The Road to Financial Sustainability for Hospital CFOs

Strategies to Achieve Permanence In A Changing Market

Bank of America Merrill Lynch

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Participants Include:

Chris Bergman, CPA
Vice President and Chief Financial Officer, Dayton (Ohio) Children's Hospital

Thomas Chan
Vice President and Chief Financial Officer, Meritus Health (Hagerstown, Md.)

Jeff Wakefield
FHFMA, CPA, MHA
Chief Financial Officer, Marion (Ind.) General Hospital South Nassau Communities Hospital

Charles Alston
Market Executive and Senior Vice President, Bank of America Merrill Lynch

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By Brooke Murphy

Policy reform and economic pressure in the last 10 years have caused many hospital and health system CFOs to reconsider their organizations' permanence and longevity.

Consider that between 2010 and 2017 alone, 81 rural hospitals — roughly 5.3 percent of all rural hospitals in the country — shuttered their doors, according to the Sheps Center for Health Services Research at the University of North Carolina. Moreover, more than one in two hospital administrators believe financial sustainability to be moderately or extremely challenging, according to a 2017 Sage Growth Partners survey.

As healthcare organizations face increased financial pressure, it is increasingly essential for CFOs to craft strategies that ensure their organization has the financial resources required to operate over the long-term.

This Becker's Healthcare e-book, based on survey responses from financial executives and a live roundtable discussion with three hospital and health system CFOs and a healthcare strategy expert, discusses financial sustainability in healthcare.

CFO participants in this report include:

- Chris Bergman, CPA, Vice President and Chief Financial Officer, Dayton (Ohio) Children's Hospital
- Thomas Chan, Vice President and Chief Financial Officer, Meritus Health (Hagerstown, Md.)
- Jeff Wakefield, FHFMA, CPA, MHA, Chief Financial Officer, Marion (Ind.) General Hospital
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Sustainability is Not Equal to Profit Margin

When CFOs were asked to define "sustainability,"

it didn't take long for a common definition to emerge. Financial sustainability occurs when an organization makes strategic decisions and capital investments to possess sufficient financial resources to meet the medical needs of its community — regardless of a patient's ability to pay — over a period of time.

Sustainability is not new to healthcare, but it has gained attention as changes in the market cause organizations of all sizes to question their long-term viability.

In times of high profitability or when hospitals are "just trying to keep the lights on," CFOs' priorities are typically focused on the here and now; financial sustainability takes the back seat to more immediate concerns, such as labor contracts, budgeting and payer negotiations. Today, declining government reimbursement, rising operating costs and shifting financial risk from payers to patients has made it more difficult for providers to generate the capital necessary to cover overhead costs and grow or maintain clinical and community services central to their mission. Health systems that comfortably recorded a 7 percent or greater profit margin five years ago may struggle today to simply stay in the black.

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Vice President and Chief Financial Officer
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As a result, Mr. Alston said some of his healthcare clients have altered the methods they use to measure financial health. "Delivering operating margin and profitability goals has always been the focus and was easier achieved in the past. The changing environment has challenged organizations to meet those same [financial] goals, causing finance leaders to think differently about financial strategy," Mr. Alston said.

At Dayton Children's Hospital, rethinking financial strategy means moving beyond the practice of "counting every single healthcare dollar" to ensure short-term returns and a positive bottom line.

"We get caught with 'single year-itus' about hitting a [financial] target without having that longer vision," Mr. Bergman said. "But ask yourself, 'How do I set a course to make sure I'm here 100 years from now?' That takes away a lot of the pressure from any one given year."

Transforming financial practice from the executive

level down doesn't happen in one night. The pace of change often depends on a hospital or health system's geographic location and market. For instance, Mr. Chan said financial strategy and economic concerns in Maryland's healthcare market differ considerably compared to other regions due to the state's unique reimbursement model.

