
**REPORT TO THE ERIE COUNTY LEGISLATURE
92 FRANKLIN STREET
BUFFALO, NEW YORK 14202**

JANUARY 2008

**AUDIT OF THE SALE, PURCHASE & OPERATION AGREEMENT
BY AND BETWEEN ERIE COUNTY AND THE ERIE COUNTY
MEDICAL CENTER CORPORATION AND CERTAIN OTHER ITEMS
FOR THE PERIOD JANUARY 1, 2005 THROUGH JUNE 30, 2007**



**MARK C. POLONCARZ
ERIE COUNTY COMPTROLLER**

**Michael R. Szukala
Deputy Comptroller - Audit & Control**

January 7, 2008

The Honorable
Erie County Legislature
92 Franklin Street, 4th Floor
Buffalo, New York 14202

Honorable Members:

The Erie County Comptroller's Office has completed an audit of the Sale, Purchase and Operation Agreement by and between Erie County ("County") and the Erie County Medical Center Corporation ("ECMCC") dated January 1, 2004, as amended (the "SPOA") to determine if the parties thereto met their respective obligations to one another and others, if any, as contained in the SPOA. Our office also examined expenditures for advertising, promotional and informational reports to the public by ECMCC during the examination period, as well as certain other items for the period January 1, 2005 through June 30, 2007. Our work was authorized under Section 12.7 of the SPOA and Public Authorities Law 3632(5). In addition, this audit analyzed the financial consequences to the County from the sale of ECMCC and its cessation as an operating department of county government.

Our audit was conducted in accordance with Generally Accepted Government Audit Standards.

Due to time and staff constraints, we did not examine professional services and consulting contracts as outlined in our Entrance Letter dated August 31, 2007.

REPRESENTATION LETTER

It is the practice of the Erie County Comptroller's Office to require a Representation Letter from those we audit. A Representation Letter is a standard document in which the management of the audited entity attests to a number of issues, including but not limited to, "We are responsible for the fair presentation of the results of our operation," and "We are responsible for establishing and maintaining a system of internal control." A Representation Letter was presented to ECMCC management for the period of our audit. They returned a modified version of our letter that did not include the above two assertions and contained certain other changes.

In addition, the secretary of the Board of Directors failed to provide a certification of the Board minutes as we requested. As a result, we could not conclude that the minutes we received were complete. During the exit conference, the President and Chief Executive Officer of ECMCC certified the minutes although he was not responsible for keeping the minutes of the meetings of the Board of Directors, which certification was accepted by our office.

ECMCC failed to provide both a complete Representation Letter and a certification of the Board minutes by the secretary. Together, these failures constitute a scope limitation. Accordingly, we were unable to apply other auditing procedures to satisfy ourselves as to the accuracy and propriety of the financial records provided and statements made by ECMCC management and whether or not ECMCC management fulfilled its responsibility to design, implement and maintain a system of internal controls to prevent and detect fraud.

BACKGROUND

In 2003 the Erie County Medical Center (“ECMC”) was a hospital owned and operated by the County. Constructed over thirty years ago, the facility had 550 licensed beds as of December 2003 and is located within the City of Buffalo. ECMC also includes the Erie County Home, a skilled nursing facility in Alden New York, adjacent to the Alden Correctional Facility (“Home”). The Home had 638 licensed beds as of December 2003.

Prior to January 1, 2004, ECMC and the Home were an administrative unit of the County and considered as an operating department within County government. While the hospital’s governing body, its Board of Managers, was appointed by the County Executive and County Legislature, and the County maintained significant influence over the hospital, ECMC management operated with a considerable degree of autonomy from the County.

As an operating department within County government, ECMC’s Board of Managers annually submitted their proposed operational and management budget to the County Executive for his review and approval. The County Executive recommended the amount of the County’s contribution to ECMC’s and the Home’s operating budget to the County Legislature for their final action and determination on the annual County subsidy. In certain years, for instance, the County Legislature appropriated a larger County contribution than ECMC had requested. In other years, the County contribution was less than ECMC’s request.

On January 1, 2004, the County sold certain hospital assets to ECMCC, a new public benefit corporation created under the laws of the State of New York. The contract effectuating that sale is the SPOA. The 61 page agreement, exclusive of its attached schedules, documents the sale, lease and certain operations of ECMCC. The SPOA, without the accompanying schedules, is attached and annexed hereto as Exhibit “A.”

The enabling legislation creating ECMCC provided that the County would continue a certain degree of financial support to the corporation. Specifically, the legislation directed the County to “maintain and provide an operating contribution to the corporation in an annual amount that is the difference between the corporation’s total revenues minus total expenses.” *See* NYS Public Auth. Law § 3632 (5).

On August 1, 2004, the SPOA was amended by the parties through the “First Amendment to the SPOA” (the “First Amendment”). This document listed specific vehicles transferred to ECMCC by the County, and clarified or altered the SPOA on the following substantive issues: (1) closing costs of the sale; (2) future capital improvement costs at ECMCC to be borne by the County; (3) the County’s annual operating subsidy to ECMCC; and (4) other disputed items. The First Amendment is attached and annexed hereto as Exhibit “B.”

In September 2004, ECMCC’s management developed a business plan that anticipated a County operating subsidy for 2005 of over \$39 million. After discussion with the County Executive and other administration budget officials, ECMCC reduced this request to approximately \$29.8 million. In his proposed budget for 2005, County Executive Joel A. Giambra recommended a subsidy of \$4 million. The final 2005 amended budget approved by the County Legislature increased this appropriation to \$25 million.

In February 2005, the County experienced a significant budget crisis following the County Legislature’s inability to balance the 2005 Adopted Budget through adoption of legislation authorizing a new, additional compensating sales and use tax. The County Executive and Legislature were compelled to take remedial steps and actions to balance the County’s 2005 Budget and address a deficit of more than \$100 million. As a result, the Legislature reduced ECMCC’s subsidy from \$25 million to \$19 million.

Faced with the reduction in the operating subsidy, ECMCC commenced a lawsuit against the County seeking a decision and order that the County provide it a 2005 subsidy of \$29.897 million, which suit was assigned to the Hon. Joseph G. Makowski, J.S.C. Before a jury trial began, Judge Makowski, the County and ECMCC entered into a Consent Decree dated April 29, 2005 addressing the issue of capital funding for the years 2004, 2005 and 2006 (the “First Consent Decree), a copy of which is attached and annexed hereto as Exhibit “C.”

On December 30, 2005, Judge Makowski issued a Memorandum Decision which, among many other items, determined that the County shall provide an annual subsidy to ECMCC in accordance with the provisions of ECMCC’s enabling statute.

On February 24, 2006, Judge Makowski, the County and ECMCC entered into a Second Consent Decree which detailed the annual debt service, operating and capital subsidy the County would provide to ECMCC for the years 2005 through 2009 (the “Second Consent Decree”). This Second Consent Decree did not address all financial issues between the parties for the years 2005 through 2009, and left open the issue of the subsidy in the year 2010 and in future years. A copy of the Second Consent Decree is attached and annexed hereto as Exhibit “D.”

EXECUTIVE SUMMARY

- ❖ The 2004 sale of County assets to ECMCC is expected to cost the County and its taxpayers at least \$503 million for the period 2004 through 2033, the last year the County would be currently required to make a debt payment under current agreements. (See Section A. COST TO THE COUNTY FROM THE SALE OF ECMCC)

- ❖ As of November 2007, \$174,467 of the \$26,351,750 paid to ECMCC by the County for capital improvements as per the Second Consent Decree has been expended by ECMCC. Pursuant to the findings of the New York State Commission on the Future of Healthcare in the 21st Century (“Berger Commission”), the New York State Department of Health (“DOH”) is preventing these funds from being spent. (See Section E. CAPITAL PROJECT EXPENDITURES BY ERIE COUNTY)
- ❖ ECMCC senior management and their legal counsel deliberately engaged in efforts to conceal a payment to a vendor for the purchase of advertising services associated with the potential merger of ECMCC and Kaleida Health. (See Section H. AN INVOICE FROM “CITIZENS TO SAVE ECMC”)
- ❖ Internal control is a function of ECMCC management. We found several areas where we could not rely on the controls in place. This was the result of the weaknesses noted in non-compliance within senior management and the Board of Directors. (See Section K. NON-COMPLIANCE AND INTERNAL CONTROL SUMMARY)
- ❖ ECMCC spent \$56,499 on advertising associated with a public relations campaign concerning the Berger Commission-ordered ECMCC-Kaleida merger. (See Section H. AN INVOICE FROM “CITIZENS TO SAVE ECMC”)
- ❖ ECMCC senior management overrode internal controls and neglected to document actions as required by ECMCC By-laws. (See Section G. INTERNAL CONTROLS AT ECMCC)
- ❖ ECMCC has consistently violated reporting requirements to the County as required within the SPOA. (See Section B. SPOA REPORTING REQUIREMENTS)
- ❖ Through June 30, 2007, the County has lost more than \$14.6 million in reimbursements due to a New York State advisory for intergovernmental transfers with additional County losses (and corresponding ECMCC gains) likely in future years. (See Section C. SPOA SECTION 2.5 – SUPPLEMENTAL PAYMENTS (INTERGOVERNMENTAL TRANSFERS))
- ❖ ECMCC currently spends more than \$100,000 for meals for the students at School #84, a Buffalo Public School located on the grounds of ECMCC. The County contributes to ECMCC for the cost of these meals. To reduce the County’s expense, the County should discuss with the Buffalo Public Schools any possible Federal and State reimbursement. The potential annual reimbursement through the school breakfast and lunch programs is \$46,000. (See Section F. SCHOOL #84)

AUDIT FINDINGS

A. COST TO THE COUNTY FROM THE SALE OF ECMCC

The financing of the sale took place on January 23, 2004 when ECMCC issued a revenue note in the amount of \$85,000,000, the proceeds of which are broken down as in Figure 1:

Figure 1

Par amount of note	\$	85,000,000
Less: Fees of the sale		<u>450,170</u>
	\$	84,549,830
Less: Amount for Escrow Deposit to defease existing county bonds		21,967,775
Net proceeds to Erie County	\$	<u><u>62,582,055</u></u>

In addition to the \$85,000,000 the County also acquired \$63,215,134 in Net Accounts Receivable for a total value of \$148,215,134.

