audit report
OFFICE OF INSPECTOR GENERAL

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97-PH-212-1002	

TO: John Sepulveda, Director, Hospital Mortgage Insurance Staff, H

FROM: Edward F. Momorella, District Inspector General for Audit, Mid-Atlantic, 3AGA

SUBJECT: Newport News General Hospital
Section 242 Hospital Program
Newport News, Virginia

As requested by your staff, we audited the operations of Whittaker Memorial Hospital Association Inc. (mortgagor) doing business as Newport News General Hospital (hospital). The purpose of the audit was to determine whether the mortgagor and Healthcare Affiliates of Virginia Inc. (agent) operated the hospital according to the terms and conditions of the Regulatory Agreement and applicable HUD directives. The report contains one finding. Based on our tests, we determined that the mortgagor and agent did not properly manage the hospital's financial operations. As a result, HUD's and the hospital's interests were not adequately protected.

Within 60 days, please give us, for each recommendation made in this report, a status report on: (1) the corrective action taken; (2) the proposed corrective action and the date to be completed; or (3) why action is considered unnecessary. Also, please furnish us copies of any correspondence or directives issued because of the audit.

If you have any questions, please contact Irving I. Guss, Assistant District Inspector General for Audit, at (215) 656-3401.

Executive Summary

We audited Newport News General Hospital to determine whether the mortgagor and agent operated the hospital in accordance with the Regulatory Agreement and applicable HUD directives.

Hospital financial operations improperly managed

Based on our tests, the mortgagor's former Board of Trustees did not properly oversee hospital management and maintain adequate controls over hospital operations as required. The mortgagor and agent paid ineligible and unsupported expenses totaling $768,874 and $682,714, respectively, from hospital funds. The former Board of Trustees were either unaware of restrictions on operating expenses or considered costs reasonable in order to retain the services of a skilled management agent. As a result, the hospital was deprived of funds needed to meet financial obligations.

We recommend that the current Board of Trustees take appropriate action to recover the ineligible costs, and provide justification for the unsupported costs.

During the audit the draft finding issues were discussed with hospital officials. The draft finding was provided to a designated hospital representative, and no written response was received. We discussed the draft finding with the Executive Committee of the current Board of Trustees at an exit conference on November 21, 1996. The committee agreed with our presentation.

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Abbreviations

HUD	Department of Housing and Urban Development
OIG	Office of Inspector General

Introduction

Newport News General Hospital is a 126-bed community hospital located at 5100 Marshall Avenue, Newport News, Virginia. On October 25, 1983, the hospital received a Section 242 HUD insured mortgage of $13,269,700. On November 6, 1990, the hospital filed for bankruptcy. The hospital's original mortgage had been in financial default from the period of November 1990 to October 1995. Under a confirmed plan of reorganization, the hospital executed a Deed of Trust Note with HUD in the amount of $4,000,000. The first payment under the new note was due on October 1, 1995. HUD is the mortgagee and payments have been current since October 1995.

On June 1, 1993 the hospital entered into a management agreement with Healthcare Affiliates of Virginia, Inc. to operate and manage the hospital. As compensation for the management services to be rendered the hospital agreed to pay a management fee of $360,000 per year payable in equal monthly installments. Joseph F. Johnson, Jr. is the Chief Executive Officer of the agent. In November 1995 the agent's services were terminated.

William Batts, III is the chairman of the current Board of Trustees. The hospital's financial books and records are maintained at 5100 Marshall Avenue, Newport News, Virginia.

Audit Objectives

The primary objective of the audit was to determine whether the mortgagor and agent operated the hospital in accordance with the Regulatory Agreement and applicable HUD directives. Specific audit objectives were to determine whether disbursements from operating funds were for hospital related expenses.

Audit Scope

We reviewed available hospital's books and records. We interviewed responsible hospital staff and directors, the former Board of Trustees, and the former management agent concerning hospital disbursements.

Audit Period

Audit work was performed between June 1996 and November 1996 and covered activities from January 1992 to December 1995.

We conducted the audit in accordance with generally accepted government auditing standards.

