



IMA INSIGHTS

THREE-PRONGED APPROACH TO MANAGING HOSPITAL COSTS

To our Healthcare Clients and Friends:

This issue of *IMA Insights* focuses on balancing the response to the pressure for short-term cost reductions with the need to change the hospital's long-term cost structure. Maintaining the proper balance between these two challenges may help predict the hospital's financial success into the future.

BACKGROUND

Hospitals have long struggled with balancing the pressures for short-term cost reduction with the need to sustain long-term improvement in their cost structures. The environmental pressures create the need for immediate and decisive actions. Several factors contribute to the pressure in significant ways. The national debt has exceeded \$9 trillion. As leaders seek ways in which to deal with this debt, the social sector receives reduced funding. This translates to fewer dollars for healthcare providers. As the economy slows, consumers make different choices about their health; some delaying what they perceive as elective services. This translates into fewer patients seeking services and impacts the management of operating costs.

KEY ISSUES

Hospital leaders face the struggle of how to minimize current operating costs while assuring safe, quality, patient care. In addition, leaders must assure sufficient funding for long-term growth.

Short-Term Cost Reduction

In the face of rising unit costs, budgeted volumes that did not materialize, or declining reimbursement, hospital leaders must act quickly to maintain operating margins. While leadership teams may identify the need for cost control and reduction, three factors often stall their efforts. First, the team may not understand the causes underlying the need to reduce costs, making addressing the costs more difficult. Second, the broader organization may not have an awareness of its financial status, making the taking of action a surprise. Third, the hospital may not have addressed such cost reduction needs effectively in the past, reinforcing the cultural barriers to such efforts.

These three factors cause delays in addressing costs. These delays exacerbate the situation, causing the operating margin shortfall to grow, in turn, necessitating greater cost reductions.

To break this cycle, and to stabilize the hospital's costs, the leadership team must act. The actions may take the usual forms, ranging from curtailing discretionary spending, to limiting supply availability and usage, to hiring freezes, position recapture, and staff reductions. Typically, leadership acts on these items sequentially, with each action seen as another link in a chain. As leadership moves up this chain of actions, the reverberations echo throughout the organization for several months. The impact of these actions embeds itself into the organization's culture and creates barriers to future actions.

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Process-Based Cost Reductions

Those hospitals facing the need to reduce operating costs may embark upon a search for process-based savings. These savings accrue to the hospital as it changes functional work processes that become more effective and efficient, thereby requiring fewer resources to operate.

The hospital faces some significant challenges in demonstrating success with this approach to reducing costs. First, hospitals often find themselves mired in blind adherence to a process improvement methodology (e.g., plan-do-check-act, quality improvement, business process reengineering, participative design, lean, six sigma, etc.). This blind adherence requires that any improvement effort go through the prescribed methodology in lock step. All methodologies have advantages. Selecting and executing the one appropriate to the hospital's needs plays a critical role in determining its success. The timeliness with which the hospital must see demonstrable results represents a significant need in methodology selection.

Often, improvement methodologies require protracted time for analysis, design, and execution of improvements. The leadership team may not perceive that it has the time required for such approaches, given the level of challenge facing the organization. In addition, once the hospital implements the improvements designed through these efforts, the costs savings identified as part of the improvement often dissipate.

Strategic Cost Management

Strategic cost management requires setting long-term goals for the hospital's cost structure and moving toward those goals. This, in turn, requires long-term forecasting of revenues and costs tied to the overarching strategic intent of the hospital.

This also requires financial analysis and selection of programs and services that the hospital offers. This may result in the hospital deciding to eliminate programs or services. Such actions often compete with the leadership teams' desire to provide all services to the community. The challenge lies in providing the services which the community needs and which the hospital can provide effectively and efficiently.

INSIGHTS

Effective management of hospital costs requires a three-pronged approach: daily management of costs, process-based cost savings, and strategic cost management.

The daily management of costs, ironically, requires the most discipline and persistence. For example, it requires translating worked hours per unit of service into daily staffing grids and corresponding staffing to volume practices. This holds true for any department with variable workloads. Most hospitals only perform this translation in nursing departments.

Staffing-to-demand provides the most effective means by which to manage labor cost. Predicting the next shift's workload offers a tool to support rational variable staffing.

If the hospital performs a staff reduction, it must align it with process-based improvement efforts. In isolation, a staff reduction eliminates resources, but does not address the underlying work processes. To reduce the likelihood of rehiring positions, the hospital must transform the

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way in which it performs key work processes. This will improve process effectiveness and efficiency, requiring fewer resources to perform it.

A periodic review of key programs and services offers a way to systematically evaluate the contribution of those to the strategic intent and financial goals of the hospital. Cycling key programs and services through a rolling three-year review allows for periodic assessment without requiring inordinate resources. Market and reimbursement changes may dictate more frequent, special reviews.

SUMMARY

Blending three sets of cost management actions – daily management, process-based improvement, and strategic cost management – provides a way to assure that the hospital controls its operating costs. Leaders must focus their attention to a blended cost management approach to improve its management of costs and position the organization for sustained long-term cost improvement.

We are pleased to have had the opportunity to provide this information to you. If you have any questions or need assistance, please do not hesitate to contact either Bob Gift at 484-356-6486 or me at 610-659-9530.

Yours very truly,



Mary Ann Holt
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IMA Consulting

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THREE-PRONGED APPROACH TO MANAGING HOSPITAL COSTS**SPECIAL ANNOUNCEMENT**

Bill Weeks, one of IMA's founding partners, has announced his retirement from healthcare consulting, effective February 2008. For the past few months, Bill has been volunteering with Ashoka Youth Venture, a program that develops and empowers youth leaders in communities across the globe. Bill has decided to make a full-time commitment to his volunteer work with Youth Venture in New York, and we have no doubt that he will add real value to this worthy organization. Bill founded IMA Consulting in 1996, and we are very thankful for his vision, commitment, and leadership -- all of which helped IMA become one of the country's leading healthcare consulting firms. Please join us in wishing Bill the best in his new opportunity!

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