SPECIAL REPORT

Review of the Relationship Between the University of Tennessee Health Science Center and the Nonprofit Corporation UT Medical Group and the University's Request for the Write-off of $7.5 Million Due to the University From the Medical Group

April 2010

STATE OF TENNESSEE

COMPTROLLER OF THE TREASURY

Department of Audit

Division of State Audit

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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.

Arthur A. Hayes, Jr., CPA
Director

State of Tennessee

A u d i t   H i g h l i g h t s

Comptroller of the Treasury   Division of State Audit

Review of the Relationship Between the University of Tennessee Health Science Center and the Nonprofit Corporation UT Medical Group and the University's Request for the Write-off of $7.5 Million Due to the University From the Medical Group

April 2010

SCOPE OF THE REVIEW

Early in 2007, an internal audit of payments due to the University of Tennessee from the UT Medical Group (UTMG) was initiated by the UT Audit and Consulting Services at the request of Dr. William Owen, then chancellor of the University of Tennessee Health Science Center (UTHSC), after he became aware that no payments had been made by UTMG officials since 1999.

A University of Tennessee internal audit report dated September 28, 2007, reported the results of that review. The internal audit report concluded that although previous officials at UTHSC had waived unpaid debt owed from UTMG in prior years, those officials had failed to formally communicate both the outstanding debt that had been waived and the fact that they had approved the waivers to university officials in Knoxville.

University officials in Knoxville have since made entries to record the debt of $7,509,338 and have requested that the debt be written off.

State Audit's review of the relationship between UTHSC and UTMG was initiated after the write-off was requested because the 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.

RESULTS OF THE REVIEW

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 overhead for the fiscal years 2006, 2007, and 2008. According to UTMG officials, due to future plans to hire more physicians in highly profitable specialties, they 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 appears 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.

This report (including the UT internal audit report) contains numerous recommendations for improved accountability and transparency regarding the operations of UTMG and its relationship with the university. Due to the conflicts inherent in the current structure wherein the medical group's officers are also officials of the university, the highest level of transparency of those operations and particularly transactions involving remuneration to insider officials must be maintained.

It is also recommended that university officials take this opportunity to perform a more comprehensive evaluation of the university's relationship with UTMG and other such entities. This evaluation should include an objective consideration of whether such practice entities, at least in their current form, are the best vehicle for the university to fulfill its mission.

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INTRODUCTION

BACKGROUND

Early in 2007, a University of Tennessee internal audit review of the nonpayment of "overhead" stipulated in an affiliation agreement between the University of Tennessee and the University of Tennessee Medical Group (UTMG) was initiated by the UT Audit and Consulting Services at the request of Dr. William Owen, then chancellor of the University of Tennessee Health Science Center (UTHSC), after he became aware that no overhead payments had been made by UTMG officials since 1999.

The internal audit report dated September 28, 2007, reported that although previous officials at UTHSC had waived unpaid overhead in prior years, those officials had failed to formally communicate both the outstanding debt that had been waived and the fact that they had approved the waivers to university officials in Knoxville.

University officials in Knoxville have since made entries to record the debt of $7,509,338 and have requested that the debt be written off.

The purpose of the affiliation agreement was primarily to formalize the relationship between the university and the group of university faculty in Memphis, who coordinate the public health services provided exclusively by themselves and other university faculty at hospitals and various clinics in the Memphis area. The agreement has been in force since July 1999. The current structure of UTMG is such that its administrative operations are performed outside of the university umbrella. The operations include the oversight of the related clinical operations, collections of patient care service fees assessed at those clinics and hospitals, and payment of expenses, the majority of which are additional compensation to university faculty at UTHSC, in Memphis, for their services to patients in the hospitals and clinics.

FINDINGS OF THE UNIVERSITY OF TENNESSEE INTERNAL AUDIT REPORT

The Overhead Balance Due for FY 2000-2005

According to the UT internal audit report (see attachment on page 11), unpaid overhead due to the university's College of Medicine from UTMG totaled $7,509,338 for fiscal years 2000 through 2005. Prior to this period, UTMG had made the payments required by the affiliation agreement.

Questions of Lack of Authority to Approve the Write-off of Prior Amounts Due to the University

The internal audit report concluded that during this five-year period various UTHSC officials waived the overhead stipulated in the affiliation agreement because of the medical group's poor financial status.

However, according to the internal auditors, the affiliation agreement had no provisions for waivers of the overhead prior to 2005, and hence there was no effective procedure prior to that year to waive the payments.

Furthermore, only the Chancellor of the UTHSC had the legal authority to waive the payments on behalf of the university. In 2004 and 2005, the Dean of the College of Medicine, and not the Chancellor, waived the payments for those years.

Lack of Proper Record Keeping by UTHSC Officials

For the years 2000-2005, UTHSC officials also failed to record the outstanding debt as accounts receivable in either their official accounting records or in the financial statements provided to the university's Treasurer in Knoxville, after amounts became due. Therefore, the university system business officers in Knoxville were not aware of this outstanding debt and were not in a position to ensure that proper write-off procedures were followed as prescribed by the State of Tennessee Department of Finance and Administration.

Lack of Adequate Communications Between UTHSC and UTK

Although there was some communication with top officials at the University in Knoxville about the financial plight of UTMG during the period when earlier waivers had been granted by UTHSC officials, apparently those communications were informal and did not result in effective oversight and review of the waivers.

In light of the work of the internal auditor, this report does not go into detail on many matters involving UTHSC and UTMG. The following items are discussed in the internal audit report:

- Overhead disbursements
- Authorizations for Waivers
- Factors Contributing to UTMG's Financial Situation
- UTMG's Germantown Building
- UTMG Revenues and Expenses Including Compensation and Benefits
- Malpractice Insurance Premiums

UTMG PAYMENTS OF OVERHEAD FOR 2006, 2007, AND 2008

Though UTMG's expenses exceeded revenues from operations during fiscal year ended June 30, 2008, funds were available to pay the overhead due to UTHSC from the sale of the Memphis Managed Care Corporation (MMCC) d/b/a TLC Family Care Health Plan, an entity owned by UTMG and the Regional Medical Center (The Med) in November 2007. According to the minutes of the UTMG Board of Directors' meeting, UTMG received sales proceeds of $18,873,534 in fiscal year 2008 from that transaction. The UTMG board of directors has designated the use of the majority of these sales proceeds in support of "strategic initiatives" and "planned growth" in programs. The expenses for this planned growth totaling approximately $13 million are budgeted over a five-year period. A total of $5,336,344 of the total sales proceeds was used to meet a portion of obligations of the affiliation agreement with UT, as mentioned above.

The sale proceeds were not, however, used to repay the outstanding amounts due of $7,509,338 from 2000-2005.

SCOPE OF THE REVIEW

State Audit's review of the relationship between UTHSC and UTMG was initiated after the write-off of accounts receivable was requested because the 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 report by the university's consultant 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.

RESULTS OF THE REVIEW

RECOMMENDATION TO APPROVE WRITE-OFF

It is the auditors' recommendation that the university's request be approved for the write-off of $7,509,338. 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 overhead for the fiscal years 2006, 2007, and 2008.

According to UTMG officials, due to future plans to hire more physicians in highly profitable specialties, they 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.