Ineligible And Unsupported Costs Were Paid From Hospital Funds

The mortgagor and agent paid ineligible and unsupported costs from hospital operating funds contrary to the Regulatory Agreement. Ineligible and unsupported disbursements totaled $768,874 and $682,714 respectively, as shown on Appendix A. The former Board of Trustees were either unaware of restrictions on operating expenses or considered costs reasonable in order to retain the services of a skilled management agent. As a result, funds were expended unnecessarily and improperly accounted for, to the detriment of effective hospital operations.

A. Ineligible Costs

The hospital's mortgage was in default during the period in which Healthcare Affiliates acted as the management agent. Audited financial statements were not available to determine the financial condition of the hospital during this period. During the period of January 1, 1992 through December 31, 1995 ineligible costs paid from hospital operating funds included the following:

1. Board Member Compensation

Paragraph (4) (d) of the Regulatory Agreement states the mortgagor: "shall not without the prior written approval of the Secretary: Pay any compensation or make any distribution of income or other assets to any of its officers, directors or stockholders;"

Article III, Section 3. of the Corporate By-Laws state: "A person shall be disqualified from membership in the corporation who is employed by the corporation or derives income from the use of its facilities."

Board members improperly compensated

Three members of the former Board of Trustees received compensation from the hospital during their tenure. From 1992 through 1995 board members received compensation for services rendered totaling $542,880. Board members were either unaware of the restriction or considered their compensation acceptable since the practice was longstanding.

2. Consultant Contracts

Paragraph 9.5 of the Management Agreement states: "...it is agreed that Manager shall not engage any such consultants without first obtaining the approval of the Board."

On June 1, 1993, an individual representing himself as the President of Healthcare Affiliates, signed the Management Agreement with the hospital. On September 20, 1993, the same individual subsequently executed a retainer agreement with the hospital as a consultant. Under this agreement the individual received compensation totaling $151,394.

The representative stated he was not an officer of Healthcare Affiliates nor did he receive payments from Healthcare Affiliates. He signed the management agreement on behalf of the corporation because he was the only representative of Healthcare Affiliates in Newport News when the agreement was drawn up.

On September 1, 1993, another individual, representing himself as an associate of Johnson & Associates, Inc. also executed a retainer agreement between himself and the hospital. Johnson & Associates is an identity of interest company of the management agent, Healthcare Affiliates. Total compensation paid under this agreement was $43,100.

Consultants paid without board approval

Board members were either unaware of the execution of these contracts or reluctant to question their eligibility. Approval of these contracts was not documented in the board minutes.

3. Unauthorized Loans

Paragraph (4) (b) of the Regulatory Agreement, states the mortgagor: "shall not without the prior written approval of the Secretary: Assign, transfer, dispose of, or encumber any personal property of the project, including rents, and shall not disburse or pay out any funds except for usual operating expenses and necessary repairs; ..."

Agent made improper loans

The management agent processed two promissory notes from hospital funds totaling $31,500. Both loans remain outstanding. The Board of Trustees were unaware of these loans.

Payment of management fees questionable

B. Unsupported Costs

During the period of June 1, 1993 through November 1995 unsupported costs paid from hospital operating funds included the following:

1. Management Fees

Paragraph 6 of the Management Agreement states: "Manager shall defer management fees if agreed upon operating goals are not met... Operating goals, at a minimum, shall include the Hospital achieving a positive net operating income and a positive cash flow on a monthly basis for the management fee to be paid."

During the period of November 3, 1993 through October 24, 1995, Healthcare Affiliates received management fees totaling $470,000. Review of periodic financial statements available for the same period disclosed the hospital generated positive net operating income for four reporting periods. However, the hospital's current accounting staff questions the validity of these financial statements. Additionally no audited statements are available to confirm the financial history of the hospital.

According to the former chairman, the Board of Trustees had considered deferment of management fees to Healthcare Affiliates. However, it was decided, that realistically, the hospital could not retain anyone without compensation. Therefore, despite the restriction imposed by the management agreement, Healthcare Affiliates received uninterrupted management fees.

2. Other Disbursements

Paragraph (9) (a) of the Regulatory Agreement states: "Income and other funds of the project shall be expended only for the purposes of the project and in connection with the mortgaged property."

Documentation was not available to confirm that the following expenses were related to or necessary for hospital operations:

- American Express - hotel and meal expenses totaling $861.

