WASHINGTON WEBINAR SERIES

IMPACT OF COST REPORT ON CAH DECISION MAKING

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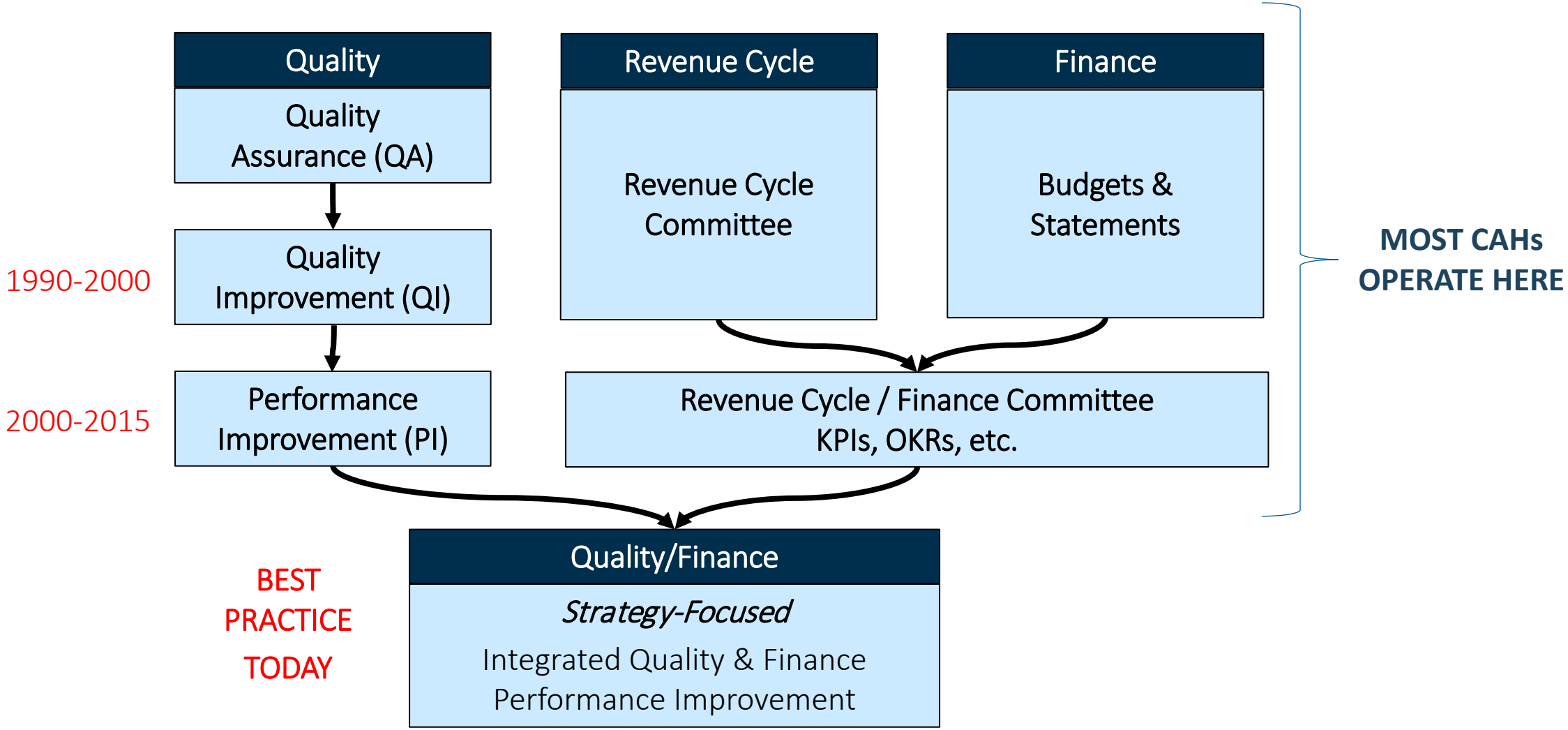
Impact of Cost Report on CAH Decision Making

- Overview
- Budgeting Process
- Financial Statements and Variance Analysis
- Cost Report Opportunities
- Questions

OVERVIEW

How Did We Get Here?