NEED FOR COMPREHENSIVE EVALUATION OF UTMG'S RELATIONSHIP WITH THE UNIVERSITY

This report (including the UT internal audit report) contains numerous recommendations for improved accountability and transparency regarding the operations of UTMG and its relationship with the university. Due to the conflicts inherent in the current structure, wherein the medical group's officers are also officials of the university, the highest level of transparency of those operations and particularly transactions involving remuneration to insider officials must be maintained.

In addition to the specific recommendations noted, this report also recommends that university officials ensure that a thorough assessment be made of the risks of fraud, waste, and abuse related to the operations of UTMG and that appropriate mitigating controls be designed and implemented.

It is also recommended that university officials take this opportunity to perform a more comprehensive evaluation of the university's relationship with UTMG and other such entities. This evaluation should include an objective consideration of whether such practice entities, at least in their current form, are the best vehicle for the university to fulfill its mission. For this evaluation to be truly valuable, university officials should not only consider the views of private consulting firms, but also consider, for example, the practice model of other universities, including East Tennessee State University.

By combining the examination of specific issues and recommendations with a comprehensive review of the benefits and drawbacks of such entities, university officials can better develop a coordinated and systemic approach to dealing with the matters illustrated by these circumstances.

CONFIRMATION OF UT INTERNAL AUDIT FINDINGS

The issues surrounding this debt were looked at initially by UT internal audit. Our subsequent review confirmed their findings and found no instances of fraud. The UT internal audit is exhibited as an attachment of this report.

REVISIONS TO THE AFFILIATION AGREEMENT ARE NEEDED TO INCLUDE PROVISIONS FOR VARYING ECONOMIC FACTORS

In April 2009, ECG management consultants issued a report at the request of the UT Board of Trustees' audit committee after conducting an assessment of the organizational structure, affiliation, and overall performance of UTMG and the UT college of medicine. ECG consultants' report included their findings and recommendations.

At this time, the affiliation agreement between UTHSC and UTMG does not provide for varying economic factors, such as recent operating losses reported by UTMG. One of the recommendations in the ECG Management Consultants report was that revisions to the affiliation agreement should be made to clarify situations where UTMG experiences any future financial difficulties. We agree with this assessment.

However, when developing the definitions of financial difficulties, UTMG and the university should include considerations of the impact of paying salaries and bonuses to UT faculty in the overall assessment of whether the group can make payments required by the affiliation agreements to the university. When revisions to the affiliation agreement become necessary due to changing economic factors, the revisions should take into consideration not only the need for the medical group to make payments to the university for contractual obligations but should also consider whether payments to physicians, particularly those who are members of the medical group's board of directors, should also be reduced to meet the group's obligation to the university. The mechanism for any needed reductions in compensation is already provided for under the UTMG physician contracts.

UTMG contracts with individual UT physicians to deliver patient care services. This includes UT physicians who are also officials of UTMG. Under the current contract model, the physicians receive an annual planned income and adjustments on a monthly basis based on performance targets. Those performance targets are set for each physician, the physician's department, and UTMG. Those contracts provide that UTMG has the right to reduce the annual planned income amount by no more than 50 percent.

As previously noted, there is a lack of transparency and an inherent conflict when UTMG officials are, in effect, contracting with themselves. Some degree of independence should be added to this process, particularly when the decision is made to cut other payments to the university rather than cutting payments to physicians who are also UTMG officials or staff.

THE UTMG BOARD OF DIRECTORS NEEDS TO INCLUDE BOTH A UNIVERSITY OF TENNESSEE KNOXVILLE DESIGNEE AND THE UTHSC CHANCELLOR

Frequent turnover in top officials at UT Knoxville and UTHSC and the lack of proper contract management by UTHSC officials contributed to the lack of transparency and accountability with regard to the payments due to the university by the group and to the efforts to waive those amounts in the past. These issues effectively prevented the UT Board of Trustees from having any control or input regarding the transactions between UTHSC and UTMG.

To promote greater and clearer communications between the university's administrators in Knoxville and those at UTHSC and to assure that the university's interests are adequately considered in the decision-making of the UTMG board of directors, it is recommended that both a UT Knoxville designee and the UTHSC Chancellor be given voting positions on the board of directors for UTMG. We also agree with the UT consultant that a Health Affairs Committee of the UT Board of Trustees would aid in communications and add transparency to the medical group's activities.

We have been advised that the UT Board of Trustees is in the process of establishing such a committee that will be exclusively dedicated to the oversight of UTHSC and UTMG. Additionally, ECG recommended that UT consider developing a three-year business plan for both entities and consider streamlining the funds flow between UTHSC and UTMG.

TRANSACTIONS BETWEEN UTHSC AND UTMG SHOULD BE RECORDED AND UT COMMITMENTS NEED TO BE FORMALIZED TO PROVIDE FOR GREATER ACCOUNTABILITY

Future transactions need to be formally recorded between UTHSC and UTMG. UT officials in Memphis and Knoxville need to assure the public that they are complying with all relevant laws, policies, and procedures in their interactions with the medical group.

Apparently, the affiliation agreement was not given the attention it warranted as a formal, significant contract of the university. The business relationship between the officials at UTHSC and UTMG has long been one where such transactions were treated too casually. Year after year, an informal settlement of receivables and payables between the two entities was calculated but the respective receivables and payables were not recorded by UTHSC officials, resulting in inaccurate university financial records. The unrecorded receivables included amounts due from the affiliation agreement. Furthermore, when payments were received pursuant to the affiliation agreement, they were misclassified as gifts/donations rather than as contractual payments. No receivables derived from the affiliation agreement were recorded by UTHSC as a result.

UT commitments (including promises or obligations to UTMG and similar entities) should also be formalized. As noted in this review, plans for the university to rent UTMG facilities such as the new Germantown medical clinic were made verbally. Such matters should be reduced to writing in the future, rather than the parties having to rely on informal promises to take actions that are material to the future economic health of the group.

As mentioned above, the affiliation agreement should be revised to ensure adequate accountability and transparency. The agreement should contain appropriate references to university policies and procedures, and those requirements should be followed. Any revisions should specify the contributions of each party with accountability for yearly measurements and enough flexibility to allow for those contributions to change yearly, as appropriate. However, flexibility without accountability and transparency is unacceptable. Any such changes should be made formally, with proper oversight and review by top officials of the Memphis campus and UT officials in Knoxville. The President and Chief Financial Officer should take the proper actions to ensure that the leadership of UTHSC understand their responsibilities to the university, including the need to promptly advise the President, Chief Financial Officer (who should in turn notify the audit committee of the board of trustees), and general counsel of any changes to contracts, or to the related economic circumstances of related parties such as UTMG. UTMG's financial statements should be reviewed by officials in Knoxville and UTHSC officials to ensure proper and consistent accounting for transactions between the two entities.

OTHER AFFILIATION AGREEMENTS

State Audit's review determined that UTHSC has six other affiliation agreements with smaller specialty medical groups. Collections on many of these agreements were also found to be in arrears. Additionally, the recording of transactions and monitoring of the obligations under some of these affiliation agreements was also found to be deficient and included other waivers of debt by university officials. The other affiliation agreements also obligated those groups to make payments to the university.

Those groups are the Boston Baskin Cancer Group – Department of Internal Medicine, the Campbell Clinic – Department of Orthopaedic Surgery, Semmes Murphey – Department of Neurosurgery, Semmes Murphey – Department of Neurology, University Pathology Group – Department of Pathology, and the Thoracic and Cardiovascular Surgery Association – Department of Surgery.