The value of the assets was adjusted to equal \$81,816,415 and it was agreed that the County would provide an additional \$3,183,585 in capital funding to make up the difference. This agreement was memorialized in the First Consent Decree and the County dedicated tobacco proceeds to fund this amount.

Subsequent to the note sale, in August 2004, ECMCC issued \$101,375,000 of "Erie County-Guaranteed Senior Revenue Bonds, Series 2004," (the "Series 2004 Bonds") the annual debt service for which the County, in accordance with Section 12.1 of the SPOA and Section 12 of the Second Consent Decree, is obligated to pay in the form of an operating contribution to ECMCC.

We have determined that the cost of the sale of ECMCC by Erie County will cost taxpayers over \$503 million between the sale itself in 2004 and the retirement of ECMCC's debt by 2033.

Our estimates of future costs were based on historical and current information and are conservative in nature. Some amounts are not speculative, but are known at this time. ECMCC debt payments are established values. Our analysis clearly defines which amounts are speculation and estimate, and which amounts are known at this time.

ECMCC is not the first public hospital to be transformed to a Public Benefit Corporation in New York State. Both Nassau and Westchester Counties have turned their county hospitals into Public Benefit Corporations. In November 2004 the New York State Comptroller's Office issued a report on the sale of ECMCC that references the sale of these two hospitals as examples

of what not to do. Specific recommendations in the report discuss the lack of a written, detail business plan before the sale of the hospital, a problem the ECMCC sale shares with the other two hospitals. The report noted that both Westchester and Nassau Counties still provide significant financial support to the hospitals they once owned and warned that Erie County should plan to continue its significant subsidies to ECMCC.

Following is a conservative estimate of the cost of the SPOA showing actual costs and future commitments of Erie County which totals \$503 million.

Figure 2 – Cost of Sale Summary

<u>DESCRIPTION</u>	<u>LOCATION</u>	<u>TOTAL PAYMENTS/ COMMITMENTS TO DATE(6/30/07)</u>	<u>FUTURE PAYMENTS/ COMMITMENTS</u>	<u>GRAND TOTAL</u>
<u>Cost of Sale to Erie County</u>				
Debt related to ECMCC sale ¹	ECMCC/Home	\$ -	\$ 196,316,172	\$ 196,316,172
Capital (County) ²	ECMCC/Home	67,857,563	37,704,001	105,561,564
Operating Subsidies (Budgeted) ³	ECMCC	60,928,481	-	60,928,481
	Home	4,737,170	-	4,737,170
Bonded Subsidy ⁴	ECMCC	6,789,997	824,635	7,614,632
Cost of Sale				375,158,019
<u>Continuing Carried Forward Costs</u>				
Malpractice ⁵	ECMCC	1,527,500	1,687,500 *	3,215,000
	Home	70,000	-	70,000
Workers Comp ⁶	ECMCC/Home	14,652,716	36,287,222 *	50,939,938
Retiree Health ⁷	ECMCC/Home	7,494,997	66,344,485 *	73,839,482
Continuing Costs				128,064,420
Total		\$ 164,058,424	\$ 339,164,015	\$ 503,222,439

(*Estimated amounts)

Notes on our calculations and assumptions

- 1) This amount is for the full repayment of the Series 2004 Bonds for the years 2008 through 2033.
- 2) Total payments to date represent the sum of all bond issues and tobacco funded projects for ECMCC/ECMC. The Future Payments amount is the sum of the interest on the bonded debt plus the future capital commitments made to ECMCC by Erie County.
- 3) Section 13 of the Second Consent Decree provides that the County subsidy for 2008 and 2009 is zero and Section 14 states that subsidies for 2010 and beyond must be negotiated. Due to the difficulties involved in predicting the results of such negotiations, future costs have been listed at zero. The reader is cautioned that such costs could be substantial.
- 4) The total payments to date amount is from the issuance of the Series 2006 C Bonds. Future payments are the sum of the payments for the years 2008 through 2011.
- 5) Malpractice costs are settlements related to actions taken at ECMC before January 1, 2004. Future payments represent one estimate of a range of settlements for various outstanding cases.
- 6) Workers Compensation costs are payments made for those cases that occurred before January 1, 2004. Future payments are one estimate of a range of settlements for various outstanding cases.
- 7) Section 21 of the Second Consent Decree discusses health care costs for retirees. Our figure only includes those employees who retired from ECMCC on or before December 31, 2003. This figure includes no costs or estimates for employees working at ECMCC after January 1, 2004. Though the County assumes no future costs for employees retiring at ECMCC after January 1, 2004, ECMCC disputes this contention. As a result, future litigation may be required to determine this issue and the costs may change. If the County is obligated to pay for such costs, the reader is cautioned that such costs could be substantial.

The cost of the sale includes additional future County financial obligations to ECMCC. Specifically, Sections twelve and thirteen of the Second Consent Decree state:

12. For the year 2008 and for each year thereafter, The County agrees to appropriate an operating contribution to ECMCC at least sufficient to pay the total annual debt service as described in section 12.1 of a certain Sale, Purchase and Operation Agreement between the County and ECMCC dated as of January 1, 2004, as amended. The County agrees to wire transfer the full amount of the annual operating contributions to the ECMCC Master Trustee on or before March 10 of each year. The County agrees to be responsible for any interest or penalty imposed as the result of the County's failure to timely transfer funds as called for in this Consent Decree.
13. For the years 2008 and 2009, ECMCC agrees that the County is not obligated to provide an operating contribution to ECMCC beyond that called for in paragraph 12 above.

Pursuant to the Second Consent Decree, the amount of the total annual debt service expected to be paid by the County for the years 2008 and 2009 is \$13.2 million.

In fact, for the period 2008-2033, the total debt service the County is obliged to pay under the SPOA and Second Consent Decree is over \$196 million. The payments average \$7.6 million per year after the year 2010.

After 2009, the County's commitments change. Paragraph fourteen of the Second Consent Decree states:

14. For the year 2010 and the years thereafter, ECMCC has reserved all of its rights under sections 3632(3) and 3632(5) of the Public Authorities Law. By no later than December 1, 2008, ECMCC and the County agree to commence good faith negotiations that are intended to yield an agreement on the process by which the County will fulfill its obligations under the Public Authorities Law to provide an operating contribution to ECMCC for the year 2010 and the years thereafter, beyond that called for by paragraph 12 of this Consent Decree. In the event that the parties fail to execute an agreement by June 1, 2009, either party may seek a judicial determination concerning the language quoted in paragraph 3 of this Consent Decree to the extent that it has not been finally determined through the appellate process involving this Court's Memorandum Decision dated December 30, 2005, or any order entered thereon. Notwithstanding any appellate decision to the contrary, in no event shall the rights and obligations of the parties for the years 2010 and thereafter be other than as agreed to in paragraphs 1 and 2 of the Consent Decree. The parties agree that the Supreme Court of the State of New York shall retain jurisdiction of this action for this purpose.

That portion of paragraph one of the Second Consent Decree that paragraph fourteen refers to is reproduced below:

ECMCC and the County acknowledge that the above-quoted language from section 3632(5) is not ambiguous. ECMCC and the County acknowledge that the above-quoted language from section 3632(5) creates a statutory obligation on the part of the County to provide an annual operating contribution to ECMCC that is the difference between total revenues and total expenses, consistent with the language quoted in paragraph 3 below and the other language in the ECMCC Act.

The excess of expenses over revenues for ECMCC in future years cannot be reliably determined. In 2005, the difference between expenses over revenues was estimated to be \$23.4 million. The 2005 financial statements of ECMCC show that expenses exceed revenue by \$16,574,326 with the County providing an operating and capital subsidy totaling \$19,776,756. The 2006 difference between expenses over revenues was projected to be \$24.2 million. The 2006 financial statements of ECMCC show that revenues exceed expenses by \$10,417,175 prior to the County providing an operating and capital subsidy of \$51,716,613. Figure 3 summarizes the 2005 and 2006 financial statement data of ECMCC:

Figure 3

Erie County Medical Center Corporation
Statements of Revenue, Expenses and Changes in Net Assets

Year	2005	2006
Operating Revenue	\$ 290,864,128	\$ 337,726,640
Operating Expenses	308,953,780	330,236,721
Operating income (loss)	\$ (18,089,652)	\$ 7,489,919
Add: non-operating items		
Investment income	\$ 578,466	\$ 2,927,256
Other Contributed Capital	936,860	-
	1,515,326	2,927,256
Operating loss before subsidy	\$ (16,574,326)	\$ 10,417,175
Add:		
Erie County contribution-operating	\$ 19,000,000	\$ 20,000,000
Erie County contribution-capital	776,456	34,716,613
ECMCC contribution to Erie County	\$ 19,776,456	(3,000,000) \$ 51,716,613
Change in Net Assets	\$ 3,202,130	\$ 62,133,788

SOURCE: ECMCC 2006 FINANCIAL STATEMENTS

Using historical net revenue over expense data going back to 1985, and noting that from 1985 to 2003 the hospital was a department of the County and from 2004 onward it was a independent public benefit corporation, and with no basis to value changes in operations by ECMCC, we estimate that the expenditures over revenues for ECMCC for future years could range anywhere

from \$12.1 to \$24.5 million. Further, because of the possible merger of ECMCC with Kaleida Health, there is no way to accurately estimate ECMCC's future operating losses or profits.

