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GAO

United States General Accounting Office
Washington, DC 20548

Human Resources
Division

JUN 30 1980

Mr. Earl M. Collier Jr., Acting Administrator
Health Care Financing Administration
Washington, D.C.

Dear Mr. Collier:

We recently completed a review of [hospitals' use of contract management services]. In particular, we examined those arrangements where the management firm provides "full service management" and assumes responsibility for management of the day-to-day operation of the hospital. The cost of these contracts can be significant and hospitals' use of them is increasing at a rapid rate.

There are a number of concerns we noted in connection with the use of these contracts. For example,

- the contracts frequently covered excessively long periods;
- the fees for many of the contracts were often based on a percentage of gross revenues;
- the fees varied widely;
- the documentation of the services actually provided was inadequate;
- the adequacy of controls over payments to the firms was questionable;
- Medicare intermediaries generally were not reviewing the reasonableness of the fees charged; and,
- the Health Care Financing Administration (HCFA) had not developed adequate standards and instructions governing reimbursement for the costs of the contracts.



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In summary, we believe that HCFA and its intermediaries need to take action to assure that Medicare reimbursement for the cost of these services is reasonable. 1/

Our review included site visits at seven Medicare intermediaries, two in HCFA's San Francisco Region and five in the Atlanta Region. Work was also performed at HCFA headquarters and at the Blue Cross Association in Chicago. We held discussions with eight firms that provide contract management services and we also reviewed the provisions of 66 contracts.

We did audit work at three hospitals which were operated under management contracts. Our basic purpose here was to attempt to assess the reasonableness of the fees charged. The hospitals were selected primarily on the basis of the length of the management contract, how the contract fee was calculated, amount of fee charged, and the hospital's location relative to our field staff.

Our findings, conclusions, and recommendations are presented below.

BACKGROUND

The 66 full service management contracts we reviewed varied in their wording but they had some common characteristics. First and foremost, the management firm was responsible for management of the day-to-day operation of the hospital and usually placed its own employees in key positions, such as hospital administrator and controller. In some instances, the director of nursing was also an employee of the management firm.

Under all of the contracts, the hospital's Board of Directors retained the ultimate control and responsibility for the operation of the hospital. Further, all of the contracts contained specific provisions limiting the extent of the management firm's authority. For example, a common

1/ Our review did not specifically cover State Medicaid efforts relating to hospital management contracts. However, because the States normally use Medicare reimbursement principles, the matters discussed in this report may also affect Medicaid.

provision limited the amount the firm could expend for capital improvements without prior Board approval.

Another major feature of the contracts was that they can provide the hospitals access to a wide variety of administrative and health expertise. On the administrative side, this can include financial management, national purchasing contracts, inventory control systems, and maintenance. Clinical expertise was available in many areas, including diabetics, nursing, respiratory therapy, and pharmacy.

Hospitals that retain management firms generally have been characterized as being in serious financial trouble. Officials of one management firm stated, however, that more and more, hospitals seeking its services are those not necessarily in financial trouble, but hospitals simply reacting to the increasing pressures to keep costs down.

Discussions with management firms revealed a number of problems that hospitals have and that the firms attempt to address. These problems include (1) excessive number of hospital beds or underutilization, (2) overstaffing, (3) excessive inventories, and (4) untimely collection of receivables.

RAPID GROWTH OF USE OF MANAGEMENT CONTRACTS

A comprehensive inventory of hospitals utilizing management contracts is not available; however, there is evidence that the number is significant and growing rapidly. According to a survey conducted in the summer of 1978 by the Federation of American Hospitals of its members, 265 hospitals were being managed under full service contracts which represents an increase of about 76 percent over the prior year.

The number of hospitals managed by contract, as reported by the Federation, is not all inclusive because only Federation members were surveyed. We identified 15 management firms not included in the Federation's survey. We did not attempt to determine the total number of hospitals managed by these 15 firms nor do we believe that we identified all of the firms providing such services. Our review was limited to 7 of Medicare's 83 intermediaries, and the 7 intermediaries reviewed lacked complete knowledge of hospitals managed under contract.

