

Margins Squeezed? Here's Where to Find Operational Efficiencies

Robert D. Betka Jr. and Myra J. Mengwasser, for HealthLeaders Media, October 6, 2008

The current economic downturn has caught many businesses in an unanticipated margin squeeze. Healthcare organizations are no exception, with the impact being felt from the declining value of investment portfolios, reduced access to capital, increasing supply costs, and a rising proportion of uninsured patients. News reports are filled with reports of quarter-over-quarter increases in hospital charity care as employers reduce head count or restrict healthcare benefits. Recent inflationary pressures may exacerbate the current situation. So what can your organization do to ensure that it is generating the margin necessary to fund future operations and investments? A margin improvement audit may be the solution.

Determine your margin requirement

Your target margin should be an operating margin that is sufficient to meet your board's financial performance expectations and fund future capital requirements, particularly now that rating agencies are reviewing hospitals with greater scrutiny.

In addition to operating margin (net revenues less operating expenses), be sure to consider operating cash flow, existing debt service, and other sources and uses of cash. If net cash flow is negative, your margin improvement target will be the additional operating income necessary to fund your desired level of capital expenditures. Even if net cash flow is positive, opportunities may still exist to improve operating performance.

Identify specific improvement opportunities

Margin improvement opportunities are a function of two management actions: reducing operating expenses and increasing operating revenues. As simple as that sounds, it is not always easy to find those areas where more costs can be cut or revenues boosted. Most of us have been through this exercise before. But approaching the challenge systematically may elicit new or innovative opportunities that may have been hidden thus far.

In addressing operating expenses, first consider labor, supply, and overhead costs. The hidden costs inherent in "how we have always done things" need to be explored. Do a deeper dive into how the work is organized and performed.

Labor

While we want to protect our work force from unnecessary staff reductions, particularly among direct caregivers, these areas typically offer opportunities for labor savings. Analyze and assess your use of premium-priced labor, such as agency staff, overtime, and skill-mix. Developing an in-house pool can be a better quality and lower cost option than hiring external agency personnel. Over the past few years, many hospitals have completely eliminated outside agency use and reduced overtime by developing more flexible staffing options for their employees.

A productivity assessment, particularly using comparisons to independent benchmarks, can illuminate underperforming departments or functions where restructuring, redesign, or process innovation may be appropriate. Probe deeply and identify the reasons behind the numbers to derive additional savings opportunities. Critically evaluating your management and organizational structure can also pin-

point opportunities for efficiency improvement. Changing how you are organized in terms of management layers and span of control may dramatically improve operating results. Particularly among larger, complex organizations, there frequently exist numerous orphan cost centers or dispersed management functions that could be consolidated or reorganized to be more lean and effective. Consider organizing around processes; that's one powerful way to ensure focus on critical business needs.

Supply and drug costs

Supply and drug costs are typically the second-largest driver of operating expenses in most healthcare organizations. Even with the consolidation of national group purchasing organizations and increasing competition among medical suppliers, there is still room for improvement in supply and drug costs. Challenging contract pricing for discounts is the first step in identifying these opportunities. By analyzing contracts for your A-list vendors—the top 10 by annual spend—you might achieve up to a 10% discount without too much negotiation; your B-list vendors—the next 10 by annual spend—might elicit a 5% discount. Consolidating purchases among fewer vendors may also be a way to leverage vendors to achieve some savings. Our experience suggests that there is ample opportunity for long-term savings in challenging of drug expenses as a function of clinical utilization patterns, however, the degree of difficulty and time necessary for physician practice changes to occur means this is not a near-term solution to a margin problem.

Overhead

Overhead costs represent the third category addressed by the margin improvement audit. Most hospitals will find ample sav-

ings in assessing and evaluating their purchased service contracts, including physician agreements and medical director contracts. Many hospitals will be surprised at the number of separate contracts for similar services, such as biomedical engineering, office equipment repair, and maintenance services. By consolidating and renegotiating these contracts, savings of up to 10% of the contract amount can be achieved. For multi-entity organizations, consider consolidating duplicate contracts under a single vendor for the enterprise. Physician contracts should be reviewed to ensure that they contain performance expectations and are relevant to the current organizational strategy; medical director contracts should explicitly state the services and time commitment expected to be delivered and provide for accountability in job performance, such as monthly time logs.

Operating revenues

Operating revenues are somewhat more difficult to influence in the short term, requiring a strategic approach. Since most payer contracts can not be reopened at will, there is usually only a once-a-year opportunity to renegotiate commercial or managed care prices. However, this effort can yield significant new revenue, particularly if your payer contracts are underperforming compared to Medicare or national benchmarks. Also consider re-evaluating case-rates and carve-outs that may result in an effective overall rate increase. Certain revenue codes, implants and devices, DRGs, and drugs are appropriate for case-rate or carve-out provisions.

In the near term, improving revenue capture can be a fruitful opportunity for most hospitals. Three tactics can provide significant benefit: point-of-service cash collections; improved clinical documentation and charge capture; and a reformed denials

management program. On the front end, cash collections requirements for patient co-pays should be instituted in the emergency department and selected ancillary departments with high outpatient volumes. Our experience suggests that collecting up to 40% of "eligible" co-pays is a reasonable target for most hospitals, depending on market and payer mix. On the back end, routine documentation audits and educational and training efforts for physicians can result in an improved case-mix index through more accurate and complete documentation and coding. With the advent of payers reducing or eliminating payment for the occurrence of "never events," which CMS defines as "serious and costly errors in the provision of healthcare services that should never have happened," the capture of clinical documentation is more important than ever before. A related effort at analyzing denials and hard-wiring the appeal process can also increase revenue capture and reduce underpayments.

Launch the margin improvement initiative

The margin improvement audit outlined thus far will undoubtedly result in a portfolio of improvement opportunities for your organization. To ensure that these opportunities are acted on and the identified savings achieved we advise the use of two tools: a management action plan in which each initiative is assigned to an executive sponsor; and a project management framework to monitor the implementation of each opportunity and to track the results against expectations.

Robert D. Betka Jr and Myra J. Mengwasser are both a senior principals with the Noblis Center for Health Innovation and can be reached at Robert.Betka@noblis.org and Myra.mengwasser@noblis.org