The Second Consent Decree refers to negotiations to begin in 2008 between ECMCC and the County to determine the amount of any operating contribution to ECMCC for the years 2010 and beyond. The very nature of these negotiations make any prediction of costs to the County beyond 2009 speculative. Our estimates of the costs to the County assume that the County will be expected to pay both ECMCC's total annual debt service and the difference between ECMCC's total revenues and total expenses.

Figure 4 is a summary of the costs to the County for ECMCC for the years 2008 and 2009 only. The Second Consent Decree specifies that the County's annual operating contribution to ECMCC for 2008 and 2009 is zero.

Figure 4

Year	Actual Principal	Actual Interest	Capital Contribution	Total Estimated County Cost
2008	\$ -	\$ 5,561,532	\$ 15,000,000	\$ 20,561,532
2009	2,070,000	5,561,532	8,000,000	15,631,532
Total	<u>\$ 2,070,000</u>	<u>\$ 11,123,064</u>	<u>\$ 23,000,000</u>	<u>\$ 36,193,064</u>

Between 2004 and 2007, the County provided the following operating payments to ECMCC, all of which exceeded the annual debt service of the ECMCC bond issue.

<u>YEAR</u>	<u>AMOUNT</u>	<u>SCHOOL #84</u>
2004	\$ 12,665,651	\$ 1,431,189
2005	19,000,000	1,431,189
2006	20,000,000	1,431,189
2007	14,000,000	1,431,189

The SPOA provided for a transition period that expired on December 31, 2004 that was extended to June 30, 2005 by the Erie County Legislature through their approval of Comm. 30E-30. Our examination of transactions found that during the transition period all transactions were accounted for on the County's books in the same manner as before the effective date of the SPOA. All cash activity including subsidy transactions were accounted for in Accounts Receivable/Accounts Payable accounts titled Advance to Enterprise Fund-ECMCC and Advance to Enterprise Fund-Home. The agreed to subsidy amounts for the years 2004 and 2005 were recorded in these accounts and no cash was paid to ECMCC. For the years 2006 and 2007 we confirmed that \$20 million and \$14 million respectively was paid to ECMCC in a timely manner to meet the March 10th due date specified in the Second Consent Decree.

Pursuant to Sections 12 and 13 of the Second Consent Decree, the County is not obligated to provide an operating contribution to ECMCC in 2008 and 2009 beyond the amounts required for the annual debt service on the Series 2004 Bonds. Pursuant to Section 14 of the Second Consent Decree, for the year 2010 and thereafter, ECMCC and the County agree that no later than December 1, 2008, good faith negotiations will commence to yield an agreement on the process by which the County will fulfill its obligations under the ECMCC's enabling statute to provide an operating contribution to ECMCC for the year 2010 and the years thereafter, beyond that called for in the Second Consent Decree.

As more fully described in Section F. "SCHOOL #84" herein, the County provides services for School #84 pursuant to the 1946 transfer of the Meyer Memorial Hospital (now ECMCC) and hospital lands with the provision that the County maintain an extant Buffalo Public School thereon, referred to as School #84. The services include buildings and grounds maintenance, repairs, improvements and utilities, as well as medical and therapeutic services to students, and food/cafeteria services. Most or all of these services provided by the County have been delivered by ECMCC staff or by vendors with whom the County or ECMCC contracts for services.

B. SPOA REPORTING REQUIREMENTS

Among other requirements, the SPOA requires ECMCC to disseminate certain information on a monthly, quarterly and yearly basis to certain parties in County government. However, our audit finds that ECMCC did not always comply with these SPOA reporting requirements. Specifically, ECMCC failed to abide by the following sections of the SPOA:

Section 6.9

Section 6.9 of the SPOA states that ECMCC is to report annually the name, the principal business address, the principal business activities of each subsidiary; the name of all Board Members and Officers of each subsidiary; the number of employees of each subsidiary; a list of all contracts in excess of \$100,000 entered into by the ECMCC and its subsidiaries identifying the amount, purpose and duration of such contract; and a financial statement and balance sheet for each subsidiary prepared by an independent certified public accountant. Such reports shall be filed with the Clerk of the Legislature and the County Executive at the same time the audit and annual reports are submitted.

The required reports from ECMCC were not transmitted to the County at the same time the annual financial statements were submitted.

Section 12.7:

Section 12.7 of the SPOA states that ECMCC shall provide to the County monthly reports such as all committee meeting minutes, balance sheets, income statements, actual and projected cash flows and quarterly interim unaudited financial statements. ECMCC did not comply with this requirement for the years 2004, 2005 and 2006 and the first two quarters of 2007.

ECMCC officials have stated that they provided this information by hand-delivering it to employees in the County Executive's office or the County's Division of Budget, Management and Finance during monthly meetings of the ECMCC Board of Directors. Unfortunately, not every meeting was attended by a County employee from these offices. When asked for copies of the ECMCC Board of Director's minutes, these County officials were unable to provide minutes for eight board meetings. The SPOA does not require ECMCC to provide any information to the Budget Office. The Legislature and the County Attorney were not provided the above reports.

Prior to the conversion to a public benefit corporation, ECMC regularly sent board and committee meeting minutes to the County Legislature which entered said documents into the public record. Following their conversion, ECMCC discontinued this practice and no longer provided these reports to the Legislature. Upon the commencement of this audit and only after we probed the absence of these reports, ECMCC resumed providing such documents to the Legislature.

ECMCC's reports did not include projected cash flows extending twelve (12) months from the month being reported. This specific reporting requirement is expressly described in this section of the SPOA. In failing to include cash flows, ECMCC did not comply with the SPOA.

The ECMCC Board Minutes dated June 13, 2007, the last Board Meeting in our audit period, did not include projected cash flows extending twelve (12) months from the month being reported. Subsequent to our audit period, the September 27, 2007 and October 25, 2007 meeting minutes did contain a twelve month projection.

Section 12.8:

Section 12.8 of the SPOA states in part that ECMCC shall provide to the County, on a yearly basis, ten (10) financial measure calculations, along with detailed explanations of the source of the component figures. These are required to be supplied, at most, within two hundred forty (240) days. ECMCC did not comply with this section of the SPOA for the years 2005 and 2006.

At its April 26, 2007 board meeting, ECMCC posted the financial measures for 2004, 2005 and 2006. This was well beyond the deadline for fiscal year 2005. Additionally, this section of the SPOA also mandates that the calculations be accompanied by sufficient detailed explanations as to how the measures were calculated. These explanations were not included in the April 26, 2007 board minutes. Upon our request, we received the detailed explanations during this audit.

Section 12.8(d) includes various certifications required to be made by ECMCC's chief financial officer and chief executive officer concerning the Financial Measures Disclosure Statement. Section 12.8(d) reads as follows:

- (d) The Financial Measures Disclosure Statement shall be certified by the Corporation's Chief Financial Officer and Chief Executive Officer as of the date the Financial Measures Disclosure Statement is submitted by the Corporation to the County.

The certification shall include the following statements:

- (i) that the Financial Measures Disclosure Statement does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered;
- (ii) that the financial statements, and other financial information included in the Financial Measures Disclosure Statement fairly present in all material respects the financial condition, results of operations and cash flows of the Corporation as of, and for, the periods presented in the Financial Measures Disclosure Statement;
- (iii) that the Corporation's Chief Executive Officer and Chief Financial Officer have evaluated the Corporation's disclosure controls and procedures as of a date within 90 days of the Financial Measures Disclosure Statement and have concluded that as of the evaluation date, the disclosure controls and procedures were adequate to ensure that material information relating to the Corporation was made known to the officers by others within the Corporation; and
- (iv) that there have been no significant changes in the Corporation's internal controls or in other factors that could significantly affect such controls subsequent to the date of their evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

Based on documents provided to this office, there is no evidence that the above certifications were made.

Section 13.0:

Section 13.0 of the SPOA specifies whom should receive copies of various filings. Specifically, that if it is not provided in the agreement, in this case sections 12.7 and 12.8, ECMCC should send the applicable communication to the County Executive, Chair of the Erie County Legislature and to the County Attorney. ECMCC did not comply with this for the years 2004, 2005, 2006 for sections 12.7 and 12.8, and the first two quarters of 2007 for section 12.7.

During the course of this audit, our office issued three Interim Audit Memorandums ("IAMs") to ECMCC seeking clarification on several issues. ECMCC's failure to comply with the above sections of the SPOA constituted the majority of the inquiries in the IAMs. We also understand that separately, and unrelated to this audit, the County Attorney has sent two letters to ECMCC's counsel seeking similar information.

