



Sustaining Operating Margins for the Long Term



To Our Healthcare Clients and Friends:

This issue of *IMA Insights* explores the implications for hospitals of recent and forecasted trends in patient services revenues and operating expenses. This article does so in the context of the continuing healthcare reform focusing on reducing waste from within the system. While much of the national discussion has focused on the long-term reduction, this article offers actions open to hospitals to address short-term needs and position themselves for long-term success.



BACKGROUND



In late May, the Pennsylvania Healthcare Cost Containment Council (PHC4) released its compilation and analysis of hospital financial performance. The report provided data from fiscal years 2006 through 2009, July 1 through June 30 of each year. While the report presents data and analyses from Pennsylvania acute care hospitals, the information gleaned from the findings provide insights into the state of hospital providers across the country. Some of the findings include the following:

- Negative total margins increased in hospitals during fiscal year 2009;
- Total operating margin percentages declined;
- Non-operating losses (investment and contributions) contributed significantly to the decline in total margins;
- Operating expenses increases outpace growth in patient services revenue;
- Uncompensated care revenue increased, reflecting the state of the economy; and
- Hospital inpatient utilization declined, as well as reflected by fewer inpatient discharges and inpatient days, and lower overall length of stay.

Additionally, internal analyses reveal a similar erosion of the patient margins. Patient margins indicate the ability of hospitals to meet operating expenses solely from net patient revenues. Negative patient margins indicate the need to subsidize operations from non-patient services revenues. Data shows that aggregated patient margins show the total moving further into negative figures, reflecting the inability to survive on patient services revenues.

CHALLENGES

Hospitals face eroding revenues, escalating expenses and unrealized projected volumes in a period of increasing regulatory scrutiny of operating and clinical performance. The historic practice of raising prices no longer offers relief, as prices rose 3.7 times faster than payments. The shift of inpatient to outpatient services similarly provides little respite, as outpatient reimbursement is declining, as well. As an example, CMS has reduced the payment for outpatient laboratory services by minus 1.9 percent for calendar year 2010 compared to calendar year 2009.

The Patient Protections and Affordable Care Act of 2010 has focused national attention on reducing waste from the system. Dr. Donald P. Berwick, recently appointed Centers for Medicare and Medicaid Services Administrator, has indicated that he will create a systemic approach to eliminating waste and redundancy. It appears as though he will do so through the Center for Medicare and Medicaid Innovation (CMI), the new entity created by the law. CMI will test “innovative payment and service-delivery models designed to reduce Medicare and Medicaid expenditures while preserving or enhancing the quality of care”. As we are all aware, the new law mandates reductions in Medicare spending over time. How, then, can hospitals bolster margins in an era of declining reimbursement?



INSIGHTS

Sustaining operating margins over the long term requires not only day-to-day attention and bold, decisive action in managing revenues and controlling expenses, it also requires that hospitals change the way they do business.

In the short term, hospitals can initiate several actions to improve margins. Those include:

- Redesign revenue cycle processes, denials management, cash collection, and cash acceleration initiatives to increase the receipt of revenue;
- Adopt meaningful departmental labor productivity targets, incorporating those into the operating budgets, departmental reporting, and managerial performance reviews;
- Assess supply costs and material management practices, focusing on product utilization with an eye to eliminating misuse; and
- Undertake discretionary expense (e.g., insurance, legal, advertising, premium pay, outsourcing) analyses to reduce associated expenses by challenging the underlying assumptions that support the expenses and by requiring periodic reviews of the benefits received from those expenditures.

In the mid-term, hospitals may:

- Manage productivity measures, coupled with monitoring cost per unit of service;
- Redesign benefits programs, with attention to reducing costs for current and retired employees, balancing the need to remain competitive in the labor market with the need for reducing expenses;
- Analyze utilization and service intensity to identify opportunities for improved clinical utilization practices by physicians. Elimination of unnecessary inpatient utilization holds the potential to reduce workloads that drive labor and supplies expense;
- Redesign key processes by eliminating waste and non-value added activities to simplify and streamline workflow (e.g., throughput), adapting LEAN thinking and methods; and
- Incorporate more labor saving technologies (e.g., electronic health records, smart phones, web-based registration and appointment scheduling) that are cost-justified and that produce increased efficiencies. Hold those who cost-justified the acquisition of the technologies accountable to achieve the cost savings used to justify the purchase.

Long-term sustaining of margins requires disciplined implementation of the above, but also requires the following:

- Transform care delivery models with a focus on preserving quality and safety outcomes and reducing underlying costs;
- Define long-term competitive advantages with attention on capacity management and rightsizing capacity over time;
- Avoid duplication of costly medical technology (e.g., laboratory, imaging) by seeking ways to increase utilization of existing services;
- Eliminate services, programs, and locations with marginal or negative incomes that are not core to the organization's mission; and
- Seek strategic alignment among the components of the healthcare delivery system. Create an integrator role for the communities served, focusing on developing synergistic rather than competitive relationships that foster improved services, enhanced quality, and reduced costs.



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SUMMARY

The erosion of operating income, escalating costs, and uncertainty of future investments require hospitals to aggressively manage the revenue and expense side of their organizations. The initiatives briefly discussed above can help hospitals achieve their mission's profitably.

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We are pleased to have the opportunity to present this information to you. Should you have any questions or comments, please feel free to call me at (484) 356-6486.

Truly yours,

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