- Management Agent President - travel, entertainment, and administrative expenses totaling $13,811.
- AT&T - cellular long distance telephone calls by the Chief Executive Officer totaling $804.
- Director of Clinical Services - relocation, travel, year end bonus, and miscellaneous expenses totaling $14,091.
- Cellular One - cellular telephone bill totaling $750.
- Compusa - Laptop computer, which the Management Agent President retained upon his departure, totaling $2,200.
- Days Inn - local hotel room charges for the Chief Executive Officer, a consultant and others totaling $3,375.
- Featherstone Apts - temporary housing for the Chief Financial Officer totaling $17,058.
- The Harbours - temporary housing for the Director of Clinical Services totaling $3,600
- Chief Operating Officer - travel, year end bonus, living and miscellaneous expenses totaling $22,417.
- Healthcare Affiliates - travel, telephone,and miscellaneous expenses totaling $22,367.
- Potential employee - lodging in New Orleans totaling $316
- Chief Executive Officer - hotel and airline reimbursement, and administrative expenses totaling $3,306.
- Kiln Creek Country Club - country club dues and entertainment expenses totaling $11,124.
- Minolta Leasing Services - copying machine located at another office of the management agent but leased to the hospital totaling $5,807.

- Oakwood Corporate Housing - housing expense for the Chief Executive Officer totaling $11,615.

- Radisson Hotel - local restaurant expense totaling $484.

- Director of Marketing - living allowances, moving and miscellaneous expenses totaling $2,683.

- Uniglobe Hampton Roads Travel - travel for hospital employees and employees of Healthcare Affiliates totaling $64,326. Travel included reimbursement for frequent trips home by the Chief Financial Officer, the Director of Clinical Services, and family members.

- Consultant - retainer fee and express mail expense totaling $8,414.

- Consultant - service agreement and miscellaneous expenses totaling $3,305.

In summary, the former Board of Trustees stated that overall they were aware of and approved the expenditures made by Healthcare Affiliates. The Board felt the expenditures were necessary to: 1) recruit and retain quality staff; and 2) generate new revenue sources for the hospital.

In our opinion the management agent and former Board of Trustees ignored HUD Regulatory Agreement requirements and HUD financial requirements in administering the financial operations of the hospital. Although the hospital was experiencing serious financial problems, the former Board of Trustees approved the disbursal of hospital funds to pay costs not directly related to operations. As a result, the hospital was deprived of $1,451,588 of needed operating revenue.

Recommendations

We recommend the Board of Trustees:

1A. Recover and repay to the hospital operating account $768,874 improperly paid from operating funds.

1B. Develop and provide reliable historic financial data to support the payment of management fees totaling $470,000, or recover and repay the hospital operating account for all or any portion not supported.

1C. Provide documentation supporting the propriety of other unsupported disbursements totaling $212,714 or recover and repay the hospital operating account for all or any portion not supported.

Internal Controls

In planning and performing our audit, we considered internal controls of the management of Newport News General Hospital to determine our auditing procedures and not to provide assurance on internal controls. Internal controls is the process by which an entity obtains reasonable assurance as to achievement of specified objectives. Internal control consists of interrelated components, including integrity, ethical values, competence, and the control environment which includes establishing objectives, risk assessment, information systems, control procedures, communication, managing change, and monitoring.

Internal controls assessed

We assessed the following internal controls which were relevant to our audit objectives:

- Cash disbursements
- Board of Trustees oversight

Assessment results

A significant weakness exists if internal controls does not give reasonable assurance that the entity's goals and objectives are met; that resource use is consistent with laws, regulations, and policies; that resources are safeguarded against waste, loss and misuse; and that reliable data are obtained, maintained, and fairly disclosed in reports. Based on our review, significant internal control weakness's covering cash disbursements and Board of Trustees oversight is described in the finding in this report.

Follow Up On Prior Audits

This is the first OIG audit of the hospital.

Schedule of Ineligible and Unsupported Costs

	Ineligible 1/	Unsupported 2/
Compensation to board members	$542,880	
Consultant contracts	194,494	
Unauthorized loans	31,500	
Management fees		$470,000
Inadequately documented disbursements		212,714
	$768,874	$682,714
Total Costs	$1,451,588	

1/ Ineligible costs are clearly not allowed by law, contract, or HUD policies or regulation.

2/ Unsupported costs do not clearly violate policies or regulations, but warrant being contested for various reasons, such as the lack of satisfactory documentation to support eligibility and HUD approval.

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