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April 28, 2010

The Honorable Justin P. Wilson
Comptroller of the Treasury
State Capitol
Nashville, Tennessee 37243

Dear Mr. Wilson:

Attached to this letter is a report summarizing our findings related to the request to your office and the Commissioner of the Department of Finance and Administration dated March 7, 2008, by the University of Tennessee Vice President and University Treasurer, for the write-off of $7,509,338 due to the University of Tennessee's Health Science Center (UTHSC) from the University of Tennessee Medical Group (UTMG). The request has been approved by Commissioner M. D. Goetz, Jr.

State Audit's detailed review was initiated after the write-off was requested and because an internal audit report prompted additional questions and concerns regarding the relationship between the university and UTMG. We have reviewed the University of Tennessee internal audit report and the supporting documents gathered by the internal auditor. We requested and reviewed additional records at both UTHSC and UTMG. We also reviewed a consultant's report on the medical group's structure and operations. Furthermore, we interviewed current and former university administrators, faculty, and consultants; current and former UTMG administrators and board members; and relevant third-party individuals, including bank officers and consultants.

It is our recommendation that you approve the university's request for the write-off. First of all, accounts receivable are to be written off if they are deemed no longer collectible. The university has deemed the debt is no longer collectible based upon UTMG's representations that it cannot pay the past due amount of $7,509,338. UTMG did receive over $18 million from its sale of a related entity. From that $18 million, UTMG paid approximately $5 million to UTHSC for contractual obligations for the fiscal years 2006, 2007, and 2008. According to UTMG officials, due to future plans to hire more physicians in highly profitable specialties to remedy

UTMG's financial difficulties, the medical group could not use any of the remaining sale-related funds to repay the outstanding debt to the university. Given these representations, it appears that in order to preserve the medical practice group as a going concern, the write-off of the accounts receivable is in the overall best interests of the state and the university.

However, as noted in the internal audit report and discussed further in this report, the circumstances related to the failure of university officials in Memphis to properly record the receivables and the failure of university officials in Memphis, who control UTMG, to pay the debt to the university present serious legal and policy questions that are not fully addressed by writing off the amount due. Some of these key individuals were seriously conflicted in their interests and roles as state officials and employees of the university since they were on both sides of the pertinent transactions as university employees and as UTMG directors.

The write-off is appropriate in spite of numerous errors in judgment by all officials concerned, only because the medical group is considered by the university as being too important to the operation of the medical school to fail. However, unless these officials, particularly university employees who are also employees and officials of UTMG and who are also compensated by UTMG, act with more sensitivity to their fiduciary responsibilities to the university and the state, future problems such as this may be expected to occur.

The work of this office and the university's internal audit staff highlights the serious risks inherent in relationships between public institutions and related affiliations as presented in this matter. Although such arrangements may be an accepted practice and are stated to be critical to the mission of public institutions, they present significant transparency and accountability challenges.

Although no acts of fraud were discovered in these reviews, it is essential that top management of the university, both in Knoxville and Memphis, carefully assess the risk of fraud, waste, and abuse in the relationships and transactions between the university and UTMG, as well as with other such entities.

That risk assessment should be performed by management familiar with and responsible for the relationship and interactions between UTMG and UTHSC and other such entities. It should be documented and presented to the audit committee of the University of Tennessee for their review and approval. After they have completed the risk assessment, they should design and implement written internal controls to effectively mitigate those risks and to provide appropriate transparency and accountability of the relationship and transactions between UT, UTMG, and other such entities. Those controls should also be presented to the audit committee for their review and approval.

The risk assessment should be reviewed and updated on a regular basis, and internal controls should be adjusted as required to mitigate any additional risks noted. All such actions should be adequately documented.

In the future, all transactions between UT and UTMG should be recorded completely, accurately, adequately, and timely in the books and records of UTHSC. Top officials at UTHSC should promptly inform top officials of the university in Knoxville of any unusual or questionable interactions or transactions with UTMG or other similar entities. UTHSC officials should also ensure that they understand those circumstances when prior formal approval from UT officials is required. In all such circumstances, they should obtain formal written approval before taking the actions in question.

Sincerely,

Arthur A. Hayes, Jr., CPA
Director