Cost-Based Reimbursement

- CAHs receive cost-based reimbursement for inpatient and outpatient services provided to Medicare and, in some states, Medicaid patients
  - Cost based reimbursement provides significant advantages to CAHs by allowing them to get paid at 101% of costs for the Medicare and Medicaid revenue

- For example, cost-based reimbursement enables CAHs to complete certain capital initiatives that would otherwise not be available to PPS hospitals
  - When a CAH completes a facility replacement, addition, and or renovation, the amounts expensed as deprecation and interest will increase reimbursements received from cost-based payors
    - For example, if a CAH spends $1M per year on depreciation and interest for the facility, and the CAH is 50% cost-based, meaning Medicare and Medicaid make up 50% of the charges, the hospital would receive an additional $500K / year due to the facility initiative
      - Under the same scenario, the CAH would receive 50% of the total capital cost, as depreciated, and interest from cost-based payors of the term of the loan and depreciable life of the asset

- *The above is for educational purposes as CAH cost-based reimbursement is based on allowable and unallowable expense and the allocation of expenses to cost-based and non-cost-based departments*

BUDGETING PROCESS

Revenue and Expenses

- Successful organizations realize the importance that both revenue and expenses play in the overall financial performance of an organization
  - Most CAHs focus more on expense management and often overlook the importance of revenue generation

- <u>Revenue</u>
  - Revenue is the term used to describe income earned through the provision of a business' primary goods or services
    - For CAHs, this includes, but is not limited to: patient services, 340B, dietary/cafeteria sales, gift shops, pharmacies, etc.

- <u>Expenses</u>
  - Expense is the term for a cost incurred in the process of producing or offering a primary business operation
    - For CAHs, this includes, but is not limited to: salaries and wages, fringe benefits, supplies, malpractice insurance, facilities and equipment, etc.

Budget Intent and Options

- Organizational complexity and the financial acumen of finance and departmental management staff will often dictate the involvement and use of the following most common budgeting approaches for business entities:
  - Incremental Budget
    - An incremental budget uses prior year's budget/actual operational performance and adjusts revenue and expenses, based on management assumptions, to project the next financial year
  - Zero-Based Budget
    - Zero-based budgeting starts from scratch each year where department managers are required to justify all revenues and expenses disregarding current financial performance
- Regardless of the budget methodology selected, each organization completes an annual budget that may include one of the following reasons:
  - Required by the CEO and or Board as an annual process
  - An expense authorization by the Board for current year expenditures
  - A tool to create accountability and involve department managers in the organization's financial performance
  - A process driven by the finance department to project financial performance

Incremental Budget Pros and Cons

- As stated, an incremental budget is prepared using the previous year's actual performance or budget as a basis where incremental amounts are either added or subtracted to create the new budget
  - <u>Pros</u>
    - Easier for department managers not well-versed in financial preparation to complete
    - Easier for finance staff to engage department managers
    - Less time-consuming and more cost effective
  - <u>Cons</u>
    - Carries forward the operating and financial inefficiencies from prior years
    - Assumes current operating performance is representative of future operating performance which may lead to a lack of innovation and growth
    - Encourages increased spending since prior year's performance is the starting point
    - Can lead to an increased focus on expense management instead of revenue growth
    - Less responsive to market variation

Zero-Based Budget Pros and Cons

- As stated, zero-based budgeting is a system where all revenues and expenses must be justified for each fiscal year disregarding current financial performance
  - Pros
    - Better equipped to address and incorporate market variation
    - Can lead to innovation and growth since managers must justify all revenue and expenses
    - Forces business to evaluate unnecessary costs
  - Cons
    - Extremely time consuming and costly due to the justification and validation of revenue and expenses
    - Requires a higher financial acumen for staff to complete
    - Harder for finance staff to engage non-financial staff around the budgeting approach
    - Can lead to short-termism where managers sacrifice long-term performance for short-term gains

Engaging Department Managers - Budget

- **Increase Financial Acumen**
  - Hold periodic trainings with hospital staff and department managers to increase financial knowledge around:
    - Cost-based reimbursement
    - Contractual adjustments and bad debt
    - Revenue Cycle process
    - Correlation between budget and financial statements