CONCLUSION

In conclusion, the long and successful history of UTMG and UT/UTHSC has provided benefits to the UT community and the people of Memphis. However, the events of the past eight to ten years have revealed that due to the complex nature of the relationship and its vulnerability to unforeseen negative economic factors, greater cooperation and communication between the parties are essential to the long-term success of that relationship. In addition, it is essential that the relationship be grounded on a strong contract and that all university officials take proactive steps to assure transparency and accountability in all their efforts.

In the future, officials must be held accountable for their decisions and actions. UTMG must avoid placing the university in a position of having to "rescue" the group from the consequences of risky decisions and actions. University officials must assure the public that they are complying with all relevant laws, policies, and procedures in their interactions with the group. University officials should also ensure that transactions between the two entities are properly accounted for with complete, accurate, and formal accounting entries and that officials and personnel in both entities understand that casual and informal settlements are unacceptable.

In regard to the future of overhead payments to the university, certainly a change is needed according to the officials interviewed by the auditors. The practice group was once profitable in the 1980s and early 1990s and was able to contribute to the university to support the basic sciences. According to the UT consultant's report, the overhead fee to the university's College of Medicine was similar to standard provisions in other affiliation agreements between universities throughout the United States and their practice groups. According to UTMG officials, the downward pressures on reimbursements for medical services and rising costs of expenses such as insurance seriously impair the current ability of UTMG to make substantial overhead payments to the university's College of Medicine. In the future, UTMG's current financial strategies may provide more available funds for the nonprofit entity. Certainly, the total contributions of UTMG should be considered in the establishment of future overhead amounts. However, there should also be a mechanism to ensure that if these fees meant for the university's basic sciences are decreased or temporarily postponed in the future, the practice group has taken every step to minimize other costs and that any amounts spent in efforts of retention are based on sound analysis and include independent input and approval from university officials.

RECOMMENDATIONS

1. It is the auditors' recommendation that the university's request be approved for the write-off of $7,509,338.

2. University officials should take this opportunity to perform a more comprehensive evaluation of the university's relationship with UTMG and other such entities. This evaluation should include an objective consideration of whether such practice entities, at least in their current form, are the best vehicle for the university to fulfill its mission. For this evaluation to be truly valuable, university officials should not only consider the views of private consulting firms, but also consider, for example, the practice model of other universities, including East Tennessee State University.

3. Revisions to the affiliation agreement should be made to clarify situations where UTMG experiences any future financial difficulties.

4. When developing the definitions of financial difficulties, UTMG and the university should include considerations of the impact of both salaries and bonuses to UT faculty in the overall assessment of whether the group can make payments required by the affiliation agreements to the university.

5. When revisions to the affiliation agreement become necessary due to changing economic factors, the revisions should take into consideration not only the need for the medical group to make payments to the university for contractual obligations but should also consider whether payments to physicians, particularly those who are members of the medical group's board of directors, should also be reduced to meet the group's obligation to the university.

6. The affiliation agreement should be revised to ensure adequate accountability and transparency.

7. The agreement should contain appropriate references to university policies and procedures, and those requirements should be followed.

8. Any revisions should specify the contributions of each party with accountability for yearly measurements and enough flexibility to allow for those contributions to change yearly, as appropriate. Any such changes should be made formally, with proper oversight and review by top officials of the Memphis campus and officials in Knoxville.

9. To promote greater and clearer communications between the university's administrators in Knoxville and those at UTHSC and to assure that the university's interests are adequately considered in the decision-making of the UTMG board of directors, it is recommended that both a UT Knoxville designee and the UTHSC Chancellor be given voting positions on the board of directors for UTMG.

10. The UT Board of Trustees should continue its efforts in establishing such a Health Affairs Committee to aid in communications and add transparency to the medical group's activities.

11. UTMG and UTHSC officials should take all steps necessary to provide full accountability for their actions and proper transparency of their actions, including but not limited to prompt and formal communications to top officials in Knoxville regarding any issues between UTMG and UTHSC.

12. Future transactions need to be recorded between UTHSC and UTMG.

13. UT officials in Memphis and Knoxville need to assure the public that they are complying with all relevant laws, policies, and procedures in their interactions with the medical group.

14. The President and Chief Financial Officer should take the proper actions to ensure that the leadership of UTHSC understand their responsibilities to the university, including the need to promptly advise the President, Chief Financial Officer (who should in turn notify the audit committee of the board of trustees), and general counsel of any changes to contracts, or to the related economic circumstances of related parties such as UTMG.

15. UTMG's financial statements should be reviewed by officials in Knoxville and UTHSC officials to ensure proper and consistent accounting for transactions between the two entities.

16. 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.

17. 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 management 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.

18. 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.

19. In the future, all transactions between UT and UTMG should be recorded completely, accurately, 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, UTHSC officials should obtain formal written approval before taking the actions in question.

THE UNIVERSITY OF TENNESSEE
HEALTH SCIENCE CENTER
UT MEDICAL GROUP
INTERNAL AUDIT REPORT
September 28, 2007

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September 28, 2007

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Memphis, TN 38163

Dear Dr. Wall:

Enclosed is our audit report of the UTMG College of Medicine overhead payment, which is received from UTMG each year as specified in the Affiliation Agreement between UTMG and the UT Health Science Center (UTHSC). Dr. William Owen, former UTHSC chancellor, requested the audit when he learned that UTMG had not fully paid the annual overhead since 1999. As stated in our report, UTMG has not paid $11,568,006 from fiscal year 2000 to 2007. University management was aware the overhead was not being paid, but only two written waivers were prepared. One waiver for $1,980,634, however, was made before such a waiver was allowed by the Affiliation Agreement, and another $3,565,285 was waived by a former dean of the College of Medicine, who does not have contract authority for the university. In addition, the university failed to record unpaid amounts as receivables. Had this been done, state officials would have had to approve any write-off. Previously, the overhead could have been waived through a contract amendment. Since 2005, the agreement allows the university to waive the overhead payment through written agreement prior to the payment becoming due. In such case, a receivable would not have to be recorded; however, university officials failed to do this. We recommend that the amounts owed by UTMG be recorded as accounts receivable, any future write-offs be processed in accordance with university policy, and the new affiliation agreement between the university and UTMG be amended to protect the university's interests.

We also reviewed all property and leasing arrangements between the university and UTMG. Exceptions noted include a lease agreement that should be approved by the Tennessee Department of Finance and Administration, a property for which no signed agreement exists between the university and UTMG, and two properties that need new agreements.

We appreciate your written response to the findings specifying the corrective actions you and your staff have taken or plan to take. Thank you for the excellent cooperation we received from everyone at the Health Science Center and UTMG. If you have any questions, please contact me.