EXCESSIVE DURATION OF CONTRACTS

The duration of the 66 management contracts we reviewed ranged from 1 to 27 years. Two thirds (44) were for 3 years or less while one third or 22 contracts were for 5 years or more. Eleven or about 17 percent were for 10 years or longer.

Long term management contracts normally would not represent prudent business practice. ^{1/} The longer the term of the contract, the greater the difficulty in predicting hospital needs and the costs associated with meeting those needs. Although any contract normally can be terminated for just cause, long term contracts can severely restrict the flexibility and options of the Hospital Board.

It should also be noted that while most of the contracts we reviewed were for 3 years or less, the contracts often were apparently designed with a long-term involvement in mind. Management firm officials stated that they enter into management contracts anticipating long term relationships even though the initial contract periods are relatively short. Officials of one of the largest hospital management firms in the country told us that they have experienced about an 80 percent renewal rate on management contracts.

Although a short term contract should provide the Hospital Board more flexibility, certain contract provisions tend to create a dependency on the management firm. For example, the objective of the contracts is not to develop the management capability of top hospital employees because at the onset they are replaced by employees of the management firm. Further, upon termination, the contracts often preclude the hospitals from retaining the firm's employees. In some cases, we noted that the management systems, operating manuals, etc. developed by the management firm are also removed from the hospitals upon contract termination. The loss of top management and the basic management systems tends to create a dependency on the management firm and at a minimum would appear to have a disruptive influence on hospital operations should the Hospital Board choose not to renew the firm's contract.

^{1/} In some cases, the length of the management contract is dictated as a condition of the bonds issued to finance the construction of the hospital.

MANAGEMENT FEE STRUCTURES

The basis for calculating fees for 24 of the 66 contracts we reviewed involved percentage arrangements, most of which were percentage of gross revenue. Most (35) contracts fees were fixed amounts. The other seven contracts provided for a fixed amount per day per occupied bed. The schedule on the following page describes how fees were set for the contracts we reviewed.

Fee Structure For Full
Service Management Contracts

<u>Fixed</u>	<u>Number of contracts</u>	
Fixed fee, ranging from \$60,000 to \$485,000 annually	33	
Fixed amount per hospital bed (\$1000 and \$2828 per year)	<u>2</u>	35
 <u>Percentage</u>		
Fixed percent of gross revenue, ranging from 3 to 8 percent	13	
Fixed percent (3 to 8) of gross revenue not to exceed a fixed amount or fixed percent of net profit	3	
Fixed percent (3 and 6) of gross revenue plus a fixed percent (25 and 33) of net profit	2	
Fixed annual fee (\$55,000 and \$125,000) plus a fixed percent (11 and 50) of net profit	2	
Fixed percent (8) of gross revenue plus a fixed fee (60,000 annually)	1	
Fixed percent (3) of gross revenue but not less than a stated fixed amount (\$120,000)	1	
Fixed annual fee (\$52,000) plus a fixed percent (8) of adjusted gross revenue plus 50 percent of net profit	1	
All net profits	<u>1</u>	24
 <u>Fixed amount per occupied bed</u>		
Fixed amount per day per occupied bed, ranging from \$2.59 to \$7.00	<u>7</u>	<u>7</u>
Total		<u>66</u>

In addition to payment of management fees, 30 of the contracts required hospitals to either pay directly, or reimburse the management firms for, salaries and fringe benefits of management firm employees serving as administrators and/or controllers of the hospitals. Also, 19 of the 66 contracts contained provisions for annual increases in management fees based on changes in the consumer price index or other stated criteria.

A basic problem with percentage arrangements is that at the onset the total dollar amount of the fee is not known. Additionally, with percentage of gross revenue arrangements, there is no direct incentive to keep costs down; the incentive is to maximize revenues and thereby the fees received.