WE RECOMMEND that ECMCC take the appropriate steps to comply with Sections 6.9, 12.7, 12.8 and 13.0 of the SPOA.

Additionally, **WE RECOMMEND** that future information include: the certifications in Section 12.8(d), all committee meeting minutes, balance sheets, income statements, actual and projected cash flows and quarterly interim unaudited financial statements and that this information go to the parties that did not receive them or received them intermittently – the County Executive, the Chair of the Erie County Legislature and the County Attorney.

WE ALSO RECOMMEND that the County Executive, the County Attorney and County Legislature establish measures and procedures to monitor ECMCC’s future compliance with the SPOA and, if necessary, measures to immediately address non-compliance by ECMCC.

C. SPOA SECTION 2.5 – SUPPLEMENTAL PAYMENTS (INTERGOVERNMENTAL TRANSFERS)

Under current laws and regulations, the state share of Medicaid spending must consist of public funds and no more than 60 percent (60%) of the state share may be from local funds. In the past, New York State required its counties to contribute 50 percent (50%) of the State’s share for all Medicaid expenses. That formula was changed in January of 2006 when the state implemented a cap on most Medicaid expenses for counties. However, that cap is not applicable to supplemental Medicaid payments made to public hospitals.

When local funds are used as part of the state share of Medicaid, they are often transferred to the state through an intergovernmental transfer (“IGT”). However, over the years, states have also used creative financing arrangements (often involving IGTs) to generate additional federal Medicaid revenues.

While IGTs are legal and a frequent financing source for states, they can become problematic when they are used in conjunction with other Medicaid special financing mechanisms such as an Upper Payment Limits (“UPL”) or Disproportionate Share Hospital (“DSH”) payment arrangements. These financing arrangements create incentives for states to reduce their own funding for the hospitals and nursing homes they operate and replace their funds with federal dollars. Some of these creative financing arrangements have also helped states to close budget gaps and maintain services by increasing the federal share of total spending.

The Federal Government FY 2006 budget proposed \$15.2 billion in federal savings over 10 years by restricting the use of certain IGTs and limiting payments to state and local hospitals and nursing homes to the cost of services provided to Medicaid patients. As a result, the DOH is advising recipients to retain the full value of their future Medicaid payments provided to them or face the possibility of a reduction in federal Medicaid funding in the future. This advice has financial consequences on the County.

Notwithstanding the foregoing, the DOH in the same advisory letters also notes that the above requirement does not in any way prohibit “a public provider from reimbursing their sponsoring government for appropriate expenses incurred by the local government on behalf of the public provider.”

Until 2004, all IGT money that the County provided as its share to ECMC was reimbursed with federal dollars. Procedurally, the state debited the County's fifty percent (50%) share on a Monday and remitted the County's 50% and a federal share of 50% to ECMC's bank account on Wednesday. The state then debited forty percent (40%) back on Friday, leaving a net benefit of ten percent (10%) for ECMC with the County receiving its fifty percent (50%) back, thus netting down to zero paid.

In 2005, there were no IGT transactions.

In 2006, the County was no longer receiving its fifty percent (50%) reimbursed back from the federal share and ECMCC began to retain the entire IGT payment. The total 2006 IGT payment was \$11,575,928. It reflected an **increase in funding to the hospital of \$10,418,335**. ECMCC received not only a \$10.4 million benefit, but the **County lost its share of return payments from the hospital totaling in 2006, \$5,787,964**.

We note that due to this unbudgeted County expense of \$5.78 million, and following County discussions with ECMCC, the corporation provided \$3,000,000 to the County as part of a voluntary non-exchange transaction. The County sought an ECMCC payment of the entire \$5,787,964 but was not successful. Through this transaction the County also paid ECMCC two payments totaling \$2,000,000 for rent during the years 2004 through 2007 for certain County health facilities located on ECMCC's campus. In making the \$3,000,000 payment, ECMCC stated: "ECMCC has achieved remarkable financial results for the calendar year 2006 and desires to contribute to the County's available discretionary funds for use in bettering the quality of life in Erie County".

In March 2007 the County paid \$8,874,289 for IGT which represented its fifty percent (50%) share of the \$17,748,579 total received by ECMCC. As such, **the increase in funding to the hospital in 2007 was \$15,973,721 and the loss to the County for its un-retained share was \$8,874,289**.

In 2007, the County requested an opinion from its independent auditor, Deloitte & Touché, LLP, regarding whether the County could record these IGT payments as prepayments of future year subsidies to the hospital. This would, in effect, reduce the County's future year subsidy since the IGT amount would be subtracted from that year's subsidy payment. Deloitte & Touche's opinion was that such an action would not be appropriate.

The DOH's advisory allowing ECMCC to retain the entire IGT payment occurred subsequent to the SPOA which took effect in 2004. During the County's 2006 and 2007 fiscal years, and due to the advisory, **ECMCC has collected an additional \$26,392,056 in revenue and the County has incurred \$14,662,253 in new expense**. Without state action, this trend will only continue to grow as additional IGT payments are made. There is no provision in the SPOA to address these new IGT obligations.

Given that IGT procedures changed in 2006, two years after the creation of the SPOA in 2004, to the great benefit of ECMCC and to the detriment of Erie County, **WE RECOMMEND** that the County Attorney begin proceedings to change the agreement to address this inequity. The

intention of such a change would be to bring Erie County back in line with the spirit of the SPOA while still allowing ECMCC the benefit of an additional forty percent (40 %) of the total IGT payment that New York State collected prior to the procedure change in 2006.

D. ERIE COUNTY BONDS ISSUED FOR ECMCC CAPITAL PROJECTS AND ECMCC DEBT COSTS

Pursuant to the SPOA and Second Consent Decree, the County is obligated to ECMCC regarding debt service and payment for capital projects. Sections 12.2, 12.3 and 12.4 of the SPOA specified that the County provide ECMCC capital project funding for the years 2004, 2005 and 2006. The Second Consent Decree provided that the County issue bonds for capital projects at ECMCC. With the exception of 2006, amounts are due at December 31 of the prior year and payable 15 days thereafter.

Pursuant to the Second Consent Decree, the County is obligated to provide ECMCC a capital subsidy for 2008 and 2009 of \$15,000,000 and \$8,000,000, respectively. Neither of these obligations has been bonded as of the date of this report, although the County Legislature has authorized the bonding of the 2008 \$15,000,000 obligation, which is due and payable on December 31, 2007. The 2009 obligation of \$8 million is due and payable on December 31, 2008.

The Erie County Fiscal Stability Authority (“ECFSA”) must authorize Erie County’s sale of all debt. As of the date of this report, the ECFSA has not authorized any such sale. The Erie County Legislature must consent to the sale of debt by the ECFSA. As of the date of this report, the Erie County Legislature has not consented to such a sale. Should the current impasse continue, it is possible the County will be unable to meet its obligations to ECMCC as stipulated in the Second Consent Decree and be subject to a \$150,000 per month interest penalty.¹

Figure 5 is a summary of bonds issued by the County to satisfy the SPOA and Second Consent Decree.

¹ On December 31, 2007 the County Legislature approved Comm. 27E-2, a proposal to resolve the borrowing issue through the county’s issuance of mirror bonds. ECFSA is scheduled to vote on that item on January 4, 2008.

Figure 5

**DEBT SERVICE
ERIE COUNTY BONDS ISSUED FOR ECMCC CAPITAL PROJECTS**

BOND ISSUE DATE	DATE OF LAST PAYMENT	PRINCIPAL	INTEREST
8/19/2004	4/1/2009	\$ 3,577,500	\$ 479,412
12/7/2006 *	11/1/2011	32,850,000	5,633,177
12/28/2005	12/1/2012	22,650,000	5,706,044
TOTAL DEBT SERVICE		<u>\$ 59,077,500</u>	<u>\$ 11,818,633</u>
LESS: BONDS FOR OPERATING SUBSIDY			
12/7/2005	11/1/2011	<u>6,500,000</u>	<u>1,114,632</u>
DEBT SERVICE FOR CAPITAL PROJECTS		<u>\$ 52,577,500</u>	<u>\$ 10,704,001</u>

* Bond issue comprised of \$6,500,000 for operating subsidy and \$26,350,000 for capital project funding to meet the requirements set forth in the consent decree of February 24, 2006.

In addition, pursuant to Section 12.1 of the SPOA and Section 12 of the Second Consent Decree, for the year 2008 and each year thereafter, the County agrees to appropriate an operating contribution to ECMCC at least sufficient to pay the total annual debt service of the Series 2004 Bonds. The amount of principal is \$101,375,000 and the interest to maturity in 2033 is \$94,941,172. The 2008 debt service payment is for interest only in the amount of \$5,561,532 and beginning in 2009 the average annual debt service payment is \$7,630,157 for the remaining 25 years.

It is understood that included in the operating subsidies paid to ECMCC was County funding for the debt service payments for 2005 through 2007 totaling \$16,684,596.

The funding for capital projects is only partially satisfied by the issuance of bonds. The County utilized tobacco funds to fund ECMCC capital projects. Since January 1, 2004, when ECMC became ECMCC, approximately \$11,673,049 of County tobacco funds has been expended to finance ECMCC capital projects.

