

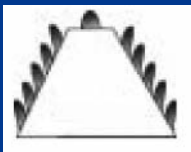
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Integrated Planning Offers Boards a Strategic and Financial Roadmap



By Elaine Zablocki

Ten years ago Delnor Health System used to develop a financial and strategic plan and then “store the binder on the shelf and sort of hope it would happen,” recalls Vice President and CFO Michael E. Kittoe. Now Delnor follows a rigorous, highly integrated planning process, relying on sophisticated tools and analytics to develop tightly coupled financial and strategic plans and constantly monitor results. Long-term plans are translated into operational timelines and goals; strategies and tactics are assigned to specific leaders; and each leader is accountable for carrying out that strategy. “Now we put a whole new level of discipline behind the financial and strategic plan,” says Kittoe.

Delnor, a 159-bed community hospital in Geneva, Ill., is just one of a growing number of hospitals and health systems that are using an integrated financial and strategic planning process to keep the organization on course. “Running a hospital of any size is an incredibly difficult thing to do,” says Kenneth Kaufman, founder and managing partner of financial and strategy consulting firm Kaufman, Hall & Associates, Inc., in Skokie, Ill. “Doing things informally is likely not going to get the organization where it wants to go. Board members and management need a disciplined way of approaching the problems that must be solved, and we’ve found over the years that an integrated and multi-year strategic financial plan is an excellent guide. It functions as a set of guardrails that help keep the hospital on the correct side of the road.”

Recently The Governance Institute in San Diego, Calif., published an 84-page white paper by

Kaufman, *Focus on Finance: 10 Critical Issues for Hospital Leadership*, which offers key insights on all aspects of integrated strategic financial planning (see sidebar on page 2). “Disciplined planning starts with an engaged board of trustees and CEO,” Kaufman writes. “They set the tone for the organization, establish management expectations, engender broad participation, and ensure that the organization makes a real commitment to planning.”

He advocates an integrated planning process that includes five interrelated functions:

1. A continuous strategic financial planning process that balances an organization’s mission-based and market strategies with its financial capabilities.
2. Capital structure management that is appropriate to the organization’s current financial and credit position.

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- 3. A capital allocation process that enables the organization to prioritize capital spending decisions related to all organizational investments.
- 4. An annual budget that reflects the strategic, financial, and capital plans.
- 5. Ongoing monitoring and control functions that accurately assess whether strategic, financial, and capital targets are being met.

Kaufman advocates a calendar-driven planning process (see Figure 1), an approach rigorously applied by General Electric to drive exceptional performance. “You do your planning in the same sequential form every year,” he explains. “You update the strategic plan, and then you prepare your long-range financial plan. Then the long-range financial plan generates short-term profitability targets and your capital constraints. When capital requests come in, you know the amount of capital available for spending that year.”

The Monroe Clinic and Hospital, in Monroe, Wisc., a physician practice and community hospital with approximately 60 beds and 75 employed physicians, uses an integrated calendar-driven planning process, relying on a five-year strategic plan and a five-year financial plan. Its board meets formally every two months and reviews the strategic dashboard each time, including financial indicators such as debt-to-capitalization ratio, operating

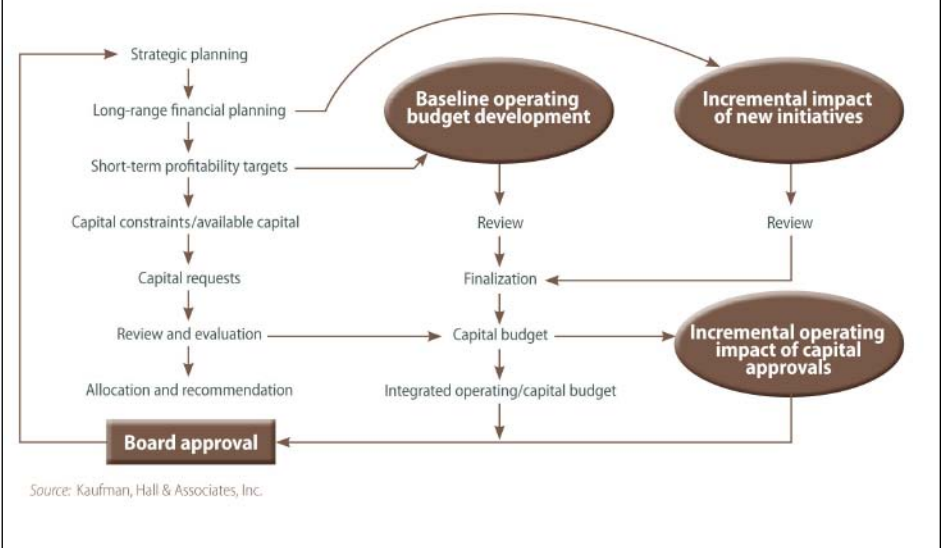
10 Critical Issues for Hospital Leadership

1. Disciplined Planning: The Groundwork for Success
2. Why Credit Ratings Matter
3. Finding the Right Balance of Cash and Debt
4. How Much Can the Hospital Afford to Spend?
5. Strategic Market Assessment
6. Setting Organizational Direction
7. Financing Organizational Strategy
8. Managing Capital Structure and the Balance Sheet
9. Understanding and Managing Risk
10. Achieving Growth and Scale: An Imperative for Sustained Competitive Performance

Source: Kaufman, K. 2008. *Focus on Finance: 10 Critical Issues for Hospital Leadership*. San Diego, Calif.: The Governance Institute.