Sincerely,

Judith A. Burns
Assistant Director

bn A06038

c: Mr. Kennard D. Brown
Mr. Steven H. Burkett
Mr. Anthony A. Ferrara
Ms. Brenda H. Jeter
Mr. James R. Maples
Mr. Charles M. Peccolo Jr.
Dr. John D. Petersen
Dr. Gary W. Rogers
Mr. Steve J. Schwab, M.D
Audit Committee

UT HEALTH SCIENCE CENTER
UT MEDICAL GROUP
INTERNAL AUDIT REPORT

PURPOSE AND SCOPE

This audit was performed at the request of Dr. William Owen, former chancellor of the University of Tennessee Health Science Center (UTHSC), after he learned that the UT Medical Group Inc. (UTMG) had not paid the university the full College of Medicine "overhead" disbursement for fiscal years 2000 through 2005 as stipulated in the Affiliation Agreement between UTMG and UTHSC. The scope of the audit included reviewing the validity of the waivers of the overhead payment and reviewing the factors that contributed to UTMG's financial situation and inability to pay the overhead. In addition, we reviewed the property and lease arrangements between the university and UTMG.

BACKGROUND

Patient care activities rendered by full-time faculty in clinical departments at medical universities are an essential component of the teaching programs for students, residents, and fellows. UTMG is the entity through which the university allows its medical faculty to render these essential patient care activities in a private practice setting and to earn additional compensation for those activities. UTMG's origins trace back to the Faculty Medical Practice Corporation (FMPC) founded in 1974. In 1983, FMPC was reorganized as University Physicians Foundation Inc. after achieving 501(c)(3) non-profit status. The corporate name was subsequently changed to UT Medical Group Inc. in 1990 to reflect its association with the UT Health Science Center. UTMG has the authority and responsibility to enter into agreements with hospitals and other healthcare organizations for patient care activities provided by university faculty. UTMG also bills, collects revenue, and compensates faculty for their patient care services. Patient care by medical faculty must be provided through UTMG (certain exceptions are specified in the Affiliation Agreement), and the income that medical faculty may derive from patient care is limited to an amount agreed upon by the university and UTMG. The current agreement between UTHSC and UTMG was approved in July 1999 and revised in 2005.

Section 4 of the Affiliation Agreement specifies the following disbursements to the university.

- (b) A sum equal to 2.5 percent of patient care collections (cash basis) by UTMG shall be disbursed to the university. The money shall be placed in a special fund titled College of Medicine Special Education Account and used for official university purposes as determined by the dean of the College of Medicine. The money is to be disbursed on a quarterly basis within 30 days following the end of each calendar quarter throughout the fiscal year. This disbursement is commonly referred to as the "College of Medicine Overhead."

- (c) A sum equal to 2.5 percent of patient care collections (cash basis) **may** be distributed, at the discretion of the appropriate UTMG department chairperson, to the university and placed in a special fund titled Chairman's Special Education Account and used for official university purposes by the appropriate academic chairperson.

- (g) A sum equal to 2.5 percent of cash collections, up to a maximum of $250,000 per year, **may** be allocated annually to the UTMG Research Fund to fund research approved by UTMG's Board of Directors through its Research Committee and to support the College of Medicine's programs in research and education.

According to the Affiliation Agreement, these covenants are valid unless otherwise agreed between the university and UTMG in writing.

Once the College of Medicine overhead becomes payable, it should be recorded as a receivable in the university's accounting records. Any write-off of the receivable must be reported to the university controller, and written approval must be obtained from the commissioner of the state's Department of Finance and Administration and the state comptroller of the treasury. The Affiliation Agreement (as amended in 2005) states, however, that the College of Medicine overhead may be not paid if it is "... agreed between the University and the Group in writing." Therefore, if a written agreement is approved by both the university and UTMG prior to the payment becoming due, the payment does not have to be made and the receivable does not have to be recorded.

Beginning in fiscal year 2000, UTMG began falling behind in its payments to the university. The factors contributing to UTMG's financial condition are discussed more fully later in this report. A significant issue restricting UTMG's ability to pay the overhead, however, was the financial requirements of the $23.55 million loan for the physicians' building in Germantown, Tennessee. This building was built to move a portion of the physicians' practices to the suburban community in an effort to broaden the patient population that supports the teaching programs of the university and to diversify the payer mix of the patient population being served. Diversifying the payer mix was projected to improve financial performance of UTMG and the College of Medicine in the long term. UTMG's patient base in downtown Memphis had resulted in TennCare, self-paid, and indigent charges constituting 68 percent of total charges and only 54 percent of collections, according to a 2003 report. Mr. William Rice, UTHSC chancellor at that time, was aware of and supported the plans regarding the Germantown building initiative to improve the payer mix. When UTMG failed to meet some of the financial ratios required in the loan covenants for this building, however, the loan was in default. A forbearance agreement executed by the bank prohibited UTMG from paying the overhead due to the university unless the financial ratios were met and written approval was obtained from the bank. Mr. Rice stated he was aware of the covenants of the forbearance agreement.

OVERHEAD DISBURSEMENTS

The following chart shows the computed overhead due from 1999 to 2007, amounts paid, and the unpaid balance. As noted below, fiscal year 1999 was the last year the overhead was paid in full; only partial payments were made for fiscal years 2000, 2001, 2002, and 2006. From fiscal year 2002 through 2006, the overhead was not accrued as a liability on the UTMG financial statements. Also, except for fiscal year 2007, UTHSC did not record any of the unpaid amounts as receivables. The UTMG financial statements for these years state the university agreed to waive the overhead payment.

Fiscal Year	Overhead	Overhead Paid	Balance
1999	$1,353,000	$1,353,000	$ 0
2000	1,454,559	831,228	623,331
2001	1,472,198	721,251	1,374,278
2002	1,710,377	848,143	2,236,512
2003	1,707,541		3,944,053
2004	1,743,198		5,687,251
2005	1,822,087		7,509,338
2006	1,923,668	490,000	8,943,006
2007	2,625,000		11,568,006

AUTHORIZATIONS FOR WAIVERS

Mr. William Rice, Mr. Emerson Fly, former university chief financial officer, and Dr. Joseph Johnson, former president, all stated they were aware of UTMG’s financial difficulties and the university’s efforts to assist UTMG by suspending overhead payments. They felt the physicians' private practice was an integral part of UTHSC and steps should be taken to help UTMG remain solvent to preserve the faculty and teaching programs. They all indicated they expected UTMG to resume paying the overhead when it became more profitable. It is worthy to note that during the period of UTMG's financial difficulties, the university and the Health Science Center experienced significant turnover in the president’s, chancellor’s, and other key financial positions as listed below.

Presidents

Dr. Wade Gilley	1999-2001
Mr. Emerson Fly	2001-2002
Dr. John Shumaker	2002-2003
Dr. Joseph Johnson	2003-2004
Dr. John Petersen	2004-present

System Chief Financial Officers

Mr. Emerson Fly	1999-2001
Position did not exist	2001-2003
Mr. Emerson Fly	2003-2004
Dr. Jack Britt	2004-2005
Dr. Gary Rogers	2005-present

UTHSC Chancellors

Mr. William Rice	1999-2002
Dr. James Gibb Johnson	2002-2003
Mr. William Rice	2003-2005
Dr. William Owen	2005-2007
Dr. Hershel Wall	2007-present

UTHSC Medical School Deans

Dr. Henry Herrod	1999-2005
Dr. Hershel Wall	2005-2006
Dr. Steve Schwab	2006-present

UTHSC Chief Business Officers

Mr. Robert Blackwell	1999-2002
Ms. Joanne Hadley	2002-2005
Mr. Anthony Ferrara	2005-present

Although staff at the university and UTMG acknowledge verbal agreements existed to suspend or waive the overhead payments, only two signed waivers exist. One signed waiver was included in the 2002 year-end settlement agreement of receivables and payables between UT and UTMG. Each year a settlement sheet is prepared to offset various payables and receivables between the two parties. The settlements are approved by a UTMG official and usually the UTHSC chancellor or dean of the College of Medicine. After both parties approved the settlement, the offsetting amounts were totaled and a check was issued to whomever was owed the remaining balance. In 2002, the settlement sheet showed a waiver of the overhead of $1,980,634. This represented the balance of accrued overhead through 2001 less the settlement balance applied to the overhead. Dr. James Gibb Johnson, who served as interim UTHSC chancellor for part of 2002 and all of 2003, signed the agreement. The waiver did not include the overhead accrued for 2002. The UTMG financial statements for 2002 and 2003 acknowledge the overhead was waived, but no signed waivers of overhead exist for these years. Dr. Johnson stated he did not specifically recall waiving the overhead, but it was his understanding that the overhead was optional and UTHSC officials had authority to waive it. This occurred, however, prior to the 2005 amendment to the agreement allowing the overhead to be waived through a written agreement.