- **Budgeting Process**
  - Engage managers in the process of developing operating and capital budgets to foster ownership and accountability
    - Educate all managers on the budget process and basic financial management principles
    - Industry best practice uses the zero-based budget methodology

- **Revenue Improvement**
  - Implement systems and increase focus on revenue generation instead of expense management
    - Work with department managers to understand the importance revenue plays in overall financial performance
    - As a CAH, you cannot cut you way to success from an expense perspective

INCOME STATEMENT AND VARIANCE ANALYSIS

Financial Statements

- According to Investopedia, financial statements are written records that convey the business activities and the financial performance of the company and include:
  - Balance Sheet
    - The balance sheet provides an overview of a company's assets, liabilities, and shareholder's equity at a given point in time
  - Income Statement
    - The income statement provides an overview of revenues, expenses, and net income over a specific range of time
  - Cash Flow Statement
    - The cash flow statement measures how well a company generates cash to pay its debt obligations, fund operating expenses, and fund investments

Income Statement Importance

- Although the balance sheet and cash flow statement are critical to the overall success of a CAH, the income statement should be used by hospitals to drive accountability and performance expectations with department managers

- Direct expenses play a material role in the financial performance of organizations; however, can also be skewed in organizations with a system relationship

- For department managers, the G&A allocation is one of the most overlooked areas when trying to project departmental financial performance

	Combined Entities		
Income	HOSPITAL	CLINIC	Combined
Net Patient Revenues	$ 41,974,479	$ 2,181,025	$ 44,155,504
Other Operating Income			
340B Pharmacy	$ 653,857	$ 115,925	$ 769,782
Miscellaneous	766,187	-	766,187
Total Other Operating Revenue	$ 1,420,044	$ 115,925	$ 1,535,969
Total Revenue	$ 43,394,523	$ 2,296,951	$ 45,691,473
Expenses			
Salaries & Wages	$ 21,838,829	$ 1,236,667	$ 23,075,496
Benefits	2,825,886	176,810	3,002,696
Other	16,102,008	575,269	16,677,277
Depreciation	1,049,200	16,026	1,065,226
Interest	8,410	39	8,449
Total Operating Expenses	$ 41,824,333	$ 2,004,812	$ 43,829,145
Operating Income	$ 1,570,190	$ 292,138	$ 1,862,328
			-
Non-Operating Revenue and (Expenses)			
Other Expenses	$ (90,301)	$ -	$ (90,301)
Overhead Allocation	372,664	(372,664)	-
Total Non-Operating Rev / Exp	$ 282,363	$ (372,664)	$ (90,301)
Net Income (Loss)	$ 1,852,553	$ (80,526)	$ 1,772,027

Engaging Department Managers – P&L

- **Increase Financial Acumen**
  - Hold periodic trainings with hospital staff and department managers to increase financial knowledge around:
    - Revenue Cycle
    - G&A Allocations
    - Direct Cost v. Fully Allocated Cost
    - Financial Statements
    - Financial Metrics

- **Variance Analysis**
  - Consistently hold managers accountable for monthly variance reporting by requiring rationale and actions related to positive/negative budget variances
    - Create tied approach where variance to budget dictates who meets with department manager
    - Industry best practice provides departmental P&Ls to each revenue generating department (that ties back to budget) and then holds those departments accountable to overall performance

COST REPORT OPPORTUNITIES

Cost Report Opportunities

- **Cost Report Improvements**
  - Establish a bad debt policy that pulls claims back from the collection company, after a certain period of inactivity, for inclusion on the cost report
    - Target outpatient Bad Debt 10% of patient responsibility
  - Work with cost report preparer to determine if investment funds can be designated as funded depreciation to avoid significant offset
  - Implement a time study process and conduct medical record time studies to accurately capture true worked time by department for inclusion on the cost report
  - Monitor Worksheet E, Part B (Outpatient) to ensure the hospital is not passing on greater than 40% of the cost of care to the beneficiaries in the way of co-insurance and/or deductibles
  - Evaluate med/surg department square footage to incorporate the hallways to ensure accuracy of cost report; Minimum expectation is at least 300 square feet allocated for each inpatient bed