It should be noted that when ECMCC paid the County \$85,000,000 to as the part of the purchase price under the SPOA, the County used \$21,967,775 of the proceeds to create an escrow account for the defeasance of all existing bonds relating to ECMC. This allowed ECMCC to become a debt free entity when it became a public benefit corporation.

The combined County commitment for debt service on the sale of the hospital is specified by the SPOA, First Amendment and Second Consent Decree as in Figure 6:

Figure 6

	<u>Principal</u>	<u>Interest</u>	<u>Total</u>
County issue bonds	\$ 59,077,500	\$ 11,818,633	\$ 70,896,133
ECMCC issued bonds	<u>101,375,000</u>	<u>111,625,768</u>	<u>213,000,768</u>
Total Debt Service Outstanding	\$ 160,452,500	\$ 123,444,401	\$ 283,896,901
Future Debt per Decree (Est.)	<u>23,000,000</u>	<u>4,000,000</u>	<u>27,000,000</u>
Total Anticipated Debt Service	<u><u>\$ 183,452,500</u></u>	<u><u>\$ 127,444,401</u></u>	<u><u>\$ 310,896,901</u></u>

Section 17 of the Second Consent Decree stipulates that the County is to provide, at the County's cost, capital funds to ECMCC totaling \$49,351,750 to be paid in four annual installments broken down as follows:

2006	\$11,351,750
2007	\$15,000,000
2008	\$15,000,000
2009	\$ 8,000,000

The 2006 and 2007 amounts were respectively paid on June 30, 2006 and December 21, 2006. To fund the obligation the County issued \$26,350,000 taxable bonds on December 7, 2006. The 2008 and 2009 amounts are to be bonded no later than the last day of the calendar year preceding the year in which the funds are payable. In the event that the County fails to make payment in accordance with the agreement, the County is to pay \$150,000 in interest for each calendar month that all or any part of the capital funds remains unpaid.

Section 12.2 of the SPOA addresses the Year 2004 Subsidy and specifies that for the 2004 fiscal year \$29,500,000 was the total agreed to as the operating contribution that the County was to pay to ECMCC. Further, this section also contains the acknowledgement by ECMCC that the Debt Service payments on bonded indebtedness assumed by the County in the amount of \$5,086,424 are to be offset against the County's 2004 contribution.

The \$29,500,000 amount was traced to the 2004 County Budget as follows:

ECMC Subsidy	\$20,240,817
Home Subsidy	3,971,336
School 84 Subsidy	1,431,189
Debt Service (\$5,086,424 less \$1,229,766 included in the ECMC subsidy)	<u>3,856,658</u>
Total Subsidy	\$29,500,000
Less: Restricted for capital purposes	11,651,671
Contracted payments for School 84	1,431,189
Debt Service no longer required (1 st Amendment)	<u>3,751,489</u>
Total non-operating subsidy	<u>\$16,834,349</u>
ECMCC Net Subsidy for operating purposes	<u><u>\$12,665,651</u></u>

The total amount of the 2004 County contribution to ECMCC was \$14,096,840 comprised of the net subsidy for operating purposes and the payment for School 84.

The First Amendment changed the amount of debt service principal and interest from \$5,086,424 to \$3,751,489 for interest only. However, the total amount for debt service was included in the 2004 budgeted amount to ECMCC and part of the agreed upon contribution amount of \$29,500,000. The impact of this change caused the County to overpay the 2004 County contribution to ECMCC by \$1,334,935 representing debt service principal.

The County subsequently issued bonds and used Tobacco settlement funds to finance \$11,651,671 for seven capital projects.

Section 12.3 of the SPOA states that the County shall provide ECMCC with full funding of existing capital programs for the years 2004, 2005 and 2006, totaling \$23,037,300, as authorized in the County's 2003 Capital Budget, as amended from time to time. The County established and funded ECMCC capital projects totaling \$15,182,550 based on the budgeted amounts for 2004 and 2005. The remaining \$7,854,750 was included in the Second Consent Decree with an additional \$3,497,000 for unspecified capital projects equaling the 2006 capital subsidy of \$11,351,750 as provided for in Section 17 of the Second Consent Decree.

Section 12.4 of the SPOA estimates that \$12,700,000 is the amount available to complete several ongoing (prior to the sale of the hospital) capital projects at ECMCC administered by the County and that the County agrees to continue all work on these capital projects and to complete these ongoing capital projects at its sole cost and expense. The December 31, 2003 adjusted balance of available funds for the ongoing projects was \$11,488,007.

We were unable to obtain information from ECMCC identifying capital assets (plant and equipment) that formed the basis for the capital amounts contained in the Second Consent Decree. Our office inquired as to the existence of a formal capital plan adopted by ECMCC's Board of Directors and requested a copy of any such capital plan to support the funding estimates. In our discussions with ECMCC's chief financial officer we were informed that there was no capital plan or listing available to support the calculation of the capital amounts that were agreed to by ECMCC and the County in the Second Consent Decree.

However, on October 2, 2007 we received a copy of ECMCC's 2008 Capital Budget showing a \$15 million estimate and we were informed that a capital budget had been adopted by ECMCC's Board of Directors. This amount coincides with the Second Consent Decree's 2008 capital obligation totaling \$15,000,000 and which is required to be paid by the County by December 31, 2007. We note that ECMCC's development of a 2008 Capital Budget occurred subsequent to our audit inquiry.

We also received a listing of ECMCC departmental requests for capital expenditures that was reviewed by the Capital Committee of ECMCC - an entity established by the chief financial officer who represented that it meets bi-weekly and projects capital expenditures for 2007, 2008 and 2009.

Figure 7 is a summary of Capital Funds provided by the County.

Figure 7

SUMMARY OF ECMCC CAPITAL PROJECT FUNDING PROVIDED BY ERIE COUNTY

Ongoing capital projects at 12/31/2003	\$ 11,488,007
2004 capital purpose funding	11,651,671
2004 & 2005 budget estimates; \$7,387,625 and \$7,444,925 respectively	15,182,550
2005 ECMCC Demolition/Abatement/Construction & Renovation - Tobacco	<u>3,183,585</u>
	\$ 41,505,813
 <u>Funding per Consent Decree issued 2/24/2006</u>	
2006 - \$7,854,750 (SPOA-SEC, 12.3) & \$3,497,000 no projects identified	\$ 11,351,750
2007- with no project identification	<u>15,000,000</u>
	\$ 26,351,750
Total capital funding provided by Erie County at 12/31/06	<u>\$ 67,857,563</u>
 Future funding per Consent Decree	
2008 - with no project identification	\$ 15,000,000
2009 - with no project identification	<u>8,000,000</u>
	\$ 23,000,000
Total Erie County Capital Funding Committed to ECMCC	<u><u>\$ 90,857,563</u></u>

WE RECOMMEND that the ECMCC Capital Committee present annually a multi-year capital plan to the ECMCC Board of Directors, or as an alternative, present the multi-year plan with the submission of the proposed annual capital expenditure budget for board approval.

WE FURTHER RECOMMEND that upon its approval by the ECMCC Board of Directors that a formal capital plan be immediately submitted to the County Executive, County Legislature, County Comptroller, County Attorney and Commissioner of Public Works.

E. CAPITAL PROJECT EXPENDITURES BY ERIE COUNTY

In addition to the cash payments for capital funding specified in the Second Consent Decree, the County directly funds and manages a number of capital projects on behalf of ECMCC as provided for and acknowledged in the SPOA, First Amendment and Second Consent Decree. For the period January 1, 2004 through June 30, 2007 Erie County has expended \$29,950,997 of \$41,409,394 of capital funding provided for ECMCC capital projects. Figure 8 provides an annual breakdown of those expenditures through June 30, 2007.

Figure 8

CAPITAL FUNDING EXPENDED BY ERIE COUNTY

Total Capital Funds Committed		\$ 41,409,394
2004 Expenditures	\$ 4,671,015	
2005 Expenditures	7,679,055	
2006 Expenditures	10,713,716	
2007 Expenditures through 6/30/07	6,887,212	
Total Expenditures	<u> </u>	<u>\$ 29,950,997</u>
Remaining Available Funds @ 6/30/2007		\$ 11,458,397
Available Funds Breakdown:		
Commitments/Encumbrances @ 6/30/07		2,605,225
Remaining Appropriations @ 6/30/07		8,853,172

In addition to the \$29,950,997 expended, the County paid ECMCC \$26,351,750 to satisfy the 2006 and 2007 capital funds requirement of the Second Consent Decree. We have confirmed with ECMCC’s chief financial officer that as of November of 2007, \$174,467 of the \$26,351,750 paid to ECMCC in 2006 per the Second Consent Decree has been expended. However, ECMCC’s 2006 financial statements reported Restricted Net Assets Expendable for Capital of \$32,706,246 and the ECMCC Controller stated this included the capital funds received from the County. In addition, Note 4 of ECMCC’s 2006 financial statements entitled “Cash and Cash Equivalents, Investments and Assets Whose Use is Limited” shows the \$26,351,750 as designated for acquisition of capital assets split between current and non-current, \$5,000,000 and \$21,351,750 respectively.

We have been informed that the capital funds have been invested by ECMCC in interest-bearing accounts and that interest earned on those funds was not being restricted with the principal amount. The corporation’s chief financial officer explained that capital expenditures are being delayed because the DOH has suspended approvals on all certificates of need (“CON”) pending the conclusion of actions arising from the Berger Commission’s recommendation of the merger of ECMCC and Kaleida Health.

