



IMA Insights

Volume 6, Issue 11 November 1, 2008

Hospitals' Response to the Current Financial Market

To our Healthcare Clients and Friends:

In this issue of IMA Insights, we explore the implications of the recent upheaval of the financial market and the short-term, operational actions healthcare leadership teams may consider in response to the crisis. While the long-term solutions may require hospitals to restructure their financing mechanisms and capital plans, some operational actions may avail themselves to leaders to assist in the short term.

Background

In the past six weeks, the crisis in the financial markets led the United States Congress to enact the Emergency Economic Stabilization Act of 2008. While it is far too early to predict whether the actions prescribed in the Act will address the financial issues completely, hospitals will most certainly experience more limited access to capital, increased costs of that capital, and decreased returns on investments. Other implications, such as the effect on revenues and other operating expenses, may also exist.

Challenges

The most obvious challenge hospitals will face due to the crisis in the financial market will be a tightening of credit availability. The reduction of the number of financing mechanisms available will hamper the ability for hospitals to gain access to capital through financing.

In addition, the credit financing that will be available will come to hospitals at higher costs. A client recently reported experiencing a quadrupling of the interest rate paid on short-term demand notes, moving from below two percent to almost eight percent in fewer than three weeks. Such movements have significant ramifications on operating expenses.

This shift in financing comes at a time when hospitals continue to have significant building and renovation projects in process. Modern Healthcare reported that acute care projects, including new hospitals, expansions, and renovations, exceeded \$25¹ billion last year. With continuing need for new and updated facilities, as well as expanded diagnostic and therapeutic capabilities, hospitals will continually need to secure financing for such initiatives.

While hospitals will experience increasing costs of their capital through higher interest rates, they most likely will experience continued decline in investment income. The trend of declining returns will continue into the near-term future, particularly if hospitals move toward less risky investments.

The secondary implications of the changes in the financial markets will also affect hospitals. As states experience financial pressures, they may delay payments to hospitals for state-funded programs. Insurers, seeking to retain their cash for longer periods, may delay payments through more highly reviewed claims.

Patients, themselves, may delay seeking treatment because of concerns over co-pays and deductibles. Such delays routinely result in increased use of emergency services, and more intensive and expensive episodes of care, when patients finally seek care.

The financial shifts that have an impact on hospitals have an impact on other industries as well. Suppliers and vendors experiencing the same limited capital and increasing costs may elect to pass a portion of those increased costs onto the

[1] Modern Healthcare, By the Numbers, December 24, 2007, page 84.

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hospitals they serve. This will result in increasing costs for supplies and services for hospitals. In addition, with the potential for more unemployment looming as other industries cut their cost of operations, hospitals may experience increases in bad debt and charity care.

Hospitals will, no doubt, continue to seek philanthropic support to help sustain their deployment of capital equipment and facility development. During such downturns as we currently experience, the availability of philanthropic funds softens, as donors experience decreased returns on their investments.

The summation of the impact of all of these factors may reveal itself greatest in its affect on bond covenants for those hospitals that currently hold debt. Decreases in revenues and increases in costs may call into play debt covenant ratios (requirements for maintaining mandated levels of performance, e.g., days cash on hand, debt-to-capitalization ratios, debt coverage ratios). The triggering of such covenants enacts potentially draconian measures by bondholders to assure financial viability.

Insights

Decreasing returns from investment income dictates that hospitals attend to their operating margins as the means by which to fund larger portions of their capital budgets. Increasing costs of capital and increasing operating costs passed along from suppliers and vendors makes improving operating margins doubly challenging in these times of financial uncertainty.

To reduce the financing burden required by major capital projects, hospitals can look at delaying such projects or reducing their scope. This action requires calling into play the agreements reached with the variety of stakeholders involved in the planning, design, and execution of these projects. The scope of these activities may range from eliminating entire projects, spreading the phasing of the projects over a longer period (with a focus on implementing those that generate new revenues or quantifiable cost savings first), eliminating portions of building projects, or re-selecting fit and finish to reduce costs incrementally. These actions may reduce the pressures for added borrowed capital and the resultant increase in interest expense.

The financial market crisis presents a set of circumstances that hospital leadership teams may leverage, to focus leader and managerial attention, to improve financial performance through more productive and judicious labor and expense management. To do so effectively, leaders must not focus in on only one aspect of costs, but turn their attentions to the entire array of operating expenses.

A review of hospital operating expense data from several recent operations improvement engagements reveals some interesting patterns. The operating expenses from the income statement were sorted into three broad categories: labor expenses (including benefits), supply expense (including all categories of supplies), and discretionary expenses (including such things as purchased services, professional fees, marketing, travel, and so on). Data was also gathered for the number of adjusted discharges for the three-year periods. For the categories of expenses, the cost per adjusted discharge was calculated and the compound annual growth rate computed. While the analysis lacks the sample size and rigor to qualify it as research, it indicates some direction for leaders.

The compound annual growth rate (CAGR) of labor expense per adjusted discharge approximated three percent; supplies expenses, six percent, and discretionary services, eight percent. Over the period, labor expenses reduced from 51 percent of total expenses to 47 percent. Supplies remained constant at 25 percent. Discretionary expenses increased from 25 percent to 28 percent. The summation may not equal 100 percent due to rounding. This abbreviated analysis underscores the need for leadership teams to examine all aspects of operating expenses in times of financial peril.

Current financial conditions mandate that hospitals become as productive as possible. Leaders should address a "back-to-budget" approach, at a minimum, by heightening the focus on sustaining departmental productivity. Each department within the hospital should have a variable workload standard that management monitors no less frequently than bi-weekly. Department managers should be held accountable to flex staffing to meet the variable workload demand. Moreover, as vacancies occur, senior leadership should question the need to fill the vacated position, with



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the intent to recapture the position by eliminating or distributing the workload performed by that role.

Similarly, managers should attend to the use of supplies. Over time, many hospitals have migrated to one-time use, disposable items. Managers should evaluate the use of such items, in light of the changing financial conditions to determine if the strategy remains viable. In a recent operations improvement engagement, challenging such thinking generated \$300,000 in savings.

The greatest obstacle may lie in addressing discretionary spending. While comparative data abound for productivity and supply costs, only limited data exist for some categories of discretionary spending. Leaders may examine those accounts in several ways. First, financial analysts can create program-specific costs by category. This allows leaders to determine the strategic importance of such programs and their concomitant costs. Second, financial analysts can trend spending by account over time, determining which accounts have experienced the greatest increases and targeting the understanding of the decisions that drove those accounts accordingly. Third, financial analysts can seek comparative data about such accounts to determine the spending of hospitals of similar size and complexity. This analysis then triggers discussions about the changes necessary to effect improvement in costs.

Summary

The upheaval in the financial markets has created a crisis for hospitals by limiting access to capital, decreasing investment income, and increasing operating costs. To mitigate the impact of this shift, hospitals must address the full array of operating expenses on their income statements, not merely look at saving labor costs. Control of discretionary spending may provide some opportunities not traditionally sought in routine cost management examinations.

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We are pleased to have had the opportunity to provide this information to you. If you have any questions or need assistance, please contact either Bob Gift, Director, Operations Improvement, or me at 866-840-0151.

Yours very truly,

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