

## Capital Demand and Access for Healthcare Information Technology

a report by

**Richard L Clarke, FHFMA**

*President and CEO, Healthcare Financial Management Association (HFMA)*



Richard L. Clarke, FHFMA, is President and CEO of the Healthcare Financial Management Association (HFMA), Westchester, Illinois, a professional membership association with more than 32,000 members in 70 chapters. He has held this position since June 1986. From 1980 to 1986, Mr. Clarke held positions with Swedish Health Systems in Englewood, Colorado, including Senior Vice President of Finance and Chief Financial Officer. Mr. Clarke has written numerous articles on healthcare finance and co-authored three books, including *Beyond Managed Care: How Consumers and Technology are Changing the Future of Health Care*.

Digital radiology systems; computerized physician order entry; major information system replacements; new in-patient and out-patient facilities; expanded emergency room capacity. For most US hospitals and healthcare systems, the list of high-priority capital projects is long and expensive. But hospitals' capital spending has been depressed in recent years, and the financial position of an increasing percentage of hospitals makes accessing the necessary capital a difficult proposition. How did we get to this state of affairs, and where will it lead us?

### Rising Demand for Capital

The abundance of high-priority capital projects arises from a combination of increased demand for healthcare services, inadequate past capital investment, and increased competition. Between 1999 and 2003, in-patient admissions increased by 9%, and out-patient visits increased by 18%, according to the American Hospital Association. The country's aging population will speed this trend. As of 2000, 12% of the US population is age 65 or older. Projections indicate that by 2030 that figure will be almost 20%. Older patients need more healthcare services, and all indications suggest that as the 'baby boomers' age, they will be more demanding than past generations about type and quality of healthcare. To cope with the aging population, hospitals – especially those in areas of rapid population growth – are embarking on aggressive plans to expand their capacity and capabilities.

Against this backdrop of increased demand, many hospitals have not invested enough capital to stay ahead of aging or out-moded buildings, equipment, and technology. Hospitals' capital spending was virtually flat between 1997 and 2001, with an average annual increase of about 1%, according to Fitch Ratings (see *Figure 1*). This apparent inadequacy of capital spending exacerbates the need for future capital spending.

Another force propelling the need for increased capital spending is increased competition, which challenges healthcare organizations to make themselves as attractive as possible to consumers,

insurers, and clinicians. One way to do that is to offer state-of-the-art facilities and technology. Thus, an organization might desire a particular type of medical technology not just to serve market demand or replace an aging system, but to improve its position in a competitive market.

All these factors fuel one striking finding of the Healthcare Financial Management Association's (HFMA's) Financing the Future project – hospitals plan an average annual increase in capital spending of 15% over the next five years.

### Challenges of Capital Access

In the face of all these reasons for increasing capital spending, the sad truth is that a significant proportion of US hospitals are not well positioned to access the capital they need due to high costs, inadequate payment for services, competitive forces, and other factors.

A look at hospital operating margins over time shows a disturbing bifurcation of hospitals into 'haves' and 'have-nots'. Median hospital operating margins overall have been relatively flat over the past five years; however, margins of higher performing hospitals are growing while operating margins of lower performing hospitals are shrinking, according to Ingenix (see *Figure 2*).

Bond ratings – which reflect profitability, liquidity, and capital structure – are another useful proxy for financial health and access to capital, and they too illustrate the widening gap between the 'haves' and the 'have-nots'. Over a 15-year period, the percentage of both high-rated and low-rated hospitals has increased, with the number of hospitals rated in the middle decreasing, according to Fitch Ratings (see *Figure 3*).

These findings suggest that some hospitals will find easier access to the capital needed for facilities, equipment, and technology; most hospitals will be challenged to come up with the necessary capital but will have realistic funding options; and a significant group of hospitals will fall even further behind as the need for capital increases and this group's ability to access capital declines.



**Thirst for IT**

Of all the potential capital projects, those given highest priority pertain to technology. According to a 2004 HFMA Financing the Future survey, the top three planned capital purchases for the next five years are:

- digital radiology systems (cited by 72% of respondents);
- computerized physician order entry (CPOE) systems (cited by 64%); and
- major information technology (IT)/information systems (cited by 61%).

This belief in IT solutions is echoed by many healthcare leaders. For example, George C Halvorson, Chairman and CEO of the country’s largest integrated healthcare organization – Kaiser Foundation Health Plan, Inc. and Kaiser Foundation Hospitals – recently wrote:

*“Re-engineering the wobbly parts of this dysfunctional system cannot be accomplished without a vitally important new tool: computerized physician support, including a comprehensive, automated medical record. Computerized support tools are, in fact, the key to solving every one of the [health system’s] problems.”*

This statement may well be prescient, but it does not absolve hospitals from the need to measure the value of IT and to ensure the value is realized. Understanding and achieving the value of healthcare IT rests on a three-legged stool:

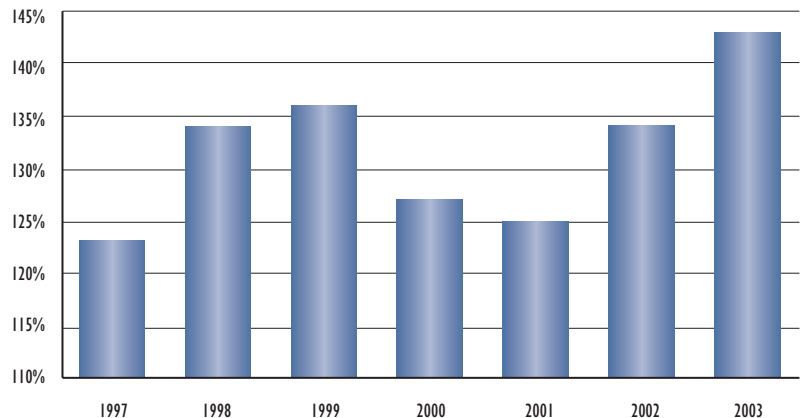
- IT must be part of a business strategy;
- IT’s return on investment (ROI) must be quantified to rationalize the significant expense; and
- the value of IT will be realized only through effective management.

**IT and Business Strategy**

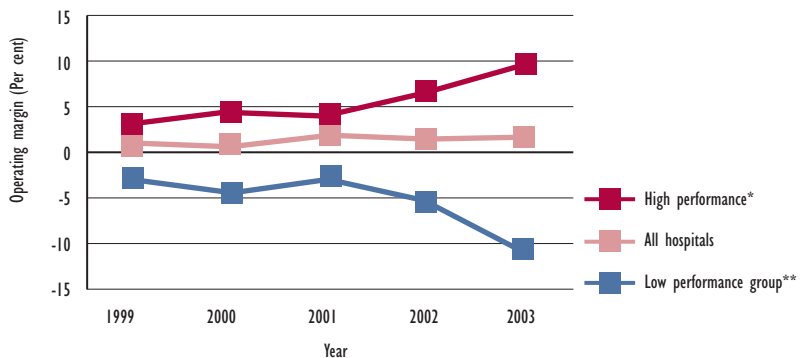
An organization must decide its strategic business goals first and then identify how IT can enable achievement of those goals. Strategic considerations include:

- Financial strategy – how the IT investment will further the organization’s goals for revenue generation, cost-containment, and creditworthiness.

**Figure 1: Trends in Capital Spending – Capital Expenditures as Percentage Depreciation Expense**

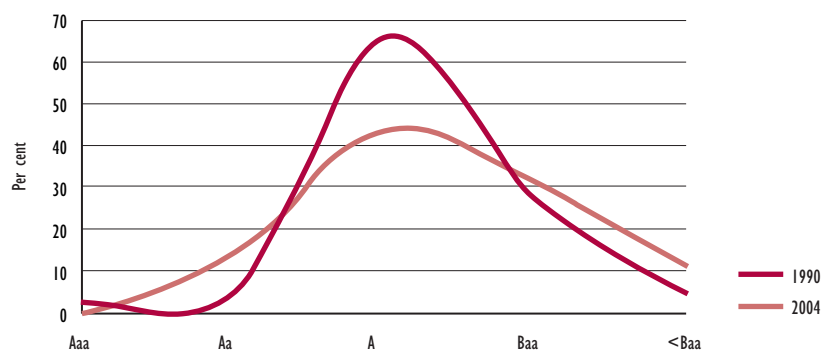


**Figure 2: Hospital Operating Margins 1999–2003**



\*ROIPLA>14.5%.  
 \*\*ROIPLA>5.4%.  
 Source: Ingenix Almanac of Hospital Financial and Operating Indicators 2005.

**Figure 3: Rating Distribution 1990–2004**



Source: FitchRatings.

1. Halvorson G C, “Healthcare Tipping Points,” hfm magazine March 2005.
2. Arlotto P, “Balancing IT Risks and Rewards,” hfm magazine February 2004.
3. Healthcare Financial Management Association and Healthcare Information and Management Systems Society, “The Value of Healthcare Information Technology”, supplement to hfm magazine, January 2003.

- Service-line strategy – how the IT investment will further the organization's efforts to rationalize services and facilities, and establish clinical excellence and superior market position in key service lines.
  - Customer service and physician relations strategy – how the IT investment will help the organization improve its ability to improve the patient experience and help physicians practice more effectively.
  - Human resource strategy – how the IT investment will enhance employee morale and ensure a more productive workforce.<sup>2</sup>
  - outlines the project's full costs;
  - identifies the value that the project either adds to or subtracts from the organization through net present value (NPV) analysis;
  - delineates risk and success factors; and
  - provides a yardstick for on-going measurement of the project's progress toward meeting concrete goals.<sup>3</sup>
- Only after such an analysis can an organization say with confidence that an IT investment provides value to the organization.

Goals related to specific processes, programs, or tactics (for example, improving the supply chain or automating a specific department) are important, but should not be the point of departure for IT investment decisions.

