through the Hotline. As stated above, upon inquiry of Mr. Hale regarding instances of fraud, he was not aware of any significant issues.

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Summary and Conclusions

Internal Control and Fraud Considerations

(To be attached to the Audit Strategies Memorandum)

With respect to any risk factors we have identified, describe any controls and/or other factors relating to the client and its business and industry that we are aware of that either mitigate or exacerbate the identified risk factors, and describe the resulting effects of the risk factors on our assessments of internal control at the entity level and the risk of fraud:

We believe the controls and factors that we have outlined above mitigate the identified risk factors in the audit.

The client's internal control at the entity level is ☒ is not ☐ effective. Describe the basis for your conclusion, if it is not obvious:

Describe our audit response(s), if any, to the risk factors we have identified that are not sufficiently mitigated by the client's controls or other factors (or our judgment that our planned audit procedures already constitute a sufficient response to the risk factors):

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During 2002, the following events/risk factors are present:

- All synthetic leases were repurchased (no longer any off balance sheet transactions) – appropriate procedures were designed to test the accounting associated with the synthetic leases.

- Outstanding interest rate swaps were cancelled – EY reviewed accounting for interest rate swaps and cancellation of the swaps.

- MCare released transmittal 1753 that clarified accounting for O/P therapy. HRC announced in August 2002 that the implementation of this transmittal would reduce reimbursement $175 million annually. This resulted in a drop in the stock price from approximately $12 to less than $4. EY designed procedures to test the allowances and the revenue deduction impact of the transmittal

- During the year, the Company paid off debt amounts early resulting in gain on extinguishment of debt – EY designed procedures to review the accounting for this transaction.

- Restructuring / Impairments – As a result of declining revenue, the Company will be closing many facilities and will record a 4th quarter loss due to the closings. In addition, FAS 142 is expected to result in a loss in the 4th quarter due to the impacts of transmittal 1753. We will review managements calculations and use our valuation experts to assist.

- Investments – HRC has reviewed its investments, and as a result of declines in the market and the economy, certain investments will need to be written down to fair value – EY valuation experts will assist in this review.

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