A CON is a public process which makes healthcare providers accountable for meeting access, quality and cost standards, and provides a context within which provider initiatives may be evaluated against alternatives for meeting state priorities for improving the health status of its citizens. New York State developed the CON process in 1965 through legislation which declared as its “policy and purpose” that “hospital and related services of the highest quality, efficiently provided and properly utilized at a reasonable cost, are of vital concern to the public health.”

The CONs being held are as follows:

CON Number	Date Filed	Item	Estimated Cost
052206B	N/A	Ambulatory Surgery Center	\$5.6 million
072045C	N/A	Renal Dialysis Stations	undetermined
None	2/20/07	Nursing Unit Renovations	\$700,000
None	4/3/07	Heart Hospital	\$91.7 million

At January 1, 2007, the amount of outstanding CONs was less than \$10 million. This is significantly below the \$26.35 million of capital funds received from Erie County in 2006.

WE RECOMMEND based on the premise that interest follows principal and that the state has not approved the CONs necessary to expend capital funds, that any interest earned on the investment of unspent capital funds also be restricted for future capital acquisitions.

F. SCHOOL #84

Buffalo Public School #84 is located on the ECMCC campus. Established to serve the most severely handicapped of students, School #84 has existed on Erie County property since 1946. During that period, many informal arrangements were developed between the County, ECMC and the Buffalo Public Schools regarding services at School #84. One of these services is the provision of meals to the students. Providing over 100 meals a day, ECMCC pays the costs of these student meals, at a cost of over \$100,000 annually.

The Federal Government and New York State both provide reimbursement to school districts for school lunches. The reimbursement rates vary with the student's economic background, and certain other factors. New York State's reimbursement rates range from a low of .065 cents per student to a high of .2150 cents per student. Federal reimbursement rates range from a high of \$2.49 per student to a low of .25 cents per student.

No organization applies for this lunch reimbursement for the School #84 students. The Buffalo Public Schools do not apply, as they do not pay for these meals and cannot apply for reimbursement for meals for which they do not pay. Neither ECMCC, nor the provider of catering services to ECMCC, nor the County presently apply for reimbursement, as according to New York State, only a school system can apply for reimbursement for student meals. The New York State regulations on what qualifies as a student meal for reimbursement are complex; not every meal will qualify. The maximum reimbursement is for only a portion of the meal cost. Assuming that all meals served at School #84 do qualify, we estimate that the amount of reimbursement that goes unclaimed annually is \$46,000.

There is no formal contract governing ECMCC's services to School #84. Due to the Berger Commission's recommendations, we acknowledge that negotiation of a contract at this point may be impractical. Any merger discussions between Kaleida and ECMCC must take into account the students and informal working relationships between ECMCC and School #84.

WE RECOMMEND that the County meet with the Buffalo Public Schools in order to determine if these meals qualify for reimbursement from New York State. Should they qualify, ECMCC should consider billing the cost of these meals back to the BPS to allow the BPS to apply for reimbursement.

G. INTERNAL CONTROLS AT ECMCC

Our internal control examination commenced with a detailed review of the twenty-four page “Purchase-to-Pay Receipt Accrual Project” study conducted by RSM McGladrey, an international consulting firm. This study, completed in August 2007, looked in detail at ECMCC’s procurement processes, including internal controls.

The RSM study recommended a series of changes to ECMCC’s processes in order to bring them in line with industry best practices. There were eighteen recommendations that included increasing vendor education of ECMCC’s processes, increasing training for the users of the accounts payable system, increasing automation and other more specific changes to ECMCC’s processes.

RSM also examined the internal controls at ECMCC for the purchasing and payables cycle. They made twenty-seven separate recommendations that address weaknesses in four “theme” areas: User departments circumventing the purchase process or poor communication between Purchasing and Accounts Payable; Delays in resolving discrepancies, Price and quantity discrepancies from vendors; and the need for certain processes within ECMCC for re-engineering.

Using the above work as a guide, we prepared our own internal control assessment, consisting of over 50 separate items for examination. We tailored our internal control assessment to those areas included in our audit, and specifically to those areas highlighted as weak in the consultant’s report.

We performed tests of transactions to confirm that the internal controls were operating as described. We engaged in a sampling of transactions and did not review all transactions. During our testing we discovered one invoice in our sample that was batched and processed individually, the only instance of this in our sample. This specific invoice will be discussed later in this document (See Section O. AN INVOICE FROM “CITIZENS TO SAVE ECMC”.) The low-level weaknesses we found in Accounts Payable parallel those discussed in the consultant’s report.

The low level weaknesses we discovered were:

- New vendors are entered by the Accounts Payable staff into the Meditech system, ECMCC’s accounting system. This “creation of a new vendor” should be done by persons segregated from Accounts Payable.
- When receiving reports are sent to Accounts Payable for processing, the goods received report is matched to the purchase order and invoice for agreement. Our concern is that industry best practice indicates that the comparison of purchase orders and invoices

should not be performed by persons who also have the ability to approve invoices for payment or release checks. Accounts Payable clerks can approve invoices for payment, but do not have the authority to release checks.

These weaknesses are mitigated by other compensating controls. It is an audit axiom that the cost of a control should not exceed its benefit. In this case, these weaknesses can be addressed through the hiring of a new person in Accounts Payable. RSM McGladrey recommended the hiring of a new person in Accounts Payable to address other weaknesses identified by their review that were outside the scope of our audit.

During our audit, we observed persons from outside Accounts Payable assisting on Accounts payable tasks. Given the pending merger, and our observations of other persons assisting in Accounts Payable, **WE DO NOT RECOMMEND** the hiring of a new person in the Accounts Payable department.

H. AN INVOICE FROM “CITIZENS TO SAVE ECMC”

ECMCC’s internal records provided to this office represented that it spent \$6,499 in attempts to influence the general public regarding the Berger Commission’s recommendations concerning a possible Kaleida-ECMCC merger. However, during our audit our office discovered a \$50,000 invoice from an entity calling itself “Citizens to Save ECMC,” with an address at 424 Main Street, Buffalo, New York. The invoice requested payment from ECMCC in the amount of \$50,000 for services listed as “sponsorship.” ECMCC did not effect payment on this invoice. Instead, the invoice was cancelled with a handwritten note stating “Canceled per SM. Paid by Colucci.” We note that ECMCC’s counsel is the law firm Colucci & Gallaher, P.C., specifically Anthony J. Colucci, III, and that ECMCC’s Chief Financial Officer is Sue McCarthy. The address 424 Main Street, the site of the Liberty Building, is also the location of Colucci & Gallaher, P.C.

Our review of the Erie County Clerk’s records did not reveal any Doing Business As (“DBA”) registration for “Citizens to Save ECMC,” nor does the New York State Department of State’s Corporation and Business Entity Database show any corporation with that name.

ECMCC bid its advertising services as required by New York State Purchase Regulations. There exists a low-bid contract with Stand LLC for ECMCC’s advertising needs.

The day after this invoice was cancelled, Colucci & Gallaher, P.C. sent an invoice to ECMCC requesting a \$50,000 payment “For disbursements rendered on behalf of Erie County Medical Center Corporation in relation to certain public relations matters.” ECMCC paid this invoice immediately, the only time a solo invoice was run in a check batch in our internal control sample.

Our office inquired further of ECMCC and Colucci & Gallaher, P.C. regarding this matter and found that the \$50,000 of hospital funds were utilized to create a television commercial and purchase television time in both Buffalo *and Albany*. This commercial was created to influence viewers regarding the potential ECMCC-Kaleida Health merger issue. The invoice from

Sheinkopf Ltd., a registered lobbyist in the State of New York (and owned by prominent political figure Hank Sheinkopf) requesting payment for the advertisements and air time was addressed to “Citizens to Save ECMC.” The Sheinkopf invoice was also dated after Colucci & Gallaher, P.C.’s request for reimbursement from ECMCC.

In our sample of invoices reviewed during this audit, the “Citizens to Save ECMC” invoice was the only invoice canceled by ECMCC. We also note that it appears that ECMCC’s chief financial officer canceled payment on this invoice. We found both items to be unusual.

This office believes the canceling of the original June 6, 2007 “Citizens to Save ECMC” invoice, resubmitting of and ECMCC payment on a June 8, 2007 Colucci & Gallaher, P.C. invoice and subsequent June 11, 2007 Sheinkopf Ltd. invoice to “Citizens to Save ECMC” reflects a deliberate attempt on the part of ECMCC senior management and its counsel to hide the payment of government funds to a vendor. This is a serious matter and it raises the question of why ECMCC and its counsel endeavored to hide the payment.

During this review, we discovered another discrepancy regarding the approval process for payment to Colucci & Gallaher, P.C. of this \$50,000. Section 106 of the New York State Open Meetings Law, to which ECMCC is subject, states that minutes shall contain a “summary of all motions, proposals, resolutions and any other matter formally voted upon and the vote thereon.” When we questioned Mr. Colucci concerning this payment, he responded in an electronic mail dated October 24, 2007, stating that the \$50,000 expense “was approved by the Executive Committee of the board, not the full board. There is no requirement of either board or committee approval, however. I doubt the matter was recorded in any minutes.”