The other waiver was signed in January 2005 at the request of UTMG's external auditors. Dr. Henry Herrod, dean of the College of Medicine and chairman of UTMG's Board of Directors, signed a memo stating it was a notice of waiving the overhead for fiscal years 2004 and 2005. The memo stated the overhead was being waived because of UTMG's financial burdens in struggling with TennCare and in the rising costs of professional liability insurance. A dollar amount was not provided, but the amounts for the two years totaled $3,565,285. The dean, however, does not have authority to sign agreements on behalf of the university. Dr. Herrod stated that Health Science Center officials, including the chancellor, were aware of the waiver. Mr. Rice, the chancellor at the time, agreed he was aware of the waiver and recalled a letter supporting it.

Thus, at the end of the 2005 fiscal year UTMG had not paid the university overhead payments totaling $7,509,338. The university had provided documents to UTMG formally waiving $5,545,919 ($1,980,634 + $3,565,285) of this amount. No written waivers existed for the remaining amount, but UTMG officials believed former university officials had verbally agreed to also waive this amount. Former university officials agreed that concessions had been made to UTMG regarding the overhead payments.

As previously noted, none of the payments due from UTMG at the end of the 2005 fiscal year were recorded as receivables on the university's records. Because UT and UTMG are legally separate entities, and the College of Medicine overhead is a contractual obligation (clause 4.b) that must be paid unless agreed to by both parties in writing, the amount due should be recorded as a receivable when it becomes due. Also, according to the Affiliation Agreement, UTMG is to pay the university within 30 days after the end of each quarter. As such, any receivable amounts determined to be uncollectible should have been formally written off and reported to the university controller, who reports them to the commissioner of the state Department of Finance and Administration in accordance with state policies. Finance and Administration's policy and procedures 0620-1-9-.02 requires all state agencies, departments, and institutions to obtain written approval from the commissioner and the comptroller of the treasury for all write-offs of $5,000 or greater or accounts totaling $25,000 or greater.

Thus, once the overhead payments became due and payable, it does not appear that university officials had authority to waive or forgive the amounts owed by UTMG. On the other hand, before the payments became due, the appropriate university officials could have amended the contract to waive the payments, consistent with their acknowledged judgment that doing so was necessary to preserve the patient care component of the university's teaching programs. Also, the 2005 contract amendment specifically allows waiving the overhead through a written agreement. Such documents, however, were never prepared and signed by an appropriate university official.

The dean of the College of Medicine was not authorized to bind the university to an agreement to waive the payments. Therefore, he was not authorized to issue the January 2005 memorandum purporting to waive the amounts due for fiscal years 2004 and 2005. A university officer authorized to bind the university should have issued the memorandum. Mr Rice and other university officials, however, were aware of the waiver.

UTMG officials have argued that, independent of the waivers, clause 4.f of the agreement with the university permits UTMG to withhold overhead payments to maintain amounts sufficient for its fiscal and operational needs. Clause 4.f of the agreement does permit the revenues and receipts from patient care activities to be used for the "... funding and replacement of reserve funds which the Group shall be entitled to maintain, in amounts to be determined by mutual written agreement of the parties to be sufficient for the Group's fiscal and operating needs as a going concern …." According to UTMG, a written agreement on a reserve amount was never prepared. Thus, there was a not a written agreement to a reserve amount that would have taken precedent over the overhead payments due to the university required in the Affiliation Agreement. In addition, even if university officials agreed in writing to allow UTMG to retain funds for a reserve, the amounts due to the university would continue to exist, thereby requiring a receivable to be recorded and state approval to write off this debt.

In the summer of 2006, UTMG officials again approached the university about their inability to pay the overhead. The group had also changed its external auditing firm, which requested a written document from the university approving the waiver of overhead. Chancellor William Owen refused to waive any fees or provide such a document and no action was taken. In January 2007, UTMG's audited financial statements were due to the bank within a few weeks, and the group was concerned that if the overhead payment had to be recorded as a liability it would not meet certain financial covenants required by the bank, which could then foreclose on various assets. Thus, for the seventh straight year UTMG was unable to pay the university, and university administrators were again faced with the dilemma that the failure to forgive UTMG's debt to the university would force the group to become insolvent and adversely affect the income of hundreds of UTHSC faculty members. Therefore, university officials again attempted to assist UTMG by entering into two written agreements to address the overhead due for fiscal years 2006 and 2007.

For 2006, the overhead amount due to the university totaled $1,923,668. In one agreement for fiscal year 2006, the university agreed to allow UTMG to pay $490,000 by January 2007 and to allow the remaining $1.434 million to remain in UTMG. This provided documentation for the external auditors, with Section 4 of the Affiliation Agreement referenced as a basis for allowing these funds to remain with UTMG. In a second agreement, UTMG agreed to contribute $1,500,000 over the next five years to the College of Medicine and to use its best efforts to obtain approval from the bank to pay the College of Medicine overhead amount due (approximately $1,000,000) for the six months ending December 31, 2006, with the remaining payments for fiscal year 2007 made timely as described in the Affiliation Agreement. This agreement was subject to approval by the UTMG Board of Directors, and the payments associated with the 2006 and 2007 overhead payments were subject to approval by their bank. Since this agreement would not be executed until January 2007, UTMG did not have to record any amounts from it as a liability for the 2006 reporting year. The effect of these agreements would have been that over a five-year period UTMG would have paid the university $1,990,000 instead of the $1,923,668 due on June 30, 2006, and would have made the payments due for fiscal year 2007. In negotiations of these agreements, UTMG officials assured the university the group was in very good financial shape for 2007, should not have any difficulty making these payments, and should be able to get their bank to remove some of the restrictions. This agreement also stated that a new affiliation agreement would be negotiated and be effective July 1, 2007. The university's chief financial officer and the president and chief executive officer of UTMG signed these agreements. Ms. Brenda Jeter, chief financial officer of UTMG, stated that shortly after the agreements were signed the UTMG board rejected the agreement committing $1.5 million over five years and payment of the overhead for 2006 and 2007. UTMG did pay the $490,000 required in the first agreement, but has not paid any amounts due for fiscal year 2007. A new affiliation agreement has not been executed as of September 2007. In 2007, the university recorded a receivable of $2,625,000 due from UTMG (based on projected revenue) and invoiced UTMG for this amount.

