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REPORT TO THE COMMITTEE ON WAYS AND MEANS HOUSE OF REPRESENTATIVES

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Information Pertaining To Changes In Ownership Of Certain Hospitals In California From Proprietary To Nonprofit Institutions B-164031(4)

Social Security Administration

Department of Health, Education, and Welfare

BY THE COMPTROLLER GENERAL OF THE UNITED STATES

MAY 27, 1971

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COMPTROLLER GENERAL OF THE UNITED STATES
WASHINGTON, D.C. 20548

B-164031(4) A G C 00226

Dear Mr. Chairman:

In accordance with your Committee's request of September 15, 1970, we have obtained information relating to six hospitals in the State of California which had changed from a proprietary status to a nonprofit institutional status. Our representatives were informed that the Committee was particularly interested in

--whether there was some change in the ownership of the hospitals and

--whether the capitalized values of the hospitals' assets were increased as a result of the changes in status and, if so, whether such increases could result in higher costs to the Medicare program.

Our representatives were requested to obtain such information for the following hospitals located in the State of California.

Community Memorial Hospital, Sacramento
Doctors Hospital of Santa Ana, Santa Ana
Golden Gate Community Hospital, San Francisco
Hillside Community Hospital of Ukiah, Ukiah
Memorial Hospital, Redding
Parkview Community Hospital, Riverside

To obtain the requested information, we reviewed records and interviewed officials of the hospitals, the fiscal intermediaries responsible for paying the reasonable costs of the services rendered to Medicare beneficiaries in these hospitals, and the State hospital licensing bureau.

Our review showed that each case involved some degree of change in ownership; in three cases, there appears to have been a complete change of ownership. In five cases, we were advised by hospital officials that the administrators or management personnel had not changed as a result of the changes in status.

Our review showed also that in five cases at least part of the acquired assets had been revalued as a result of the change from a proprietary status to a nonprofit status. In each of the five cases, the acquiring organizations recorded the acquired assets at the purchase price paid to the former owners; the purchase prices were generally based on independent appraisals of the value of the assets. In two of the five cases, the acquiring organizations leased the hospital facilities to nonprofit corporations which operated the hospitals.

In all six cases, the new organizations financed at least part of the cost of the purchase through the issuance of interest-bearing notes payable to the former owners or stockholders of the proprietary organizations.

To the extent that the new organizations provide care to Medicare beneficiaries, the (1) interest expense involved in financing the purchase of the assets, (2) depreciation expense computed on the basis of the increased asset values, and (3) costs of leasing facilities would generally be costs reimbursable by the Medicare program unless the fiscal intermediaries determine that these costs are not reasonable. Medicare regulations, however, provide that costs applicable to services or facilities furnished to a provider by organizations which are related to the provider by common ownership or control be includable in the provider's cost only at the cost to the related organization.

With respect to the six hospitals discussed in this report, the records of the Social Security Administration, Department of Health, Education, and Welfare, showed that, as of March 31, 1971, final settlement of costs reimbursable under the Medicare program had been made with one of the hospitals for two accounting periods, the last of these periods ended on October 31, 1968. Settlements had not been made with the remaining five hospitals. In view of the above, we were able to determine that additional expenses resulting from the change in status had actually been paid by the Medicare program in only one case.

The change by the hospitals from proprietary to nonprofit status could also mean a loss of Federal tax revenues. However, we did not examine into this matter during our review.

Brief summaries of the facts relating to the changes in ownership status for each of the six hospitals for which information was requested are presented on pages 1 through 10 of the report.

Where information obtained during our review indicated that the same individuals were involved in both the proprietary organization and the nonprofit corporation, we brought this information to the attention of the fiscal intermediaries for their consideration in making settlements with the hospitals involved. This report, however, has not been made available to the Social Security Administration for its review and comment.

Since this report contains information, the disclosure of which may be prohibited by the United States Code (18 U.S.C. 1905), we shall not make the contents of the report available to the public. The code provision referred to above makes it a criminal offense to disclose, among other things, the "amount or source of any income, profits, losses or expenditures" of any person or firm, except as authorized by law.