If this item was in fact approved by the ECMCC Executive Committee as Mr. Colucci claims, such approval should and must have been recorded in the minutes. Additionally, Article XII, Section 3 of ECMCC’s By-laws state that:

Section 3 Minutes. Each committee meeting shall have an agenda, time convened and adjourned recorded, and shall submit minutes of its meeting to the Secretary of the Board in advance of the regular monthly meeting.

Additionally, Article XII, Section 8 of ECMCC’s By-laws designate the Executive Committee membership as follows:

Standing Committees

Section 8 The Executive Committee. The Executive Committee shall consist of four (4) members. The Corporation’s General Counsel shall serve *ex officio* as a member of the Executive Committee. Other members of the Board may be added when advisable. The Chairperson shall preside at all meetings of the Committee. The Executive Committee shall have the power to transact all regular business of the Corporation during the period between meetings of the Board, subject to any prior limitation imposed by the Board and with the understanding

that all matters will be referred to the full Board for ratification. The Executive Committee shall meet at least quarterly, or upon the call of the Chairperson.

We note that ECMCC allows Mr. Colucci to serve as an “ex officio” member of the Executive Committee. As noted above, ECMCC’s By-laws state that all matters decided by the Executive Committee “will be referred to the full Board for ratification.” There is no record in any ECMCC Board minutes that this transaction was referred to the full ECMCC Board or voted upon.

Accordingly, there are two outstanding questions raised by Mr. Colucci’s claim. First, there is no evidence that the Executive Committee approved the payment. Second, there is no evidence in meeting minutes that the ECMCC Board of Directors approved this action by the Executive Committee, as required by their By-laws.

WE RECOMMEND that ECMCC maintain full, complete and accurate minutes of all committee meetings, notably any relating to approvals of the Executive Committee, and including all Board meetings as per ECMCC’s By-laws.

WE RECOMMEND that, as a public benefit corporation, for concerns of transparency, ECMCC not pay vendors through a third-party and discontinue the practice of procuring professional services via its counsel.

WE RECOMMEND that this advertising and invoice payment processing transaction be officially presented before the ECMCC Board of Directors, the reasons explained and documented in the minutes of the Board, and a full explanation provided to this office.

I. SPECIAL EXECUTIVE COMPENSATION

At a meeting of the ECMCC Executive Committee on January 18, 2007, that committee approved a resolution entitled, “Pay for Performance Compensation Model.” That resolution authorized performance bonuses for certain ECMCC senior management employees. In violation of the corporation’s By-laws, this resolution was not presented to nor was it adopted by the full ECMCC Board of Directors. This committee action also followed the Erie County Comptroller’s September 2006 actions in publicly questioning \$127,917 in cash bonuses awarded in 2006 to ECMCC’s chief executive officer and chief financial officer.

J. COMMITTEE MEETING MINUTES NOT MAINTAINED

ECMCC’s By-laws state that the Board of Directors shall keep a written record of all business conducted, including resolutions, findings, conclusions and recommendations that shall be filed with the minutes of the proceedings of the Board or committee. It appears that minutes were not consistently maintained for all committee meetings. The minutes of the Board of Directors do not substantiate that each committee was in compliance.

K. NON-COMPLIANCE AND INTERNAL CONTROL SUMMARY

During our audit we found several instances of non-compliance with internal controls. In and of itself, this may seem insignificant. However, when non-compliance occurs by and/or within senior management and the Board of Directors, any instance is significant. Specifically, our concern centered around the circumvention of normal purchasing procedures and lack of adherence to By-law requirements. As a result, internal control was weakened substantially, management oversight was diminished and credibility was questioned because of the “tone at the top.”²

Internal controls are those tasks that allow the organization to achieve “effective and efficient operations, reliable financial performance reporting or compliance with applicable laws and regulations.”³ An area of serious concern to any auditor is the idea that senior management may have taken actions that would override or disregard internal controls. Our audit work reveals not just the occasional item, but actions that form a pattern. That pattern demonstrates a disregard for ECMCC’s own By-laws and established procedures. Our audit shows:

- ECMCC senior management did discuss the payment to “Citizens to Save ECMCC” in its Executive Committee. Although not recorded in the minutes, ECMCC’s counsel indicated this action was approved by the Executive Committee. Such approval was not recorded in the Executive Committee minutes and any vote taken must be approved by the full ECMCC Board. There is no record of this item ever having been brought before the full ECMCC Board. This is a violation of ECMCC’s own By-laws.
- ECMCC allowed its Counsel to purchase advertising services on its behalf. As a result, ECMCC’s own financial records show these expenses not as advertising, but as a legal expense. This action impedes reliable financial reporting, circumvents standard purchasing practices and sets a precedent for continued discrepancies of this nature.
- ECMCC did not submit all the information required under the SPOA to the entities named in the document. This failure demonstrates that ECMCC management is unaware of contractual requirements, or deliberately disregarded them.

ECMCC’s Senior Vice President of Marketing and Planning provided a listing of invoices for advertising expenses. This listing did not reconcile with the ECMCC trial balance for advertising provided by ECMCC’s Controller. At the close of the exit conference, ECMCC management asked for a listing of those items that did not appear within the advertising account and this list was provided. Seven days after our exit conference, we received portions of a trial

² “Tone at the top” refers to the ethical atmosphere that is created in the workplace by the organization’s leadership.

³ 2007 Government Auditing Standards Paragraph 1.30 page 20

balance for an account entitled “Miscellaneous Marketing and Public Relations.” This trial balance contained all the invoices on our listing. In our audit we have used the listing provided by the Senior Vice President of Marketing and Planning as the basis for the actual amount revealed in our analysis.

WE RECOMMEND the ECMCC management undergo a complete fraud risk assessment of operations. The immediate focus should be to address, but not be limited to, the internal control weaknesses regarding purchasing and non-compliance. ECMCC management needs to re-establish accountability, provide for constant assurance of compliance and create vigilant monitoring of procedures and regulations.

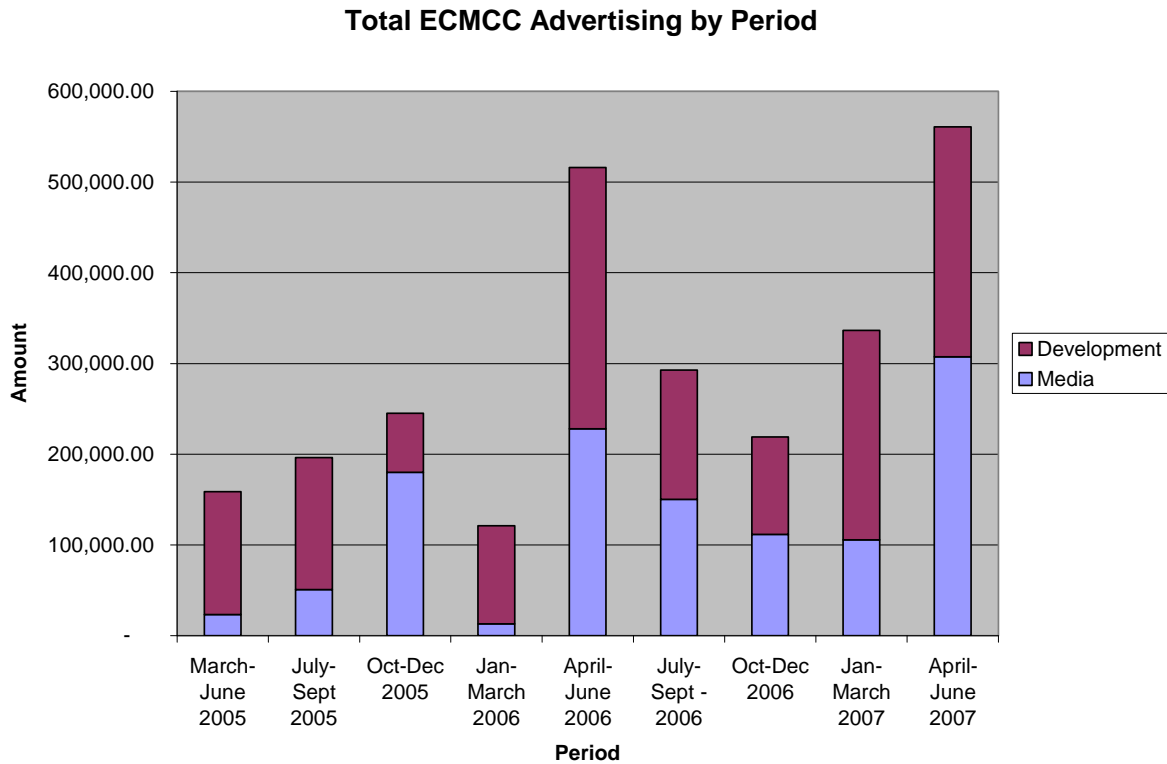
AUDITOR COMMENTS

ADVERTISING EXPENSES AT ECMCC

Our audit examined ECMCC’s advertising and public relations expenditures. During the 30 month period of our audit review, ECMCC expended about \$2.65 million on various forms of advertising. Below is a summary by category of these expenditures and Figure 9 provides a graph of these costs by period.