As part of the fiscal year 2007 audit, this matter is being reviewed by the State Audit office, which is responsible for performing the external audit of the university's financial statements. The university plans to indicate in note 4 to the financial statements a receivable and an allowance for all amounts owed by UTMG and not paid under the Affiliation Agreement from 2000 to 2007. It appears this would total $11,568,006. The amount is based on the $7,509,338 owed from years 2000 through 2005, plus $1,923,668 due for 2006, less $490,000 paid for 2006, plus $2,625,000 accrued for 2007.

It is important to note that, despite financial difficulties preventing UTMG from paying the overhead, the group routinely pays annual bonuses to its employees. UTMG officials claim this is vital to maintaining the stability of the faculty.

University physician practice groups commonly pay a similar overhead charge to the medical college, and they face many of the same challenges faced by UTMG. A survey of "overhead" rates charged by medical schools revealed the following.

Medical School	Overhead Rate as a Percent of Professional Revenue	Comments
New Jersey Medical School	10.0	
University of Colorado	10.0	
University of South Florida	6.8	7% less some exemptions
Marshall University	6.0	
University of New Mexico	5.0	
Virginia Commonwealth University	4.5	
University of Utah	4.4	
Medical College of Georgia	4.0	
George Washington Medical Center	3.0	
University of Tennessee	2.5	

This data should be interpreted with the understanding that these practices may be in locales with a more profitable patient mix. Also, some of these universities may provide significant building space, whereas UTMG owns or leases most of its space.

UTMG officials pointed out that College of Medicine officials used the overhead in the past to assist UTMG financially by allowing portions of quarterly payments to be left within UTMG and applied to departments that were generating significant losses on the clinical side. The college waived or reduced payments of the overhead in the following instances without the chancellor's signed approval.

- On December 1, 1995, Mr. James C. New, associate dean for administration, signed an agreement authorizing UTMG to reduce the dean's share of the Special Education Fund by $200,000, beginning with the first quarter of fiscal year 1996 and continuing during the first quarter of each of the next four fiscal years. This was to address a $1,000,000 deficit in the UTMG's Ophthalmology department.

- In a memo dated June 3, 1999, Mr. Robert P. Baker, who then worked in Finance and Administration for the College of Medicine, authorized Ms. Brenda Jeter, then UTMG controller, to reduce the quarterly overhead payment by $50,000 so that the funds could be applied to the Surgery department's remaining deficit of $200,000.

Therefore, applying funds to assist UTMG financially does have precedent. These individuals, however, did not have the authority to waive the overhead payments.

FACTORS CONTRIBUTING TO UTMG'S FINANCIAL SITUATION

The College of Medicine overhead payments were waived because of UTMG's poor financial condition. The following chart summarizes the income or loss from continuing operations for UTMG and the amount of College of Medicine overhead either paid or waived. The data below was taken from the audited financial statements.

Fiscal Year	Income/(Loss) from Continuing Operations	Overhead Paid
1998	$ (26,000)	$ 3,675,000
1999	(10,616,000) (1)	1,971,000
2000	102,000	1,353,000
2001	1,390,000	831,288
2002	(2,418,568) (2)	721,251
2003	(3,444,179) (3)	0
2004	667,352	0
2005	(604,785)	0
2006	(514,464)	0

(1) Before the June 30, 1999, UTMG financial statements were released, the National Bank of Commerce required a write-off of accounts receivable of $11 million, of which $8 million was subsequently collected.

(2) FY 2002 was the first year of operations for the clinics in the Germantown Building and was also the first year of lost revenue due to the closure of Baptist Hospital. The $2.4 million net operating loss was before the waiver of $1,980,634 was recorded and drove the need for the waiver.

(3) The $3.4 million loss includes a one-time accrual of $3,009,540 for deferred compensation due to termination of life insurance policies. The net loss from operations for fiscal year 2003 was $434,639.

The Germantown Building

According to UTMG, one of the fundamental problems they face has been the increasing percentage of TennCare and indigent patients in downtown Memphis's health service practices. The Germantown building was built to help improve UTMG's deteriorating financial situation by increasing the number of commercially insured patients in their client base. An analysis performed by UTMG in 2003 indicated

that, for the Regional Medical Center (The Med) in downtown Memphis, the TennCare, self-paid, and indigent charges represented 68 percent of total charges and only 54 percent of collections. For the Germantown building, TennCare, self-paid charges represented only 10 percent of total charges and 17 percent of collections. (Self-pay services in Germantown are elective services and not indigent self-pay as at The Med of Memphis.)

In March 1999, tax-exempt bonds for $23,550,000 were issued for the construction of the Germantown building. Unfortunately, UTMG's poor financial condition resulted in a default on certain financial covenants in the loan, and a forbearance agreement was issued in February 2000. Specific violations cited in the agreement for the loan default include the following.

- The ratio of current assets to current liabilities, on a consolidated basis, was less than 1.25 to 1.00 as reflected at the end of each calendar quarter.

- The ratio of total liabilities to unrestricted net assets exceeded 1.75 to 1.0 as reflected at the end of each calendar quarter.

- The ratio of debt service coverage was less than 1.25 to 1.0 as reflected at the end of each calendar quarter.

The forbearance agreement was extended through June 2004. At that time, the loan agreement was amended to include certain financial requirements and to require the bank's written approval for any payment to UT for the College of Medicine overhead. Not meeting the requirements of the agreement noted above and the loan amendment (the bank’s written approval) restricted UTMG's ability to pay the overhead.

Another factor negatively impacting UTMG was the Germantown building’s not being fully occupied for several years. During the planning stages it was understood that UT would occupy approximately one-third of the building (34,718 sq. ft.). Although there was no written document stating this understanding, the university and UTMG entered into a lease agreement for part of the space (20,381 sq. ft.) on June 18, 2003, at a rate of $24.85 per square foot. The Preventive Medicine department occupied the space on the third floor, and a multi-use conference room was on the first floor. The agreement was terminated on June 1, 2004, for a number of reasons, including the relatively expensive lease rate, Preventive Medicine’s not needing all of the space, and UTMG’s wanting to offer the entire space to another tenant. The rate being paid by Preventive Medicine exceeded rates established for state agencies, which is currently $17.00/sq. ft. for Memphis suburbs. UTMG planned to lease the vacated space to the Boston Baskin Cancer Group, also known as the UT Cancer Institute (UTCI). Unfortunately, UTCI could not occupy the space immediately, and it remained vacant for a period of time. UTMG administration estimated that the failure to lease this space resulted in approximately $1,575,000 in total lost rent revenue from 2002 through 2006.

UTMG Revenue and Expenses

The main expenses for UTMG are compensation and benefits, which have remained approximately the same over the past nine years. Total revenues and expenses over the same period, however, have declined as illustrated below (numbers are stated in thousands).