A major concern with percentage arrangements is that there may not be any reasonable relationship between the services needed or provided and the fee charged. The results of an intermediary's cost determination made because a firm was determined to be a related organization to the hospital it managed illustrates the wide disparity that can develop between fees and services received. For the fiscal year ended in 1978, the management fee was \$701,812 and was based on 6 percent of gross receipts. The intermediary, in making its related organization determination, found that the actual cost of providing the services was only \$111,743 which translates into a mark-up over cost of about 500 percent. The hospital has appealed the intermediary's determination.

WIDE DIFFERENCES IN MANAGEMENT FEES

There are significant differences in the management fees paid under full service management contracts. The schedule on the following page illustrates these differences for the 15 most expensive contract management fees in fiscal year 1978 under the contracts we reviewed. Eight of the 10 most expensive involved percentage arrangements.

Differences In Management Fees
Fiscal Year 1978

<u>Total management fee (note a)</u>	<u>Number of beds</u>	<u>Fee per bed</u>	<u>Number of employee salaries included in fee</u>	<u>Medicare utilization (percent)</u>
\$1,647,233 <u>b/</u>	412	\$3,998	1	40
813,206	219	3,713	0	46
792,555 <u>b/</u>	396	2,001	1	62
701,812 <u>c/</u>	147	4,774	2	39
391,651	320	1,224	0	21
374,163	200	1,871	0	56
368,843 <u>d/</u>	54	6,830	2	54
259,680	57	4,555	0	47
250,000	405	617	0	33
204,348	140	1,460	2	60
180,000	181	994	1	34
180,000	102	1,765	2	66
175,799	120	1,465	0	39
171,000	149	1,148	2	24
170,000	132	1,288	1	57

a/ In some cases data on actual fees were not readily available. In those instances, we estimated the fees according to the formula in the contract.

b/ In these cases, the hospital and management firm disclosed that they were related parties and a significant portion of the management fee shown was not claimed for Medicare reimbursement. Also, additional disallowances were made by the intermediary.

c/ A related party determination was made by the intermediary but appealed by the provider (see page 7).

d/ The intermediary ruled that the hospital and firm were related but had not made a final audit determination.

For the remaining 20 contracts for which data was available, the fees charged ranged from \$48,000 to \$148,000 per year. Most of the fees were less than \$100,000 per year.

Reasons which would account for or explain the wide differences in fees were not evident from reviewing the contracts which were very general with the specific services and related fees not broken out.

INADEQUATE DOCUMENTATION OF MANAGEMENT SERVICES PERFORMED

Maintaining adequate documentation for claimed costs is a fundamental principle of Medicare reimbursement. With regard to management fees, the Provider Reimbursement Manual (HIM 15) chapter 24, section 2404.2F, states

"Where a provider pays a fee for management services, such provider must identify the services furnished in sufficient detail for ***Medicare to determine that these services, for which reimbursement is sought, are necessary and proper for the production of patient care services and that the costs are reasonable.

The hospitals we visited did not maintain or provide us records in sufficient detail to show what services were actually performed.

Below is a summary for the three hospitals we visited of the use of contract management services and our attempts to assess the reasonableness of the management fee. Essentially, we were unable to make an assessment of reasonableness because we were unable to relate fees charged to the specific services actually provided.

Hospital X

Hospital X was a non-profit 320-bed facility licensed to provide general acute care. Operations started in October 1973 and from the onset the hospital experienced serious financial difficulties. During the first 16 months of operation, the original organizers of the hospital resigned at the urging of the trustee bank, and two different management groups were retained by the trustee bank in an effort to put the hospital on a sound financial basis; however, neither succeeded.

On April 1, 1975, Hospital X entered into another management contract which was to run for 5 years with an annual management fee of 5 percent of total operating

revenues. ^{1/} The contract gave the management firm responsibility for the day-to-day operations of the hospital and the firm filled the hospital administrator and controller positions with its own employees. Their salaries and fringe benefits were paid by the Hospital in addition to the basic 5 percent annual fee.