Sincerely yours,

Elmer B. Staats

Comptroller General
of the United States

The Honorable Wilbur D. Mills
Chairman, Committee on Ways and Means
House of Representatives

INFORMATION PERTAINING TO

COMMUNITY MEMORIAL HOSPITAL

SACRAMENTO, CALIFORNIA

The assistant administrator of the Community Memorial Hospital advised us that the original hospital facility with a capacity of 16 beds was built in 1949. In 1954 a group of doctors formed a corporation, Community Medical Center, Inc., which acquired the hospital as a proprietary institution. Dr. W. K. Eaton, Jr., was the principal owner of the corporation and administrator of the hospital. New wings were added to the original facility in 1961 and 1964 which increased its capacity to 110 beds.

The assistant administrator advised us also that the hospital was acquired in March 1967 by the Community Memorial Hospital--a nonprofit corporation consisting of 25 members--for the stated purposes of providing better services to the community and of avoiding local property taxes. The assistant administrator said that three of the stockholders of the former corporation were elected to the board of directors of the nonprofit corporation; Dr. Eaton was not elected as a director of the nonprofit corporation but continued to serve as hospital administrator.

The assistant administrator advised us further that the nonprofit corporation had paid about $1.7 million for the assets of Community Medical Center, Inc. The nonprofit corporation financed the transaction by assuming the Medical Center's liabilities of about $700,000 and by issuing to the stockholders of the Medical Center notes payable for about $1 million bearing interest at the rate of 4-1/2 percent per annum.

The financial statements for the proprietary and the nonprofit corporation showed that the book value of the land and building had been significantly increased as a result of the change in ownership. The book value of the land, building, and equipment as of February 28, 1967, and as of June 30, 1967, was as follows:

	As of February 28, 1967 (before change in status)	As of June 30, 1967 (after change in status)
Land	$ 58,115	$ 78,000
Building	783,770	1,172,000
Equipment	312,595	317,920
	1,154,480	1,567,920
Less accumulated depreciation	304,857	192,647
Book value	$ 849,623	$1,375,273

A representative of the hospital's accounting firm advised us that the land and building were capitalized on the nonprofit corporation's books at the purchase price paid by the corporation which was based on an independent appraisal. He advised us also that the equipment was purchased at book value and that the amounts recorded on the books after the change of status did not include any provision for goodwill.

The assistant administrator advised us that salaries and fringe benefits of the management officials did not change except for Dr. Eaton's salary which was increased from $25,000 to $36,000 annually.

We were advised by a Social Security Administration (SSA) official that the Medicare fiscal intermediary had made final settlement with the new corporation for the cost of care provided to Medicare beneficiaries for the 8-month period March 1, 1967, through October 31, 1967, and for the succeeding 12-month period ended October 31, 1968. The settlement reports for this 20-month period ended October 31, 1968, showed that the hospital incurred additional interest and depreciation expenses of about $109,000 over that which would have been incurred if the change in status had not taken place. Of that amount, about $32,000 was charged to the Medicare program and was reimbursed by the intermediary.

INFORMATION PERTAINING TO

DOCTORS HOSPITAL OF SANTA ANA

SANTA ANA, CALIFORNIA

The administrator and the assistant administrator of the Hospital of Santa Ana advised us that Doctors Hospital of Santa Ana, a partnership, was organized in 1956 to purchase land and to construct, equip, and operate a 52-bed hospital in Santa Ana. In May 1967 Doctors Hospital of Santa Ana sold its assets to Doctors Associated of Santa Ana, a partnership organized in January 1967 to acquire the hospital and to lease the facility to another firm that would operate and manage it.

The partnership agreement showed that Doctors Associated had 31 partners. The agreement showed also that 30 of the partners were active members of the attending medical staff of the hospital and that one partner was an employee of the hospital. Information obtained from the administrator of the hospital indicated that none of the members of the selling partnership had an interest in Doctors Associated.