Where to get the white paper: Hospital and health system trustees and executives may obtain a complimentary copy by contacting Lee Anne Elston at laelston@kaufmanhall.com.

Figure 1: The Integrated, Calendar-Driven Planning Process



margin, days cash on hand, and days to collect accounts receivable.

At the start of each calendar year, during a board retreat, the board

reviews key performance data and revisits the strategic plan. “Based on factors such as competition,

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community needs, and potential new services, we examine whether the strategic plan needs to be tweaked,” says Julie Wilke, vice president and CFO. “At this point we’re broadly surveying the environment.”

Later in the year, in conjunction with the financial plan, she prepares a “budgetary assumptions package,” a thorough review of past assumptions and current data on subjects such as physician recruitment, reimbursements, and the competitive environment. This information feeds into the long-range financial plan, updating it based on changing conditions in the operating environment. “The whole administrative team reviews projections for the coming year and their impact on the financial plan so we’re

prepared going into the capital budget process and annual operating budget process. This means the board, leadership, and the organization as a whole are on the same page about operations that support our expected level of capital spending, debt capacity levels, and operating performance targets,” Wilke says. “As we go out for financing related to our master facility plan, tying all these pieces together with clear performance targets is critical. They all interact.” At the end of the year, the board adopts the operating budget, the capital budget for the coming year, and the long-range financial plan.

Capital Allocation Is a Key Factor in Future Success

In Kaufman’s view, capital allocation is the key to financial success (see Figure 2). “If you don’t make appro-

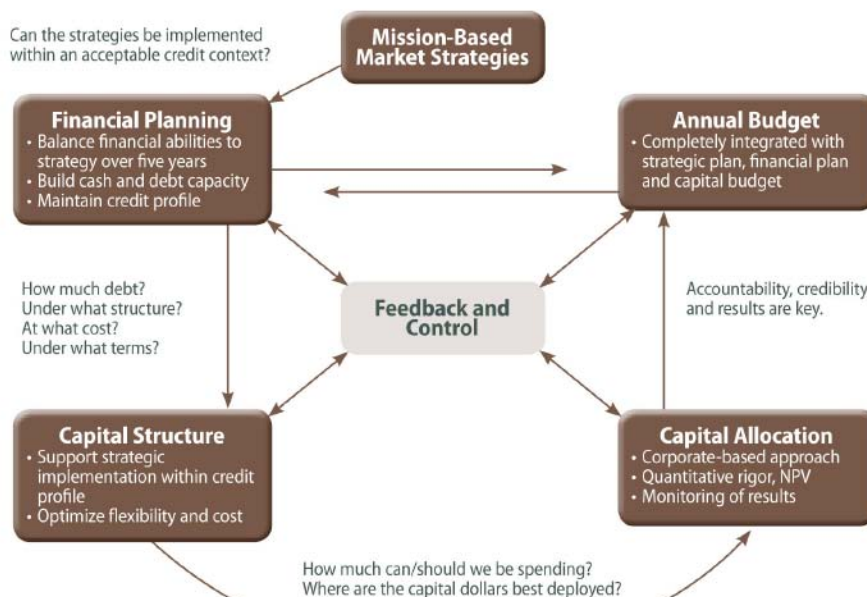
priate investment decisions, then you’ll face significant financial problems down the road. No healthcare organization has enough capital to invest in everything it might want to do It has to set priorities. This decision-making process is core to good management. The financial implications of allocation mistakes can make it hard if not impossible to get the organization turned back around.”

Baylor Health Care System, a 13-hospital system in the Dallas-Fort Worth area, has more than 450 employed physicians, a regional trauma center, and a research institute. During its financial planning process Baylor uses a sophisticated analysis to evaluate competing capital projects. “We prepare financial projections for all major capital projects and

evaluate each project’s projected return against our required minimum return for capital investments,” explains Lydia W. Jumonville, CPA, senior vice president and CFO. “Then we are able to rank and prioritize the capital projects and evaluate them in the context of our mission.”

She notes that hospitals are capital-intensive facilities requiring frequent renovation of space and replacement/upgrading of equipment. “These expenditures often do not produce new revenue or a positive return on investment.

Figure 2: Integrated Planning and Management



Source: Kaufman, Hall & Associates, Inc.

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Consequently, as we do our capital allocation, it is critical that we balance our investments in replacement capital with new revenue-producing projects.”

“Sensitivity analysis shows us that if we were off by just one percent in our growth projections for outpatient visits, five years later our operating income would be lower by about . . . 70 percent.”