The management contract described a variety of activities that the management company was to perform. For example, the firm was to

- negotiate with labor unions,
- purchase food, beverages, and operating supplies, and
- hire, promote, discharge, and supervise all hospital employees.

Further, the contract provided that the hospital was to have access to the firm's specialists as deemed necessary by the management firm at no additional cost to the hospital. From April 1, 1975, through June 30, 1979, the management firm was paid about \$2.2 million.

At the time the firm assumed management of the hospital, the bond issue that financed hospital construction, the hospital's payroll taxes, equipment leases, and other obligations were in default. Further, utility bills were delinquent to the point that utility companies had threatened to discontinue services.

According to the firm's president, the following are some of the actions that were taken after the firm assumed management of the hospital.

- New department heads were hired and new staff training programs were instituted.
- A clean-up program (paint, repairs, etc.) for all departments was implemented.

^{1/} The management firm assumed management responsibility on an interim basis on January 31, 1975. However, the management contract was not signed until April 1, 1975.

--New accounting and data processing departments were established, together with an efficient record-keeping system.

--A intensive recruiting program for new physicians was started.

From April 1975 to June 1977, the hospital occupancy rate increased from 5 percent to 28 percent and for the same period, patient service revenues went from \$1.2 million to \$7.3 million. Nonetheless, serious financial problems continued to plague the hospital. During fiscal years 1975-1977, operating deficits were experienced as follows:

<u>Period</u>	<u>Operating deficit</u>	<u>Cumulative deficit</u>
Year ended 11/30/75	\$4,032,341	\$ 8,337,102
7 months ended 6/30/76	1,727,661	10,064,763
Year ended 6/30/77	2,869,301	12,877,442

On September 29, 1977, Hospital X filed a petition for reorganization under Chapter XI of the Federal Bankruptcy Act. The Court appointed a Receiver and the hospital continued to operate with the same management firm then responsible to the Receiver. Additional deficits were experienced in fiscal years 1978 and 1979 and the total fund deficit continued to increase as reflected below.

<u>Period</u>	<u>Operating deficit</u>	<u>Cumulative deficit</u>
Year ended 6/30/78	\$2,627,309	\$15,504,751
Year ended 6/30/79	2,147,650	17,652,401

The Receiver filed a complaint with the Bankruptcy Court on July 6, 1979, requesting approval of a proposal made by a national chain organization to purchase Hospital X. On September 28, 1979, the Receiver terminated the management contract with the management firm and relieved management company personnel from further responsibility for Hospital affairs and operations. Concurrently, the Receiver entered into an interim agreement with the prospective purchaser for management of the daily operations of the Hospital. The sale of Hospital X to the prospective purchaser was completed on January 16, 1980.

During our visit to the hospital, the firm had eight of its employees located at the hospital. Two of these employees were acting as the administrator and controller and their salaries were paid by the hospital in addition to the management fee. The salaries of the six other employees were paid by the management firm. Their positions or area of responsibility with the management firm were (1) President and Chief Executive Officer, (2) Attorney, (3) Assistant Director, (4) Policies and Procedures, (5) Accountant and (6) Data Processing.

We asked the President of the management firm for documentation on the services actually provided by himself and the other five firm employees and the time devoted to the hospital's operation. The president agreed to provide us this information but never did even though we followed up on our request on two separate occasions.

Hospital Y

Hospital Y is a 57 bed facility that provides general acute care. The hospital opened in May 1977 and is managed under contract.

The management firm that manages Hospital Y also supervised the planning, development, and construction of the hospital prior to its opening. These activities were carried out under a separate contract for a flat fee of \$250,000.

The management contract is for 25 years and the annual fee is 8 percent of gross revenue. The contract gives the management firm general authority to supervise and manage the day-to-day operation of the hospital. The controller and administrator of the hospital are employees of the management firm and their salaries and fringe benefits are paid by the hospital in addition to the base management fee.