Media Purchases (radio, TV and print space)	\$1.49 million
Other Advertising Expenses (creative and other costs)	<u>\$1.16 million</u>
	\$2.65 million

Figure 9



Of the \$2.65 million expended, over 56% was spent on displaying television, radio and print advertising. In 2005, ECMCC bid out its advertising as per New York State procurement regulations for state public benefit corporations. Purchases of services of more than \$20,000 are covered under New York State competitive bidding rules for public benefit corporations, including ECMCC. ECMCC officials have stated that they believed the corporation could reduce costs and improve efficiencies through the use of an advertising agency, as well as improve the image of ECMCC within the community. Stand Advertising, LLC was selected as the bid winner. Of the \$2.65 million spent during the period of our audit, more than 87%, or \$2.33 million, passed through Stand Advertising LLC, as a media buyer and advertising agency.

The first billings of Stand LLC to ECMCC were dated March 2005. These early 2005 billings were for analysis and creative costs only. Media purchases by Stand LLC began in June 2005.

More than 28% of Stand LLC's total billings over the period of our audit occur in just nine of the two-hundred twenty three invoices sent to ECMCC during our audit period. Of those nine invoices, all for media time alone, five were for media purchases in the first half of 2007. The largest invoice received by ECMCC from Stand LLC was for more than \$115,000 in June of 2006.

In 2007, ECMCC received notice from the New York State Attorney General that a complaint had been filed against ECMCC concerning claims made by ECMCC in its advertising. The

specific claim in dispute was not identified, nor was the competitor that filed the complaint. The Attorney General's Office has received information from ECMCC on the basis for their advertising claims. As of the date of this report, this issue is still outstanding. ECMCC management has stated that the corporation believes this complaint is without merit.

DISCLOSURE STATEMENTS

Our office examined a sample of the disclosure filings for ECMCC's senior management and directors. Individuals who must file a disclosure statement are defined as those who make more than \$77,661 annually, and/or those in a policy-making position. The titles of those who file at ECMCC are listed in Exhibit "E" which is attached and annexed hereto. Employees in these senior positions are required by New York State Public Officers Law Section 73-a, to file an annual disclosure statement, disclosing their financial dealings in order to expose any potential conflicts of interest. As part of our internal control examination, we selected a sample of eight individuals from the listing of fifty-four persons at ECMCC who file statements. This list was provided to this office by ECMCC.

The Comptroller's Office does not currently maintain the resources to confirm the specific details in each filing of each covered employee. Our testing only confirmed that individuals had filed a statement, but did not examine the details in those statements. In our selection of eight persons, two statements were absent. After our determination that two statements were missing, ECMCC's counsel stated that one of the missing statements belonged to an employee who was not required to file. We do not agree. The second person had filed their statement with New York State, completely properly, and counsel did not have a copy.

Four individuals were not on our listing of those who file a statement but clearly did qualify under New York State Law. These individuals do make more than the New York State filing amount of \$77,661 but are not on the listing provided. Our review of all the statements as provided by ECMCC's counsel did not show these statements to be present.

Our sample also revealed that there were four extra statements on file. ECMCC's counsel had filed a statement, as had a senior member of his firm. These statements were not required under New York State or County laws, but were filed in "the interests of full disclosure" by these two individuals. A statement was on file for a Board member that had resigned in 2006. Finally, a person was appointed to the ECMCC board by the previous Governor but was never confirmed by the New York State Legislature. That person did attend meetings, and did file a statement, but never voted. The person in question has since been replaced by the new Governor.

WE RECOMMEND that ECMCC have the four individuals file the necessary disclosure statements with New York State.

WE RECOMMEND that ECMCC routinely monitor and confirm that every employee or director required to file a disclosure statement has actually done so. We believe it is in the best interests of ECMCC for those individuals who file statements with New York State to also send copies of those statements to ECMCC's counsel for recordkeeping. Statements filed with New

York State are unavailable for review here. A conflict that may seem trivial at the State level may not be so here in Erie County.

WE ALSO RECOMMEND that ECMCC or its outside independent auditors routinely review the contents of said disclosure statements to determine whether covered employees or directors are engaging in behavior that creates conflicts of interest.

POTENTIAL IMPACT OF BERGER COMMISSION

In 2005, then-Governor George Pataki and the State Legislature created the New York State Commission on the Future of Healthcare in the 21st Century (“Berger Commission”) to examine the future of healthcare operations across the state. Following a year-long review, the Berger Commission recommended, among other findings, that ECMCC and Kaleida Health be combined into a single healthcare entity controlled by neither and with a strong University at Buffalo role.

On September 12, 2007, following months of unsuccessful merger discussions between ECMCC and Kaleida Health, DOH Commissioner Dr. Richard F. Daines exercised his powers pursuant to the Berger Commission and appointed a new fourteen (14) member board for a unified governance structure of the two hospitals, with the fifteenth member to be the chief executive officer of the new combined entity. Three members of the new board are from Kaleida Health, three from ECMCC, three from UB, and five from the "community." There is no representation or role on the board for any County official or County designee. On October 24, 2007, the joint governing body announced a new tentative name, the Western New York Healthcare System, and named a chairman, vice chairmen, secretary-treasurer and president/chief executive officer of the new entity.

In the event that the new joint governing body and/or DOH determine that ECMCC should be closed and its operations shifted to Buffalo General Hospital, or merged into a new entity, there will be significant consequences to the County. While impossible to determine at this point what those consequences will be, there will be issues involving: (1) ECMCC’s debt service and the County’s bond guaranty on the \$101 million associated with the sale of the hospital to itself as well as the corporation’s issued debt totaling in excess of \$213 million as of June 30, 2007; (2) the status of any current or future operating subsidies; (3) the release of the County’s 2008 capital obligation and possible County reclamation of prior year appropriated but unspent capital funds at ECMCC; (4) personnel issues associated with former County employees and their status (including bumping back to the County, and retirement and health insurance obligations); (5) the status of the buildings, properties and land on the ECMCC campus (including County-leased or owned and occupied buildings); and (6) the status of School #84 (and its resultant impact on the ownership status of the ECMCC campus property).

DISCLOSURE NOTES

The Comptroller discloses that prior to his election and inauguration to the position of Comptroller, he was an attorney with the law firm Kavinoky Cook LLP. ECMCC Board

Member and Board Vice-Chairman Samuel L. Shapiro is a partner with the law firm Kavinoky Cook LLP.

A Staff Auditor within the Comptroller's Office is an in-law of the Senior Vice President of Marketing and Planning of ECMCC.

RESULTS OF EXIT CONFERENCE

An Exit Conference was held on December 28, 2007 at ECMCC with representatives from ECMCC.

The conference covered a wide range of topics including, but not limited to, a discussion of the Representation Letter, ECMCC Parking Revenues and ECMCC Internal Control issues.

Figure 2 of this audit report was the subject of much discussion. ECMCC management believed that a second schedule should exist: one that shows the cost to the County if ECMCC had not been sold. Such a schedule would be composed entirely of estimates and projections, which is why this audit report did not include such a projection. ECMCC President and Chief Executive Officer Michael Young made a case for why certain numbers should be eliminated or changed within Figure 2. As such, we adjusted Figure 2 to address certain issues.

When the IGT payments were discussed, ECMCC management discussed how the federal funds were used for patient care for the poor. ECMCC management was also stated that ECMCC forgave the County about \$1.5 million in Accounts Receivable and some rents due allegedly as a result of the County's unwillingness to negotiate some leases with ECMCC. Erie County does not agree with ECMCC's above stated contention.

ECMCC management also stated that they were never required to support all of their capital needs with documentation, and that the Second Consent Decree does not require a capital projects listing.

At several points, ECMCC management noted that County cash-flow requirements drove key decisions in the ECMCC-County relationship. It was alleged that a factor in the sale of ECMCC was County cash flow needs. ECMCC management discussed a \$150 million cash flow boost to Erie County in 2004 due to the sale of ECMCC.

Mr. Young was asked about the manner in which the transaction described in Section H "An Invoice from 'Citizens to Save ECMCC'" took place. He replied that the transaction took place in that manner in order to prevent the purchase of the advertising from being revealed through a potential future Freedom of Information Act ("FOIA") request. He stated that ECMCC received numerous requests for information under the FOIA statute, in some cases from competitors. He stated that ECMCC purchased this advertising through its legal counsel in order to prevent this information from being revealed through the FOIA.

Despite our request, Mr. Young and others at the conference were also unable to provide to us any details on the management or membership of the organization known as "Citizens to Save ECMCC."

ECMCC management agreed that if it is possible to receive federal reimbursements for meals at School #84, it should be done. They offered to assist in any negotiation between the County and the Buffalo Public Schools.

In accordance with the County's Audit Response System and Procedures, we request that ECMCC prepare a written response to our office, the Director of Budget and Management and the County Executive concerning the findings and recommendations by February 4, 2008.

We further request that ECMCC forward copies of their response to the Erie County Legislature and the Erie County Fiscal Stability Authority by February 4, 2008.

ERIE COUNTY COMPTROLLER'S OFFICE

cc: Christopher C. Collins, Erie County Executive
Anthony J. Baynes Jr., Chair, Erie County Fiscal Stability Authority
George Zimmerman, Esq., Acting County Attorney
Elizabeth Kornbrekke, Director of Budget and Management
Kevin E. Cichocki, D.C., Chairperson, ECMCC Board of Directors
Michael Young, President and Chief Executive Officer, ECMCC
Sue McCarthy, Chief Financial Officer, ECMCC
Anthony J. Colucci, III, Esq., Colucci & Gallaher, P.C.
Eliot Spitzer, Governor, New York State
Thomas P. DiNapoli, New York State Comptroller
The New York State Assembly
The New York State Senate