Year	Revenue Adjusted for Bad Debt and Charity (1)	Cumulative Percent Change	Operating Expenses Adjusted for Bad Debt and Charity (1)	Cumulative Percent Change	Compensation and Benefits per Financial Statements (2)	Cumulative Percent Change
1998	$107,048	0.00	$107,074	0.00	$70,796	0.00
1999	97,739	-8.70	108,355	1.20	72,225	2.02
2000	105,665	-1.29	105,563	-1.41	70,379	-0.59
2001	99,113	-7.41	97,723	-8.73	69,589	-1.70
2002	99,619	-6.94	102,037	-4.70	75,749	7.00
2003	97,583	-8.84	101,027	-5.65	74,810	5.67
2004	87,890	-17.90	87,222	-18.54	63,563	-10.22
2005	90,952	-15.04	91,557	-14.49	68,098	-3.81
2006	95,623	-10.67	96,138	-10.21	71,949	1.63

(1) During fiscal years 1998 through 2001, community benefit/charity care was included in the provision for uncollectible accounts. Starting in 2002, the external auditors required this to be recorded as a reduction in net revenue, as required by Generally Accepted Accounting Principles. Therefore, based on this reclassification, the revenue and expenses in fiscal years 1998 through 2001 should have been lower on the financial statements. UTMG provided the adjustment for bad debt and charity.

(2) Compensation and benefits do not include malpractice insurance premiums.

Increased Malpractice Premiums

Another factor contributing to UTMG's financial situation has been the significant increase in malpractice insurance premiums. UTMG pays the malpractice insurance premiums for medical faculty members engaged in private practice through UTMG. Area hospitals require physicians to have professional liability coverage to maintain privileges. Without these hospital privileges, medical faculty could not perform their responsibilities in clinical care and education. The following chart shows how the total malpractice insurance cost for UTMG has risen since 1998. This data was taken from the audited financial statements. UTMG has assumed this increase rather than passing the cost to the practicing physicians. It is important to note that the increase in premiums has been higher in some fields than in others.

Fiscal Year	Malpractice Insurance	Increase over Previous Year	Cumulative Increase
1998	$1,960,000	-	-
1999	1,949,000	$ (11,000)	$ (11,000)
2000	1,921,347	(27,653)	(38,653)
2001	2,232,000	310,653	272,000
2002	2,652,810	420,810	692,810
2003	3,724,616	1,071,806	1,764,616
2004	4,907,502	1,182,886	2,947,502
2005	5,205,956	298,454	3,245,956
2006	5,369,373	163,417	3,409,373

North Pauline Street Building

Yet another negative factor was the acquisition of the 135 North Pauline Street building. The university needed a home for the Department of Psychiatry, and university administrators had also been in discussion with state officials and the TennCare Bureau regarding inpatient and outpatient behavioral health services for TennCare enrollees in Shelby County. An arrangement was made between the university and UTMG in 1995 whereby UTMG would purchase the facility at 135 North Pauline Street for the purpose of being developed into a psychiatric hospital. The facility was named the University Behavioral Health Center Inc. (UBHC) and was a wholly owned subsidiary of UTMG. According to UTMG, UBHC generated a $460,000 profit in 1995 and shortly thereafter the TennCare Bureau significantly changed the business model for behavioral health services. UBHC lost $1.3 million in fiscal year 1996 and $2.4 million in 1997. In 1998, a decision was made to close down the inpatient services, resulting in an operating loss of $656,000 and a loss from discontinued operations of $962,000. The loss from discontinued operations in 1999 was $2.6 million. From 1995 to 1999, UTMG estimates it lost over $7.4 million related to the UBHC programs. According to UTMG, these losses drained and weakened the financial stability of UTMG. The building was sold in 2001, but UTMG holds a master lease. The university leases academic space to the Psychiatry department and several other tenants that cover most of the cost.

Other Extraordinary Events

In addition to these fundamental issues, extraordinary events significantly affected UTMG's financial condition. Some of the major extraordinary events are listed below. The following financial data was provided by UTMG and not verified by our office. For some events, it is not possible to measure the financial impact precisely.

- In 2000, the dialysis unit was sold for a gain of $1,806,000.

- UTMG lost two major service locations that had a much higher payer mix than The Med. In 2001, Baptist Hospital closed, and in 2004 Bowld Hospital closed. Both of these closures significantly disrupted patient care services and revenue streams that still have not been fully regained at Methodist University Hospital.

- In 2003, the university pharmacy was sold. The cumulative loss on discontinued operations was approximately $280,000.

- During this period, all Managed Care Organizations (MCO) were experiencing substantial losses. In 1999, Xantus TennCare MCO declared bankruptcy. Also, in 2001, Access Med Plus TennCare MCO declared bankruptcy. This led to more claims being denied and lower payments received. The losses are estimated to be over $2 million.

- During 2006, TennCare disenrollment led to an increase in indigent patients at The Med. Self-pay/indigent patients rose from 26 to over 31 percent of services.

UTMG stated the group has taken several cost-saving measures in recent years, including the following. Again, the financial data was provided by UTMG and not verified by our office.

- Effective July 1, 2002, the pension plan contribution rates were reduced and the vesting period was increased. UTMG estimates that, based on the previous formula, the new pension contribution rate saves approximately $1,500,000 per year.

- Effective July 1, 2003, group term life insurance replaced split-dollar life insurance for physicians and executives (see above). UTMG estimates an annual savings of approximately $190,000.

- Effective July 1, 2002, all new physicians and executives moved from individual disability policies to a group disability policy. UTMG estimates an annual savings of approximately $50,000.

- Effective July 1, 2002, vacation payout at termination was reduced to varying hours based on years of service. UTMG estimates an annual savings of approximately $90,000.

- Reduction in force and closed positions for non-physicians have been as follows:

	# of Positions	Estimated Annual Savings
FY03	29	$1,121,345
FY04	40	1,361,552
FY05	28	1,216,513
FY06	16	735,606
	113	$4,435,016

As mentioned previously, however, the total compensation and benefits for UTMG are at the same approximate level as in 1999. Therefore, these reductions in benefits and eliminated positions have been offset by increases in faculty salaries. It is important to note, however, that the compensation of medical faculty practicing through UTMG is set by agreement between the university and UTMG. This is in keeping with the fundamental purpose of UTMG, which is to provide a mechanism for the university to attract and retain qualified faculty members by allowing them to earn additional income through the private practice of medicine. Some UTHSC administrators outside the College of Medicine have expressed concern that faculty salaries may be too high, particularly regarding bonuses paid in years UTMG had financial difficulties and was unable to pay the overhead. We did not, however, attempt to benchmark the reasonableness of the salaries. The UTHSC chancellor should be responsible for addressing the reasonableness of faculty salaries with the College of Medicine.

CONCLUSION ON OVERHEAD PAYMENTS

For eight consecutive years, UTMG has not paid the full amount of the university's College of Medicine overhead in accordance with the Affiliation Agreement, which specifies a payment of 2.5 percent of patient care collections. A total of $11,568,006 of overhead was not paid from fiscal year 2000 to 2007. Efforts were made to collect amounts for 2006 (partial collection achieved) and 2007, rather than waiving the overhead. From 2000 through 2005, appropriate university officials were aware that the overhead was not paid, and it was their acknowledged judgment that waiving the overhead was necessary to preserve the patient care component of the university's teaching programs. The tenure for most of these officials during this time was only a few years, and they assumed UTMG would ultimately resume payments to the university in accordance with the Affiliation Agreement. Current university officials were unaware the waiver had been extended for eight consecutive years until the start of this audit.

If an appropriate university official had amended the contract (since 2005) or documented the waiver in writing before the amounts from UTMG became due, a receivable would not have existed. This was not done, however. Once the overhead payments became due, the debts could be written off only with the written approval of state officials. Written approval was not obtained from state officials because the payments due from UTMG were not recorded as accounts receivable on the university's records.