The management contract provides, among other things, that the management firm

--make available to the hospital for consultation and advice specialists in various fields without charge to the hospital;

- perform those duties necessary to meet requirements of laws and regulations, obtain necessary licenses and permits, and meet standards for accreditation;
- recruit qualified physicians;
- supervise preparation of an annual budget; and
- establish, direct and maintain operation of a suitable accounting system.

The management agreement also provided that the management firm arrange for up to \$300,000 of working capital for the hospital either through direct loans or from other sources and that any working capital loans made by the firm or its affiliates bear interest at 2 percent above the prime rate in effect at a New York bank. During the period from April 1, 1977 to July 15, 1977, the firm made loans to the hospital totaling \$260,000. ^{1/} From April 1977 to July 1979, when the loans were repaid in full, the hospital made interest payments totaling about \$37,526.

In addition to the services provided for under the management contract, Hospital Y also secured a variety of services from a hospital that was owned by the management firm. Such services included data processing, printing, general administrative support, inhalation therapy and nuclear medicine. Through September 1979, Hospital Y was billed for about \$115,000 for services purchased from the other hospital, which was in addition to the management fee.

As of November 1979, the management firm had billed the hospital for management fees totaling \$623,852, of which the hospital had paid \$142,500. The \$481,352 balance had not been paid because of cash flow problems.

We found evidence that services were being provided by management firm employees in addition to the services furnished by the administrator and controller. For example, various memoranda were available which indicated that the firm's specialists were working with the administrator and controller of the hospital. We were unable to make an assessment of the reasonableness of the fees charged, however, because records were not available which showed

^{1/}\$50,000 of this amount was advanced prior to the effective date of the management contract.

how much time the various specialists devoted to the hospital's operation.

Officials of the management firm told us that much of the costs associated with performance of management contracts is incurred in the home office. Further, we were told that the firm does not maintain detailed records showing how much time is spent on working on matters pertaining specifically to Hospital Y or any other hospital.

Hospital Z

Hospital Z is a 181 bed for profit facility which was incorporated on December 8, 1975 for the purpose of continuing an unrelated predecessor hospital which filed a petition under Chapter XI of the Bankruptcy Act. Operations commenced on December 16, 1975, and general acute care services are provided.

The hospital entered into a management agreement with a management firm for the period December 16, 1975 to April 30, 1976. The contract provided that the firm manage the day-to-day operations of the hospital and the fee included the cost of the salary for a hospital administrator. Duties specifically mentioned in the contract included

- recruit, employ, train, promote, direct, and terminate all personnel as needed for operation of the hospital;
- assist in maintaining all licenses required, including accreditation;
- purchase supplies and equipment;
- monitor price and reimbursement schedules;
- review, analyze, and negotiate contracts for ancillary services;
- prepare fiscal operating budgets and capital budgets;
- plan, implement, supervise, and maintain business office systems and procedures; and

--prepare, analyze, present, and explain operational and management status reports.

The contractual fee agreed to for the contract period December 16, 1975 to April 30, 1976 was \$90,000. For any renewal or extension, the contract provided that the management fee would be \$15,000 per month, or 5 percent of hospital gross billings, whichever was greater. The contract was renewed for additional periods. The contract also provided that services not covered by the agreement would be billed at the rate of \$35.00 per hour, plus expenses. Year end financial statements through June 30, 1978 show total fees paid of about \$480,000.

The management contract between Hospital Z and the management firm was mutually terminated September 1, 1978. The financial position of the hospital did not improve during the management firm's tenure as the table below illustrates.

	Fiscal year ended		
	<u>6-30-76</u>	<u>6-30-77</u>	<u>6-30-78</u>
Total assets	\$6,238,188	\$6,043,919	\$5,903,115
Total liabilities	7,126,829	8,500,541	9,824,895
Deficit	888,641	2,456,622	3,921,780

	Calendar year ended		
	<u>12-31-76</u>	<u>12-31-77</u>	<u>12-31-78</u>
Occupancy rates	12.66%	19.08%	18.24%

Effective August 25, 1978, the hospital gave another management firm an option to purchase the hospital and on September 1, 1978, the hospital entered into a management agreement with this management firm. This agreement provided for management of the hospital for a period of 1 year, or until the management firm exercised its option to purchase the hospital. The contract also provided for maximum monthly management fees of \$20,000, which included salaries and fringe benefits for the administrator and director of financial services. The purchase option was exercised in April 1979.