For one, the state's global payment system, implemented in 2014 in partnership with CMS, determines each hospitals' total revenue at the beginning of the year. Hospitals have more opportunities to make changes to manage their operating expenses. However, this rate regulation system does not address long-term capital needs, which create one of the issues in access to capital for improvements and renewal among hospital providers, unless the hospital is a part of a larger system with significantly strong balance sheet.

Maryland's payment commission plans to expand the scope of its agreement with CMS in 2019 by holding providers more accountable for care outcomes, population health and total cost of care for Medicare beneficiaries, according to *Health Affairs*. This has raised risk management as a core competency to stay relevant in the market in the near-term, said Mr. Chan said.

"I think it opens up an opportunity for us to talk to [other healthcare providers in our market] about how to collaborate and share," Mr. Chan said. "In my mind, I'm thinking developing in our marketplace is not only about providing services to patients but [managing] certain high-risk areas that we share commonly between healthcare providers."

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Chapter II: 3 Tenets of Financial Sustainability

As financial risk shifts from payers to providers through various value-based reimbursement models — accountable care organizations, bundled payments and capitation — healthcare organizations are engaging in clinical practices that improve patient health across a population. Ultimately, taking population health management to the next level will require healthcare organizations to prioritize a number of capital investments both inside and outside the hospital

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Chief Financial Officer
Marion General Hospital

setting to affect social determinants of health, mitigate financial risk and support population health management initiatives.

Tenet No. 1: Investing strategically to maintain market relevance

Mr. Bergman agreed population health management is integral in planning for and maintaining financial sustainability in the future. Addressing these needs will require health systems to divert financial resources from their bottom line and reinvest them in new priorities, from health IT and analytics platforms to preventive health measures and patient programming. Mr. Bergman noted this positive attitude toward investment and spending is at odds with hospital CFOs' financial thinking 10 years ago, when a good CFO spent as little as possible to build up the bottom line.

"I've seen organizations who had a traditional CFO who drove bottom line by not spending money. But then you wake up one day and you're way behind technology-wise and your existence is threatened," Mr. Bergman said. In this way, the sustainability question has changed Mr. Bergman's perception of the CFO's role in community stewardship. "It's not about saving money but about ensuring you are current and have meaning in the community by driving value."

Mr. Wakefield predicted hospital CFOs who maintain the antiquated "no-spend" strategy will compromise their organization's ability to survive in the market. "It's not about stockpiling your cash but investing to promote your vision and mission," he said.

It's worth noting CFOs used the term "investment" in two capacities during the discussion — investing to generate short-term capital returns and investing capital or resources in projects with no expectation of capital gain. CFOs referenced the latter when discussing population health and mission; the former definition is expanded on below.

Tenet No. 2: Long-term capital investment strategy

Capital investment management has become exceptionally important in healthcare. As hospitals' margins shrink, providers have found the returns on their investment portfolios help bridge operating shortfalls resulting from lower patient volumes and reimbursement cuts. In fact, Mr. Chan noted much of his organization's operational flexibility today comes from returns

accrued from nonclinical assets.

That being said, Mr. Chan pointed out that few health system CFOs would consider capital investment management as a core competency. Managing an organization's investment portfolio requires a particular skill set, especially for large health systems with multiple asset pools. As demands for cash have increased, some systems have taken their investment strategies to a new level by seeking outside expertise.

"We give our investment advisor discretionary investment [authority] — the investment advisor can make [an] investment on our behalf ... without CFO approval," Mr. Chan said. "We want to hold the investment advisor accountable for the return on that [investment], and also recognize that ... I [as CFO] don't have the expertise to manage investments."

Mr. Bergman agreed: It may be necessary for executive teams and boards to look outside an organization — and perhaps outside the healthcare industry — to augment CFOs' investment acumen. Dayton Children's Hospital, for example, consulted a third-party investment management company to provide much-needed investment knowledge and experience.