### Quantifying ROI

If the first step of assessing an IT investment is alignment with strategic goals, close on its heels is a hard-nosed quantification of ROI. But in the case of healthcare IT – especially clinical IT – quantifying return is a slippery proposition at best.

Consider picture archiving and communications systems (PACS). PACS require multi-million dollar investments. In return, they promise to avoid the costs of producing and storing film and paper reports. Like PACS, CPOE systems carry a large price tag. The value of CPOE systems most often mentioned is avoiding medical errors. No one would minimize the importance of patient safety and the best possible outcomes of treatment. Yet quantifying the return on enhanced safety is not a cut-and-dried endeavor. Other benefits of CPOE have clear potential financial effect – for example, improving efficiency – yet they are difficult to quantify with certainty.

Kenneth Kaufman, Managing Partner of Kaufman, Hall & Associates and author of several books on healthcare finance, advises healthcare leaders to put each and every investment opportunity, whether for a new ambulatory clinic, computed axial tomography (CAT) scanner, or decision support system, through a rigorous project analysis that:

- defines the scope of the project unambiguously;
- The US government's role in helping the 'have-not'

### Managing IT Value

And then there is execution. Any assumptions about IT value are only as good as an organization's follow-through once the investment is made. As John Glaser, Chief Information Officer of Partners HealthCare in Boston says: "One manages an ROI to be positive – it is not an inherent property of the technology."

Unfortunately, implementing change is not the strong suit of most healthcare organizations. Unclear purpose, insufficient leadership support, doubt, organizational inertia, organizational baggage, lack of incentives, lack of candor, low tolerance for bad news, and unmanageable complexity all can challenge healthcare executives trying to implement change necessary for IT projects.<sup>4</sup>

Beyond change management, organization leaders must navigate other dangers to executing an IT strategy, including failure to respect uncertainty, under-nourishing IT initiatives, not anticipating short-term disruptions, not celebrating progress, and not coping with the potential instability of relatively immature technology.<sup>5</sup>

### Where the Industry Goes from Here

The future looks very different for the 'have' and the 'have-not' hospitals.<sup>6</sup> The 'have' organizations will be able to improve their clinical excellence, customer service, and competitive positions because of the flexibility that their financial health affords them. Closures or mergers into stronger institutions will be the scenarios for some hospitals that cannot raise capital, making the 'have' hospitals even stronger.

4. Glaser J, "Management's Role in IT Project Failures," hfm magazine October 2004.

5. Glaser J, "More on Management's Role in IT Project Failures," hfm magazine January 2005.

6. Healthcare Financial Management Association (in partnership with GE Healthcare Financial Services), HFMA's Financing the Future. Report 6: Where the Industry Will Go from Here, HFMA, 2004, [www.financingthefuture.org](http://www.financingthefuture.org)

hospitals finance their futures is far from clear. The current administration has made implementing electronic health records a high priority, but has not accompanied that desire with adequate funding as of this writing. Government grants for IT initiatives would be a good starting point, but they do not solve the underlying problem of an outdated, labyrinthine payment system that prevents many hospitals from maintaining the margin necessary to support adequate capital investment. Lydia Jumonville, Senior Vice President and Chief Financial Officer of Baylor Health Care System in Dallas puts this issue this way:

*“When [health systems] lose money on Medicare and Medicaid and when the uninsured and underinsured numbers keep rising, they simply don’t have the cash to invest in capital. I’m not sure I want the government to come in with some prescription to fix capital. We need to fix the payment system.”*

#### **What Each Hospital can Do to Succeed**

One truism in the US is, ‘all politics is local’. The same could be said for healthcare. The success strategy for a public hospital in an urban area is different from that of a small rural hospital, which is different from that of an academic medical center, and so on. Payer mix, population health, competition, physician supply, past capital spending, and a host of other location-specific factors come into play. That said, it is possible to identify a number of approaches hospitals should consider as they look to improve their financial health and access to capital.<sup>6</sup>

#### **Deploy Resources Strategically**

Make sure investments and purchasing decisions are driven by strategic priorities. Rationalize assets by, for example, consolidating common services provided by multiple facilities in a system. Consider outsourcing appropriate functions.

#### **Focus on Core Services**

Identify the service lines that are truly unique and core to the organization, create a competitive strategy for those service lines, and focus capital investment there.

#### **Manage the Balance Sheet**

Continuously assess whether the organization carries the right amounts of cash and debt, maintaining a balance that will help to ensure that an organization can assume new debt when necessary for capital projects and has sufficient cash for other capital projects. Different capital projects and different financial scenarios suggest different approaches to this balance, and require thinking about a number of complex assumptions and alternatives.

Ultimately, the acquisition and application of IT might be the linchpin of success in healthcare. When IT is deployed to support a savvy strategic plan, when its value is quantified, when its execution is well managed, and when it facilitates re-engineered processes, the results can be better patient outcomes, lower costs, better competitive position, and more satisfied physicians and employees. Now, if only IT could fix the payment system. ■