Because of the condition of records available for the period December 16, 1975 through September 1, 1978, and management's inability to locate other records, we were unable to identify or verify what services were actually performed by the management firm or personnel involved or time devoted to the furnishing of such services. Also, records for which the management firms were responsible for maintenance were not properly maintained. For example:

- The Controller stated that he was unable to locate the unaudited financial statements and the detail records from which the audited income and expense statement for the fiscal year ended June 30, 1977, was prepared. He stated further that he did not know whether the 1977 records were computer runs or manually prepared schedules and workpapers. The controller had been with the hospital since October 1977.
- Contract files were not complete and up to date. The contract related to cardiology services could not be located. In addition, contract files did not contain documentation showing that several contracts had been renewed for additional periods, although the controller informed us that the contracts had been renewed or extended.

The inadequacies of Hospital Z's records has been a problem for some time. Poor condition of the records were specifically cited in the 1976 and 1978 Certified Public Accounting (CPA) firm's audit reports as a contributing reason for not expressing an opinion on the financial statements. Also the CPA firm did not express an opinion on the 1977 financial statement.

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The foregoing examples (Hospitals X, Y, and Z), as it relates to the conditions of the hospitals or the performance of the management firms, should not be considered as representative or typical of hospitals being managed under contract or the firms providing such services. The examples do illustrate the problems which can occur in attempting to determine the reasonableness of fees for management services.

CONTROLS OVER PAYMENTS
TO MANAGEMENT FIRMS

The contracts we reviewed did not contain any provision which provided any specific control over payments to the management firms. Also, given that firms' employees normally fill the administrator and/or controller positions and are responsible for the day-to-day operations of the hospital, we believe the adequacy of the controls over disbursements to the firms is questionable.

Illustrative of what can happen under such circumstances occurred at Hospital X (see p. 9). According to the CPA audit report of the hospital for the period ended June 30, 1979, the management company had received payments from the hospital which exceeded management fees earned by \$418,507. Arrangements were subsequently made to recoup the overpayment.

INTERMEDIARY AND
HCFA ACTION

As early as 1974, the Blue Cross Association issued to its plans a management contract checklist which in part addressed the need to evaluate the reasonableness of management fees. We found however that for the seven intermediaries we visited, the Blue Cross plans generally were not reviewing the fees for reasonableness. Further, HCFA has been slow in developing appropriate program guidance and requirements.

For Hospitals X and Z, the intermediary had not assessed the reasonableness of any of the management fees; the intermediary, however, did determine that the parties were not related. As of November 1979, Hospital Y had not been visited by the intermediary which, therefore, had not made an assessment of the reasonableness of the fees claimed. The hospital first opened in May 1977. As a standard procedure, however, intermediary officials said that they would only make a related organization assessment and not evaluate the reasonableness of the fees claimed.

Intermediaries generally were concerned with whether the management fee was negotiated at arm's length and/or whether the management firms and the hospitals were related parties. Intermediary officials stated that Medicare has not provided adequate guidelines or criteria

for evaluating the reasonableness of management fees. According to Blue Cross Association officials, a particular problem is that the documentation requirements are not specific. They stated that if hospitals or management firms are challenged on the basis that detailed records are not kept on time spent by the management firm, the firms counter by saying that the Provider Reimbursement Manual does not specifically require these types of records.

One particular problem we noted was that intermediaries did not have a complete inventory of which providers were being managed under contract. Providers are not required to submit copies of the contracts and intermediaries usually identify such contracts only when a field audit is made of the provider hospital. Further, some intermediary officials were reluctant to ask for copies of the management contracts we requested for our review. They stated that they did not believe they had a right to ask for a copy of a management contract until they made a field audit at the provider hospital.