"That's one thing we've tried to do from a bank – a facilitator standpoint is helping with the revenue cycle side of the hospital finance shops to help streamline synergies and build efficiencies. That, in turn, builds in some longer term sustainability."

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"We went with an outsourced CIO concept — chief investment officer — where you hold somebody else accountable for it and you let them manage it because that's what they do, they do that for a living," Mr. Bergman said. "[As CFO,] that's way outside my pay grade, I can't do that."

Another way hospital systems improve financial performance is by optimizing revenue cycle and cash flow, Mr. Alston said. He described how some health systems have partnered with Bank of America Merrill Lynch to consolidate and automate their accounts receivable and payment posting processes. "That's one thing we've tried to do from a bank — a facilitator standpoint is helping with the revenue cycle side of the hospital finance shops to help streamline synergies and build efficiencies," Mr. Alston said. "That, in turn, builds in some longer term sustainability."

Long-term vision and sound investment strategies are key components of a sustainable business plan. While investment

income can help buoy a health system year to year, the sustainability of that income is uncertain, particularly given the ups and downs of the economy.

Tenet No. 3: Business evaluation, cost accounting and long-term planning

Successful CFOs are expected to tolerate a higher level of financial risk than they have been comfortable with in the past. Moving into areas beyond acute care delivery, entering new partnerships and expanding population health offerings are all examples of exploring new territory that typically comes with greater risk.

To mitigate financial risk, finance leaders emphasized the need to understand the direct and indirect costs of running their organization in the short-term, and how these costs intersect with long-term business strategy. Specifically, this component of sustainability involves evaluating the financial effectiveness and longitudinal value of current clinical operations. Mr. Bergman pointed out that, for many healthcare providers, assessing the total cost of specific clinical activities is still relatively unfamiliar.

"The sustainability question has required us finance folk to look at our [hospital] business more like businesses than we used to," Mr. Bergman said. He pointed to the largely opaque nature of hospitals' operating costs as an example of how immature healthcare cost accounting is compared to other industries, like retail or manufacturing.

CFOs expect this to quickly change, however. For any business to be sustainable, leaders must know the cost to produce and deliver products and services so the business can generate enough revenue to cover operating expenses. Without accurate costing data, CFOs and financial leaders fly blind in deciding which departments are profitable and which services to consider cutting, thereby making a hospital vulnerable to sudden or unexpected shifts in utilization.

Mr. Chan raised physician practice management as a case for sustainable cost accounting and financial strategy. Between 2012 and 2015, hospital ownership of physician practices increased by 86 percent nationwide, according to the latest figures from the Physician Advocacy

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Institute. By mid-2015, about one in four practices was hospital owned.

"Many of the physician practices that we employ ... very few are breaking even or making a profit at all," Mr. Chan said. "So I think we need to continue to find a way to improve on the physician management side ... because I cannot afford for the hospital to subsidize that operation permanently."

"We want to hold the investment advisor accountable for the return on that [investment], and also recognize that ... I [as CFO] don't have the expertise to manage investments."

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Chapter III: Health Systems, Sustainability and Community

Hospitals and health systems exist to serve their communities — not only to provide healthcare services, but to bolster the local economy and quality of life by hiring local workers and contractors, buying locally through purchasing agreements and building clinical facilities in neighboring communities.

More than half of U.S. healthcare organizations reported spending between 5.1 and 10 percent of total operating expenses on community benefits in fiscal year 2015, according to a 2017 Becker's-Bank of America Merrill Lynch survey. Organizations spent the greatest amount on charity care (83 percent), unreimbursed costs for government programs (74 percent) and subsidized health services (51 percent). During the same fiscal year, 45 percent of health systems generated at least $30 million in total annual wages and salaries for the community. These activities often lead healthcare organizations to be called "anchor institutions."

A hospital or health system cannot be all things to all people due to limited capital, infrastructure and talent. But, as this report shows, there are other less traditional ways hospitals and health systems invest in their localities through nonclinical assets — from experienced leadership to government engagement.