Cost Report Opportunities

- **Cost Report Improvements**
  - Utilize best practice time study methodology to ensure physician stand by time is accurate and fairly reflected on the cost report
    - Evaluate technology-based solutions that automate time tracking functions

	Current (@38 min)	Proposed (@20 min)	Variance
Total Cost	$ 3,048,843	$ 3,495,690	$ 446,847
Total Charges	$ 17,274,567	$ 17,274,567	$ -
RCC	0.176493	0.202361	0.025867
Medicare Charges	$ 6,035,289	$ 6,035,289	$ -
Medicare Reimb:	**$ 1,065,187**	**$ 1,221,304**	**$ 156,117**

  - Track Part A time for physicians via Time Studies for Medical Directorships, etc.

  - Monitor Ratio of Cost to Charge (RCC) levels to potentially indicate revenue cycle process improvement opportunities such as charge setting and/or charge capture improvement opportunities

Cost Report Opportunities

- **Cost Report Improvements**
  - Monitor appropriate assignment of non-Medicare or Medicare Advantage Swing Bed patients to Line 6 on Worksheet S-3-1 on the Medicare Cost Report

	Current	Proposed	Variance
Inpatient Routine Cost	$ 4,755,535	$ 4,755,535	$ -
NF Carve Out	$ 90,664	$ 104,482	$ 13,818
Total Cost:	$ 4,664,871	$ 4,651,053	
Total Days*	4,710	4,603	(107)
Routine Rate / Day:	$ 990.42	$ 1,010.44	$ 20.02
Medicare & Medicare Advantage Days*	3,777	3,777	-
Routine Reimb:	**$ 3,740,811**	**$ 3,816,430**	**$ 75,619**

* Days include Med/Surg, Swing Bed SNF, and Obsevation

  - Evaluate LDPR vs Med/Surg room usage based on observation status vs. active labor time status time studies to accurately allocate square footage
    - Ensure costs for LDRP include only the time assigned to “active” delivery otherwise these costs should be allocated to the Med/Surg cost center
  - Monitor departments with low charges relative to cost to ensure they are not missing charge opportunities, as this has a direct impact on ‘bottom line’

Cost Report Opportunities

- **Cost Report Improvements**
  - Evaluate the salaries included in Nursing Administration and ensure only the Chief Nursing Officer (CNO) and direct administrative support staff are included in this category
    - Ensure Nursing Administration costs are allocated only to departments that involve nursing functions – exclude departments such Imaging, Therapy, Laboratory, Pharmacy
  - Establish an internal threshold (such as a due from Medicare in excess of $500K) that would drive the completion and filing of an interim cost report
  - Consider consolidating RHCs for cost report purposes to remove reimbursement variances
    - The change in the RHC reimbursement methodology may impact the ability to consolidate RHC cost reports

	Clinic 1	Clinic 2	Clinic 3	Clinic 4	Clinic 5	Clinic 6	Clinic 7	Combined Totals	Consolidated Totals	Variance
RHC Allowable Cost	$ 397,089	$ 451,751	$ 309,335	$3,014,634	$4,326,832	$2,978,745	$ 349,383	$ 11,827,769	$ 11,827,769	$ -
Visits	1,432	1,883	1,761	15,845	23,906	8,967	1,731	55,525	55,038	(487)
Cost / Visit	$ 277.30	$ 239.91	$ 175.66	$ 190.26	$ 180.99	$ 332.19	$ 201.84	$ 193.61	$ 214.90	$ 21.29
Medicare Visits	395	498	512	4,061	6,260	315	249	12,290	12,290	-
Totals	$ 109,532	$ 119,475	$ 89,937	$ 772,637	$1,133,020	$ 104,640	$ 50,258	$ 2,379,499	$ 2,641,144	$ 261,645

  - The Proposed 2022 Payment Policies under the Physician Fee Schedule states Medicare will no longer allow new RHCs to file consolidated costs reports beginning with RHCs enrolled in Medicare as of January 1, 2021

QUESTIONS

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