—Michael E. Kittoe,
Vice President and CFO,
Delnor Health System

Kaufman also recommends sensitivity analysis, which assesses the extent to which changes in assumptions or input variables will affect relevant outcomes, as a valuable tool for capital allocation and long-term financial planning. “Because bad capital allocation decisions can overwhelm an organization’s financial resources, the leaders of best-practice planning organizations take extra steps to ensure that they understand the risk, expected return,

and exit strategies associated with major capital investment decisions,” he writes. “Sensitivity analysis enables executives to better understand the range of possible outcomes for individual initiatives and the interplay of a set of initiatives.”

Kittoe routinely performs sensitivity analysis on several key variables, including inpatient volume, outpatient volume, workforce productivity, annual salaries, and nonlabor expenses such as supplies. “Our board understands that it’s difficult to project five years out,” he says. “When you show them numbers with the potential results of variations, that helps them understand our risk. For example, these days most hospitals depend on outpatient services for a substantial portion of their revenues. Sensitivity analysis shows us that if we were off by just one percent in our growth projections for outpatient visits, five years later our operating income would be lower by about \$8 million, which would be a 70 percent decrease in operating income.”

Expect Course Corrections

Rigorous strategic financial planning helps hospitals make good decisions and catch problems at an early stage. “Good management involves a series of course corrections,” notes Kaufman. “There’s no way for an organization to go from point A to point C. Leaders constantly have to correct the course, as if driving on a curvy road. The planning process provides necessary feedback to make the most efficient course corrections.”

For example, during the past year, the crisis in the credit markets has impacted auction-rate securities. Delnor had to refinance its debt at a much higher rate of interest, significantly affecting its five-year financial plan. Originally planning an \$80 million expansion of the hospital’s labor and delivery unit, Delnor scaled it back to \$30 million.

As the Monroe Clinic’s executives monitored key financial measures, such as days cash on hand, operating margins, and debt service coverage, they found their financial picture improving, due in large part to successful physician recruitment and retention which fueled growth. They were able to expand plans for a replacement hospital building.

In a large healthcare system such as Baylor, each hospital has its own view of essential capital needs. “The financial planning process can pull everything together and give you the discipline you need to resolve these issues,” Jumonville says.

“One of our hospitals proposed a significant renovation of its emergency department, but the cost was in excess of what the system could support. Eventually, we found a way to redesign the project, significantly reducing its cost, while still quadrupling the department’s size and improving patient flow.”

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Use Integrated Financial Planning to Evaluate Past and Future Projects

Another essential aspect of the integrated planning process is to continually reevaluate earlier plans to see whether expected projections have been met. Several years ago, Baylor opened a new hospital in Plano. Its first-year financial results were below initial projections, in part because the hospital opened during the winter holiday season, and therefore took considerably longer than expected to be fully certified and able to bill Medicare. “We won’t open a hospital in December again,” Jumonville says. In addition, initial patient volume wasn’t as large as expected, so the hospital opened with excess staff. “This was a big project. Going back and reevaluating it in detail has taught us a great deal that we have been able to apply to future projects.”

Disciplined financial planning also helps organizations evaluate new opportunities. For example, in 2002 Baylor and All Saints Medical Center in Fort Worth began discussions about All Saints entering the Baylor system. This presented a valuable strategic opportunity for Baylor to develop a presence in Fort Worth, but there were also financial risks, including debt Baylor would assume. “We developed projections for All Saints, integrating them into our existing strategic financial plan. This enabled management and the board to evaluate this opportunity in a rational way within a short timeframe and confirm that it made sense for

us,” Jumonville says. “We’ve used this approach over the years as we have considered other opportunities.”

“If you monitor key measures and look ahead, you don’t have to scramble and make big changes in a hurry. You are spared dramatic surprises.”

— Julie Wilke, Vice President and CFO, Monroe Clinic and Hospital

Since integrated, long-term strategic and financial planning offers significant benefits, why do many hospitals fail to use this approach? “Healthcare organizations are complex places,” Kaufman says. “Their leaders often have highly ingrained ways of doing things and of thinking about financial planning. They may not yet understand the significant benefits of the disciplined, corporate finance-based approach described here, which has been successfully applied within healthcare organizations only during the past 20 years or so.”

However, Jumonville encourages other hospital systems to consider a rigorous, integrated planning process. “If you aren’t doing something like this, how do you know you’re really spending your capital

wisely?” she asks. “This process provides us a disciplined approach to evaluate and prioritize capital against operational trends and risks.”

She adds, “This really is a journey. If you follow the disciplined process, you learn from it and get better at it every year. The important thing is to just get started.”

Wilke agrees. “If you’re always monitoring key measures and looking ahead, you find that you don’t have to scramble and make big changes in a hurry. We don’t have crystal balls and sometimes assumptions turn out to be mistaken, but this planning process keeps you constantly in touch with potential developments. You can explore new assumptions, plug them into the plan, and look at the range of possible effects, and you are spared dramatic surprises.”

— Elaine Zablocki, editor of Great Boards, is a freelance healthcare journalist whose work has appeared in *Physicians Practice*, *Internal Medicine News*, *Medicine on the Net*, and numerous other publications. To contact her, e-mail greatboards@ezab.net.

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