



Healthcare Reform Will Force Hospitals to Make Cost Decisions



**TOUGH
DECISIONS
AHEAD**

To Our Healthcare Clients and Friends:

This issue of *IMA Insights* presents expense management considerations for hospital leaders in preparing for the potential impact of the coming healthcare reform legislation. While many aspects of the reform act remain uncertain, one facet stands clear. Passage will require reduced payments to healthcare providers, as well as intense efforts to reduce healthcare costs. As such, hospitals will need to find creative ways to address operating expenses.



BACKGROUND



Historically, as hospitals faced cost pressures, leadership teams sought ways to control variable expenses. Those efforts most commonly focused on labor and supplies expenses, the most readily visible and controllable. A review of comprehensive expense management engagements indicate that about 73 percent of the recommendations for financial improvement continue to come from these two expense categories. For continued success, leaders need to turn their attention to other sources for expense reduction, those not traditionally examined and more difficult to change. These include analyzing discretionary expenses, programmatic expenses, and expenses driven by utilization and service intensity.

CHALLENGES

Discretionary expenses represent those costs that are a function of leadership decision and not necessarily related to patient services volumes. Discretionary expenses exclude labor and supplies expenses, as well as fixed expenses (e.g., interest, depreciation). Discretionary expenses include such categories as physician fees, insurance, purchased services, audit and legal, and so on. Leadership teams have addressed some of these accounts (e.g., travel, dues and subscriptions) when facing cost pressures, but have accepted many of the items within the category as given. The difficulty lies in challenging the status quo and the underlying belief that “this is the way it is.”

Programmatic expenses represent those associated with a service line, component within a service line, or a standalone program. Examining programmatic expenses as a source for cost reduction presents challenges that are more complex. In many instances, information systems do not provide ready access to detailed information, or provide it in usable form. Many times, the programs are pet projects from key stakeholders (e.g., board members, community leaders, executives, physicians) or are perceptual representations of what the hospital is. In some instances, they stand out as the organization’s sacred cows, holdovers from times when monies were available to fund such activities; programs ripe for reduction, but politically charged.

Addressing utilization and service intensity as a source for expense reduction represents the most complex area. Utilization and service intensity (e.g., length of stay, ancillary service testing) drives labor and supply costs. While most reduction efforts focus on incremental improvement in departmental worked hours and supply cost per unit of service, examination of utilization and service intensity gets at the number of units of service generated. This requires engaging clinicians and adds that inherent complexity to the issue.

INSIGHTS

Discretionary expenses range from 19 to 28 percent of controllable expenses, based upon review of available data. The examination of these expenses requires detailed work and iterative questioning of the reasons behind the spending. The review of spending trends over three-to-four years, by subcategory, provides a historical look at the expansion of spending. The use of external comparative data provides an additional perspective.

For example, advertising expenditures may have remained constant over the past four years at \$1 million. Yet, hospitals of similar size, complexity, and market spend half that amount. This type of analysis leads to questions about the rationale for the spending and the drivers of it. While an inexact science, the analysis raises important questions for senior teams to answer.

Replicating this analysis and inquiry for every subcategory and account within discretionary expenses can lead to surprising returns. Doing so challenges the spending status quo and breaks the cycle of planning



the same expenditures year-to-year, without questioning their contribution to the changing economic conditions or the organizational intent. Applying this approach has yielded recommendations producing an average six percent improvement in expenses for hospitals.

Examining programmatic expenses requires altering the management mindset for the analysis. It requires looking beyond service line profit and loss statements to examine components within the service line. It also requires looking at components outside of service lines, such as administrative and business programs.

While the curtailment, elimination, or outsourcing of programs may be the initial focus, other alternatives exist. For example, as service lines proliferate, each service line tends to develop its own unique cadre of programs for education and outreach. Each education and outreach program, in turn, develops its own set of resources, leading to redundancy and inherent inefficiencies. Consolidating these types of programmatic components can continue provision of services, but at reduced organizational costs.

The examination of administrative and business programs presents a special case. Many of these programs represent a tactical response to a change in the market, regulation, or perceived employee need. As time passes, the need that created the program goes away, yet the program and its associated costs remain.

For example, many hospitals implemented diverse premium pay programs to aid recruitment of scarce employee positions. With the changing demand, hospital closures, and downsizing, selective shortages no longer exist. However, the premium pay programs remain in place, with payments made unnecessarily. This approach saved a hospital more than one-half million dollars in this category alone.

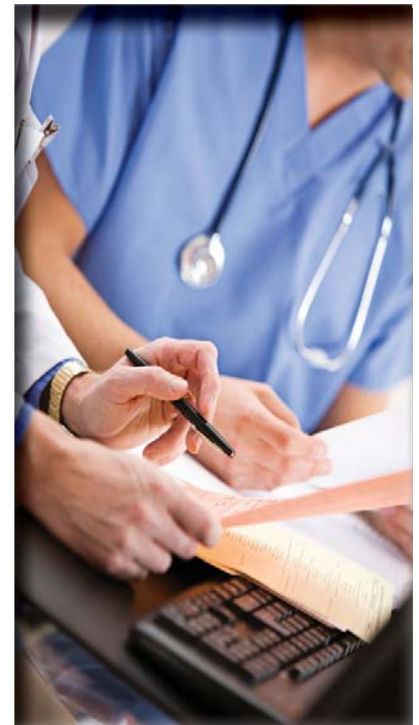
Utilization and service intensity presents the most complex arena for potential savings. It also provides the greatest potential for sustainable expense management. By reducing the number of units of service or the number of activities performed, the hospital can alter the resources needed.

A logistical example illustrates this. In an effort to expedite room turnover in the Emergency Department (ED), a hospital instituted the practice of moving admitted patients to the first available bed, regardless of service match. While this eased pressures in the ED, the practice had unintended consequences elsewhere. The hospital soon discovered that it transferred patients at three times the median rate for hospitals of similar size and complexity. The opportunity to save more than \$600,000 by reducing transfers led the hospital to change its bed management practices.

The utilization of diagnostic services provides another potential opportunity area. The number of diagnostic procedures (e.g., lab tests, imaging procedures) per discharge can vary significantly from comparable data. Similarly, length of stay offers potential, because of ever-declining national lengths of stay statistics. Pinpointing the opportunity requires data analyses by DRG and physician.

It also requires engaging clinicians in meaningful dialogue about clinical protocols and evidence-based practice. Aligning medical directors' work plans with achieving improvements in clinical utilization and outcomes will incentivize change.

While the most difficult to realize, the utilization and service intensity has potential to institute sustainable expense reduction by decreasing the work performed. It warrants detailed scrutiny and action by hospital leaders.





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SUMMARY

Going beyond labor and supply expenses to improve hospital performance can provide leaders with rewards that can position the hospital for future success. Addressing discretionary expenses, implementing programmatic changes, and challenging utilization and service intensity can yield sustainable results. Regardless of the final direction healthcare reform takes, reducing costs always positions an organization to perform more effectively.

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We are pleased to have the opportunity to present this information to you. If you have any comments or questions about how to apply these approaches in your hospital, please call me at 484-356-6486.

Truly yours,

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