In early 1977, HCFA issued for comment to the health industry a proposed revision to the Provider Reimbursement Manual which addressed management contracts. Generally the revision would strengthen the controls over the use of management contracts and provided guidance to the intermediaries for evaluating the reasonableness of the costs claimed. The proposed revision was never finalized. Instead, an Intermediary Letter was issued in September 1978, part of which addressed management contracts. For the most part, we believe the issuance did little to clarify or strengthen program requirements with regard to management contracts.

More recently, on December 13, 1979, the Blue Cross Association issued to its plans an Administrative Bulletin which provided instructions on how to evaluate the reasonableness of management contract fees. Further, on February 6, 1980, HCFA's Bureau of Program Policy issued for comment a proposed revision to the Provider Reimbursement Manual which clarifies Medicare policy regarding reasonable cost evaluation of purchased management and administrative support services. Among other things, the proposed issuance requires that hospitals keep detailed records of the services provided and the time spent by management firm employees on hospital business. We believe that this proposed action

is the only practical way to establish a basis for assessing the reasonableness of management fees claimed for Medicare reimbursement.

CONCLUSIONS

The reasonableness of the fees for management contracts should receive much greater attention by HCFA and its intermediaries. The magnitude and recurring nature of the fees coupled with the inadequacy of the documentation of services provided leaves too many unanswered questions.

Most of the tasks and/or responsibilities enumerated in the contracts are ones that would be performed or supervised by a hospital administrator and/or controller in the normal pursuit of their duties. Because of a lack of documentation, the question arises about what services the hospital is receiving in return for the fees paid above and beyond a reasonable salary/fringe benefit package for the administrator and controller.

While we are supportive of HCFA's proposal to relate reasonableness of fees to time spent, we believe it could lead to program abuse if parallel action is not taken to ensure adequate independent checks over the use of consultation services. On a day-to-day basis, the decision for the use of the management firm's specialists rests with the hospital administrator and/or controller who are often firm employees. This arrangement is vulnerable to abuse and could simply serve as a vehicle for generating more revenue for the management firm.

To provide assurance that such situations do not arise, the management firms should be held strictly accountable to the Hospital Board for the use of the firm's specialists. Documentation requirements should include evidence that the Board provided specific approval for their use. Such documentation also would serve to assist intermediaries in assessing the reasonableness of the fees claimed for reimbursement and provide a vehicle for keeping the Hospital Board informed of the firm's performance.

The Hospital Board should also be required to counter-sign or otherwise control all checks made payable to the management firm. The absence of such a procedure violates the most fundamental principles of internal management controls.

Management contract fees calculated through use of percentage formulas inherently raise a question of reasonableness. Accordingly, providers should be prohibited from using such formulas as a basis for calculating the cost claimed for Medicare reimbursement.

The use of management contracts is growing at a rapid rate and intermediaries are not fully informed as to which of their providers are managed in this manner. To keep abreast of contracts, including renewals and revisions, providers should be required to forward a copy to the intermediary as soon as it becomes effective.

RECOMMENDATIONS

To provide greater control over Medicare reimbursement for the costs of hospital management contracts, we recommend that the proposed revision to the Provider Reimbursement Manual include provisions requiring providers to

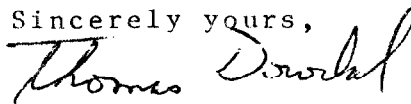
- establish appropriate controls over payments to management firms;
- maintain strict management firm accountability for the use of the firm's specialists; and,
- forward a copy of all new contracts and renewals to intermediaries as soon as they are consummated.

We also recommend that providers be prohibited from using percentage arrangements as a basis for calculating the amount of management fees claimed for Medicare reimbursement. Finally, we recommend that it be emphasized to intermediaries that the reasonableness of these fees be addressed as part of the cost report settlement process.

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We would appreciate being advised of actions taken in response to this report. Also, should you care to discuss the report's contents further, feel free to give us a call.

Sincerely yours,



Thomas Dowdal
Group Director