FINDINGS AND RECOMMENDATIONS

Finding 1: Waiving the College of Medicine overhead payments represents an exception to the Affiliation Agreement, which requires all exceptions to be approved by the university and UTMG in writing. Although former university officials acknowledge verbal agreements existed to suspend or waive the overhead payments, only two actual signed waivers exist. A former interim UTHSC chancellor signed one agreement prior to the 2005 amendment, and a former dean of the College of Medicine signed the other. The dean does not have authority to sign contracts for the university.

Recommendation: The Affiliation Agreement between the university and UTMG should be amended to state that all exceptions to its provisions must be approved in writing by the campus chief business officer and the university's chief financial officer or designee.

Management Response: *The Health Science Center fully agrees with this recommendation and will take steps to ensure the appropriate approval of such waivers in the future.*

Finding 2: The Health Science Center did not record the UTMG College of Medicine overhead as an accounts receivable. UT and UTMG are legally separate entities, and the College of Medicine overhead is a contractual obligation in the Affiliation Agreement (clause 4.b) which must be paid unless agreed to by both parties in writing. Therefore, the overhead should be recorded as an accounts receivable when it becomes due. In addition, any subsequent waiver or uncollectible amount should be processed as a write-off, with the appropriate approval from state officials obtained in writing.

Recommendation: The university should ensure that all amounts owed by UTMG, including the overhead payments, are recorded as accounts receivable and any future write-offs should be processed in accordance with university policy.

Management Response: *The Health Science Center fully agrees with this recommendation and is taking steps to record the outstanding receivables.*

Finding 3: In past years, UT and UTMG executed an annual settlement agreement whereby receivables and payables between the entities were netted against each other and the balance paid by one party. This removes expenses and revenues from the university’s accounting records, resulting in inaccurate financial data.

Recommendation: The annual settlement agreement of receivables and payables between UTMG and the university should be discontinued. Receivables and payables should be handled independently of each other and recorded appropriately in the university's accounting records.

Management Response: *The Health Science Center fully agrees with this recommendation.*

RECOMMENDATIONS REGARDING THE AFFILIATION AGREEMENT

We understand that the Affiliation Agreement is currently being renegotiated and propose the following recommendations to protect the university's interests.

1. Peer institutions should be surveyed to determine a benchmark for the College of Medicine overhead rate.

2. The Affiliation Agreement should be amended to include the following.

   - UTMG should not disburse bonuses to faculty unless the group is financially sound, meets all financial objectives required in loan agreements, and has paid the university the full annual overhead amount. In addition, bonuses should be tied to performance measures.

   - The university's written approval must be received before UTMG enters into an agreement with a lending institution, which has an impact on the university's ability to receive the College of Medicine overhead payment.

3. Officials responsible for overseeing the UTMG contract should not be a UTMG officer nor be receiving any payments or personal benefits of any kind from UTMG. The new agreement should prohibit payments to the chancellor and dean of the College of Medicine unless approved in writing by the university's chief financial officer.

PROPERTY AND LEASE ARRANGEMENTS

As part of this review, we inventoried the property agreements between UT and UTMG. We reviewed agreements where UT either received property from or provided property to UTMG, regardless of whether a formal lease contract was executed. A summary of the information gathered is provided below.

The University (Lessor) Provides Space to UTMG (Lessee)

Location	Lease #	Sq. Ft.	$/Sq. Ft.	Annual $	Monthly $
66 N. Pauline Ave.	1296	16,738	$10.34	$173,071	$14,423
Lamar Alexander Bldg.- 7th Floor	93960	313	10.34	3,236	270
920 Madison Ave- Ste. C01	No formal UT lease	940	8.40	7,896	658
920 Madison Ave.- Ste. 415	No formal UT lease	3,362	11.42	38,394	3,200
930 Madison Ave.- Ste. 850	No formal UT lease	7,628	12.00	91,536	7,628
930 Madison Ave.- Ste. 890	No formal UT lease	2,221	12.00	26,652	2,221
930 Madison Ave.- Hamilton Eye Inst.	No formal UT lease	21,000	0.00	0	0
70 N. Pauline Ave.	No formal UT lease	3,372	0.00	0	0
Total		55,574		$340,785	$28,400

The University (Lessee) Obtains Space from UTMG (Lessor)

Location	Lease #	Sq. Ft.	$/Sq. Ft.	Annual $	Monthly $
135 N. Pauline Ave.	51446	9,437	$11.52	$108,714	$ 9,060
1211 Union Ave.	No formal UT lease	7,476	$19.90	148,772	12,398
Total		16,913		$257,487	$21,457

According to the UT Real Estate office, the Facilities Revolving Fund (FRF) rate for leasing property in the Memphis central business district (where these properties are located) is $16/sq. ft. The FRF rate is the guideline rate established for state agencies. The FRF rate for leasing property in Memphis suburbs is $17/sq. ft.

Details on issues regarding the properties are discussed below.

- For the 66 Pauline Avenue building, the original leasing period has expired, but the lease continues to operate under the "holding over" clause in the contract. The "holding over" clause (clause 18 in the standard UT lease agreement) states: "In the event the Lessee remains in possession of the premises after the expiration of the lease term, or any extension thereof, this lease shall be automatically extended on a month to month basis, subject to thirty (30) days termination by either party, and otherwise on the terms and conditions herein specified, so far as applicable."

- No official UT leases exist for the Madison Avenue building properties. UT inherited these leases from Baptist hospital, which are still binding. According to UTHSC administrators and the UT Real Estate office, the State Building Commission exempted the properties from further SBC approvals. UTHSC administrators said they are aware official UT leases should be executed to replace the Baptist leases and plan to do so.

- The Hamilton Eye Institute performs academic, research, and clinical activities. The clinical functions are under UTMG. UTMG is responsible for all renovations to the clinical areas, but pays no rent for the space occupied.

- The 70 N. Pauline Avenue property was previously a storage area. UTMG paid for interior space construction and continues to pay all operating expenses associated with the space. No rent, however, is paid to UT.

- The 135 N. Pauline Avenue property, similar to the 66 Pauline building, has an expired original lease period and is operating under the "holding over" clause.

- For the 1211 Union Avenue property, the actual lease is between UTMG and Methodist hospital, where the property is located. UTMG charges the university for the lease amount. No approved sublease exists, however, between UTMG and UT. Faculty use the offices for academic purposes. Mr. Tony Ferrara, UTHSC chief business officer, said plans are underway to vacate this building as soon as space is available on campus. Current renovations in the Coleman building have prevented the faculty from moving back sooner. In addition, a UTMG business manager and other workers are located in the building, but the rental rate is not adjusted for this. Payment to UTMG is not made by check; instead, charges are offset against other items UTMG owes the university (e.g., telephone, computer services).

RECOMMENDATIONS REGARDING PROPERTY ARRANGEMENTS

- The lease for the Lamar Alexander building should be forwarded to the UT Real Estate office and approved by the state Department of Finance and Administration.

- Although tentative plans exist to vacate the Union Avenue property soon, a sublease for this property should be prepared and executed. The sublease should adjust the rental rate for the space occupied by UTMG workers. Also, any payment should be made by check rather than offsetting the charges against other payables to the university.

- New written agreements should be executed and properly approved for the Hamilton Eye Institute and the 70 N. Pauline Avenue properties. This will help avoid future misunderstandings regarding these locations.