The assistant administrator of the hospital advised us that Doctors Associated had paid about $1.1 million for the assets of the selling partnership. Unaudited financial reports furnished to us by the Medicare fiscal intermediary showed that the book value of the land, building, and equipment was increased from about $233,000 to about $842,000 as a result of the revaluation incident to the sale. The assistant administrator advised us that Doctors Associated had employed an appraisal firm and a CPA firm to establish the value of the land, building, and equipment.

Doctors Associated leased the facility to a newly formed nonprofit corporation--Doctors Hospital of Santa Ana--for a period of 15 years. The assistant administrator of the hospital advised us that in May 1967 Doctors Associated sold part of the hospital's assets--accounts receivable and inventories--with a book value of about $247,000 to the nonprofit corporation in return for an interest-bearing promissory note.

The nonprofit corporation, which was formed in April 1967, has three directors: the administrator of the hospital who is also a partner of Doctors Associated, the assistant administrator of the hospital, and an attorney who had represented the original partnership (also known as Doctors Hospital of Santa Ana), the partnership which owns the facilities (Doctors Associated) and the leasing corporation (Doctors Hospital of Santa Ana). The lease agreement provides for an annual payment to Doctors Associated of $132,000 by Doctors Hospital of Santa Ana.

We were advised by hospital officials that the administrator and assistant administrator of the hospital did not change as a result of the change in ownership.

Although the fiscal intermediary had not settled with the nonprofit corporation for any periods from the time the corporation was formed, the corporation's Medicare cost report for the period May 11, 1967, through April 30, 1968, had been audited by the fiscal intermediary's contract auditors. The auditors had made no adjustments to the reported leasing costs.

The hospital's assistant administrator advised us in February 1971 that the Internal Revenue Service, Department of Treasury, had questioned the reasonableness of the hospital's leasing costs for tax purposes but that the problem had not been resolved.

INFORMATION PERTAINING TO

GOLDEN GATE COMMUNITY HOSPITAL

SAN FRANCISCO, CALIFORNIA

Golden Gate Hospital, Inc., a California corporation, owned by a group of 21 stockholders, sold its assets in July 1967 to Golden Gate Community Hospital, Inc., a newly formed nonprofit corporation. Our review showed that four of the directors of the nonprofit corporation had served also as directors of the old corporation. We were advised by the hospital administrator that the change in status to a nonprofit corporation was made to avoid payment of property and income taxes and thereby provide capital for improving the hospital facilities and equipment.

The hospital administrator advised us that the hospital's assets had not been revalued at the time of the conversion and that the nonprofit corporation had capitalized the assets at the book value as recorded on the former corporation's books. Although the administrator of the nonprofit corporation advised us that there was no change in asset values, the corporation's balance sheet dated June 30, 1968, showed an amount of $878,266 for goodwill. The Medicare program does not allow amortization of goodwill as a charge to the program.

Financial statements obtained from the Medicare intermediary showed that the nonprofit corporation had paid about $1.5 million for the assets of Golden Gate Hospital, Inc., had financed the transaction by assuming liabilities for about $450,000, and had issued 7-percent notes payable for $1.065 million.

The administrator of the hospital advised us that there had been no changes made in management officials or in the salaries or fringe benefits of key officials at the time of the change in ownership.

SSA records show that the fiscal intermediary has not made final settlement with the nonprofit corporation for any periods that the corporation has provided care to Medicare beneficiaries. Therefore we were unable to determine the extent that the Medicare program costs will be affected by the sale of this hospital to the nonprofit corporation.

INFORMATION PERTAINING TO

HILLSIDE COMMUNITY HOSPITAL OF UKIAH

UKIAH, CALIFORNIA

The administrator of Hillside Community Hospital advised us that the hospital, a 43-bed facility completed in 1956, was originally owned by Dr. Robert Barr. Subsequently, Dr. Barr and 15 other doctors formed a corporation--Hillside Community Hospital Corporation--which operated the hospital and owned some of the hospital equipment. Dr. Barr and some of the 15 doctors who owned the corporation also organized a partnership--Hillside Associates--which owned the hospital (land and building) and rented the facility to the Hillside Community Hospital Corporation. In February 1967 Hillside Community Hospital Corporation had 18 stockholder; 15 of them were also partners of Hillside Associates.