CFOs described particular economic and social roles their organizations fill in their respective communities.

Marion (Ind.) General Hospital.

Marion General Hospital, a 97-bed hospital in Indiana, is the largest healthcare provider and one of the largest employers in its county. It reported $160 million in net revenue and provided $13.2 million in community benefit spending in fiscal year 2015.

Mr. Wakefield said the municipal government in

his region has struggled financially over the last several years. As a result, Marion General Hospital has taken over some services the municipality cannot afford to operate, including 911 emergency dispatch services. "At one point, we purchased about 30 police cars and fire trucks from [the city] for them because we had the cash and they didn't," Mr. Wakefield said.

The hospital is also involved in drug court and with law enforcement to address opioid abuse in the community.

Dayton (Ohio) Children's Hospital.

Dayton Children's Hospital is a 155-bed nonprofit organization. It reported $255.5 million in net revenue and provided $40.9 million in community benefit spending in fiscal year 2015.

As a children's hospital in a small community, Dayton Children's plays an important role in maintaining convenient, local healthcare access. This can help alleviate some stress and anxiety for families when children fall ill.

"If a kid needs any sort of hospitalization ... they can drive 60 miles to the south or 60 miles to the east and get it," Mr. Bergman said. "But on the flip side, it's nice to be able to stay close to home. So we offer that whole peace of mind factor."

Meritus Health (Hagerstown, Md.)

Meritus Health, a 231-bed hospital in Maryland, reported $372.2 million in net revenue and provided $21.3 million in community benefit spending in fiscal year 2015.

Oftentimes, a hospital system's greatest assets are the people it employs. Recognizing this, Meritus Health asks its executives and senior-level management to leverage their expertise and experience to drive positive change in their community.

"That's part of our mission, is to take care of our community. We can't do everything for them but we have to try to look for a solution ... or bring another avenue in to take care of that [need]."

Jeff Wakefield, FHFMA, CPA, MHA
Chief Financial Officer
Marion General Hospital

"For Meritus, we encourage senior leadership to participate in a nonprofit organization or organizations that promote economic development in our area," Mr. Chan said. "For example, I'm on the board of the Washington County's Chamber of Commerce. We're trying to promote more businesses to come to the Washington County area."

Partnerships and sustainable healthcare delivery

Hospitals have influence through their roles as respected organizations and large employers within their communities. They can use their leadership expertise, as well as limited financial resources, to act as catalysts for partnership and communication, working with community organizations and public health agencies to improve the wellbeing of their communities.

"That's part of our mission, is to take care of our community," Mr. Wakefield said. "We can't do everything for them but we have to try to look for a solution ... or bring another avenue in to take care of that [need]."

An important notion to emerge during discussion was hospitals' ability to facilitate partnerships between community health providers, particularly for behavioral health services.

"There are a lot of behavioral health services in the community that are very uncoordinated," Mr. Bergman said. "[Dayton Children's] just doesn't become the sole source of [providing healthcare services], but we become a source of trying to make the connections to everybody."

"[Hospital CFOs] do so much more than drive operating margins, and I like how we ended talking about strategic alliances. I believe it's true hospitals can't do everything, but they have the ability to profoundly influence their community sustainability."

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Leveraging IT platforms between unaffiliated health systems also emerged as a way to facilitate partnerships that support population health and risk management.

Mr. Chan explained how Meritus plans to use its Epic platform to collaborate with providers in the area that care for the same high-risk patient population. "It opens up an opportunity for us to talk to them about how to collaborate and share what we have once we implement."

Conclusion

During the discussion, CFOs worked through the regional challenges and industrywide concerns health systems face in the short- and long-term.

Mr. Alston succinctly summed up the conversation: "[Hospital CFOs] do so much more than drive operating margins, and I like how we ended talking about strategic alliances. I believe it's true hospitals can't do everything, but they have the ability to profoundly influence their community sustainability." ■