A new nonprofit corporation--Hillside Community Hospital of Ukiah--was formed in January 1967. The president and the vice president-treasurer of the nonprofit corporation together held 34 percent of the stock of the Hillside Community Hospital Corporation and a 43 percent interest in the partnership--Hillside Associates.

On March 1, 1967, the nonprofit corporation bought the assets of the Hillside Community Hospital Corporation for about $221,500. The administrator of the hospital advised us that these assets had been acquired at the net book value as shown on the prior corporation's books. The transaction was financed by the nonprofit corporation by assuming liabilities of about $157,500 and by issuing 7-percent notes payable for $64,000.

The nonprofit corporation, on March 1, 1967, also purchased the hospital (land and building) from the partnership--Hillside Associates--for about $694,000. This transaction was financed by the nonprofit corporation by assuming a mortgage of $116,000 on the real property and by issuing 7-percent notes payable to the former owners for about $578,000.

Data furnished to the fiscal intermediary in support of the hospital's Medicare cost report showed that the partnership had sold the hospital (land and building) to the nonprofit corporation at a price substantially in excess of the partnerships costs. The following table shows the partnership's book value (cost basis) of the hospital (land and building) at the time of the sale and the cost of the hospital to the nonprofit corporation--Hillside Community Hospital of Ukiah.

	Cost to Hillside Associates March 1, 1967	Cost to Hillside Community of Ukiah March 1, 1967
Land	$ 31,000	$ 72,000
Building	443,000	622,000
	474,000	694,000
Less accumulated depreciation	144,000	-
Book value	$330,000	$694,000

The administrator of the hospital advised us that the purchase price paid by the nonprofit corporation for the real property had been based on an independent appraisal.

The administrator advised us also that there were no changes in management of the hospital or in salaries or fringe benefits at the time of the change in ownership. According to the administrator, the hospital is controlled by a community board and any residual benefits which might accrue from its operation would go the the Seventh-Day Adventist Church.

SSA records show that the Medicare intermediary had not made final settlement with the nonprofit corporation for any periods that the corporation has provided care to Medicare beneficiaries. Therefore, we were unable to determine the extent that the Medicare program costs will be affected by the sale of this hospital to a nonprofit corporation.

INFORMATION PERTAINING TO

MEMORIAL HOSPITAL

REDDING, CALIFORNIA

The assistant administrator of Memorial Hospital advised us that the hospital, a 39-bed facility, was acquired in 1954 by Memorial Hospital, Inc., a California corporation owned by 17 persons, most of whom were doctors. In May 1967 Memorial Hospital, which had been expanded to a 132-bed facility, was acquired by Memorial Foundation--a nonprofit organization organized in 1962. The hospital retained the name of Memorial Hospital and is operated as a division of Memorial Foundation.

The assistant administrator advised us that the hospital had been sold because the former owners did not wish to retain ownership since the corporation had not distributed any of its profits. He advised us also that the management of Memorial Hospital had not changed after being purchased by the Foundation and that there were no changes made in salaries or fringe benefits as a result of the change in status.

Financial statements furnished to us by the controller of Memorial Hospital showed that the real property and equipment had been capitalized on the nonprofit corporation's books at about $771,000 in excess of the book value of the assets as shown on the prior owner's financial statement. The purchase price of about $3.3 million was financed by the Foundation by assuming liabilities of the prior owners of about $1.3 million and by issuing interest-bearing notes payable to the prior owners for $2 million.

We were advised by a representative of the hospital's accounting firm that, at the time Memorial Foundation acquired the assets of Memorial Hospital, Inc., the Foundation owned 85 percent of the stock of Memorial Hospital, Inc.

SSA records show that the Medicare fiscal intermediary has not made any cost settlements with Memorial Hospital. Therefore we were not able to determine the extent that the Medicare program costs will be affected by the additional depreciation and interest expense resulting from the change in ownership of the hospital.