Is your organization effectively positioned to manage its costs? Do you have the systems, practices, and management controls in place to yield the financial improvement required to execute your strategies?

The need for rigorous cost management is clear. Accelerated by unsustainable growth in national healthcare costs, reform and the emerging value-based business model will push hospitals and health systems to improve quality, access, and outcomes, while reducing expenses.

Many hospitals have been successfully reducing costs during the past few years; thus, as Moody’s Investors Service notes: “It will become more challenging to achieve further cost reductions after the ‘low-hanging fruit’ has been identified. Expense pressures may be particularly deleterious in an environment where revenue growth is expected to continue to be low.”

Hospitals and health systems can meet the expense reduction challenges of the coming years and improve their operating performance ahead of the curve by concurrently pursuing two important improvement initiatives:

- **Cost Management**: These initiatives focus on cost reduction and efficiency improvements of current operations, assuming no changes to the organization’s portfolio of clinical services.
- **Cost Structure**: These initiatives consider reshaping the distribution of services across the organization’s geographic market(s) to ensure the right services at the right scope and scale at the right location, with consideration to access, cost, and quality objectives; and rethinking the current portfolio of services, downsizing or divesting those that are not core to the organization’s mission.

Described here is the strategic cost management process we use with hospitals and health systems nationwide to produce the needed results.

**Assess Readiness**

An organization’s understanding of its current competence with strategic cost management is critical to the development of the capabilities needed to deliver high-quality services at the lowest-possible cost. Thus, an objective assessment of organizational readiness is recommended. This assessment should include both quantitative and qualitative analyses focused on:

- The systems, practices, and controls in place to manage costs
- How the organization uses (or not) these systems, practices, and controls
Components of Strategic Cost Management Competency

- **Cost management scope**: The breadth and depth of how major “cost drivers” are identified and defined and how corresponding improvement initiatives are planned and implemented
- **Target-setting and tracking**: The systems and processes used to set targets and monitor performance
- **Systems thinking**: The prevalent organization and culture of how costs are considered and decisions made, whether on a departmental/entity/silo basis or system-wide, as an integrated whole
- **Alignment**: The processes and methods used to ensure alignment and integration of plans, targets, and financial performance
- **Accountability and execution**: The systems and processes in place that hold management and staff accountable for delivering targeted results, executing plans, and generating success
- **Management controls**: The breadth and depth of management controls in place to hardwire success in meeting cost-management targets
- **Operational planning**: The processes used to plan and drive improvements
- **Overhead management**: The mechanisms in place to right-size overhead expenditures across the organization

Source: Kaufman, Hall & Associates, Inc.

Leading hospitals and health systems understand the need to optimize each element and are working aggressively to strengthen their cost management infrastructure and processes. But even the best-prepared organizations recognize that they have considerable distance to go to make strategic cost management part of the culture and adaptive to future changes in the industry. Preparedness, in fact, may be well below the “readiness midpoint” across competency elements for many organizations. Through identification of the systems and controls requiring improvement in design and/or application, hospitals and health systems can know where to focus their efforts to ensure that cost reduction initiatives are as effective as possible.

**Understand Your Capital Position and Quantify Your Shortfall**

Strategic cost management starts with an accurate analysis of the organization’s capital position, as commonly prepared as part of an integrated strategic-financial plan. The capital position analysis compares multiyear uses and sources of funds to identify the organization’s expected capital shortfall.
Cost reduction goals should be established to close as much of this capital shortfall as possible. The goals therefore would indicate the performance levels necessary to fund the organization’s strategies and maintain its competitive financial performance. In this way, goals are connected directly to the organization’s current financial position as well as its current and future strategic capital and other requirements.

All organizations should be thoroughly revisiting their integrated plan to examine the cumulative projected impact of strategic initiatives and changes due to healthcare reform and the new business model. Projections of payment, volume, capital costs, capital investment needs, and other variables are changing and will continue to do so. The size of an organization’s capital shortfall should be recalculated with the new data at-hand on a regular basis.

**Define the Possible Savings and Sources**

What cost reductions can your organization actually achieve to resolve its capital shortfall? As the next step, an assessment of cost reduction opportunities, applying rigorous data-driven methodologies, is completed to:

- Define the magnitude of productivity and other operational improvement opportunities that are available and achievable
- Identify the “composition” of the opportunities and their key drivers

A high-level plan that maps out the key cost savings opportunities and activities and positions the organization to move forward rapidly to implement these savings is recommended. This approach requires significantly lower investment of resources and avoids the organizational disruption that characterizes other approaches.

Review of historical trends, application of global and departmental benchmarks, peer department comparisons, and supplementary drill-down data analysis can be used to define the amount of possible savings. Use of both internal and external benchmarks helps to build consensus within the organization around the level of cost reduction that may be available.

For example, one health system used data from three separate analyses to identify its expense reduction needs and opportunity:

1. An analysis of the operating performance improvement that would be required to support capital expenditures at a targeted level
2. An analysis of cost reductions that would be required to bring each facility to a 90 percent Medicare revenue-to-cost ratio (which was then extrapolated to Medicaid and commercial business)
3. An analysis of potential cost savings based on interpretation and application of industry cost benchmarks

Each of these analyses indicated the level of improvement (i.e., cost reductions) needed to position the organization to support a greater level of capital investment, enhance operating performance, and improve the balance sheet. For this health system, the gap between the desired
level of capital spending and the level supported by operating performance provided the “burning-platform motivator” for real cost-reduction and efficiency improvements. If managers wanted the requested capital, they would be required to meet the cost-reduction targets.

Types of cost-reduction opportunities and their drivers vary by organization, but many are common to hospitals and health systems nationwide. Staffing and productivity drivers should be a key focus, as labor costs often constitute half or more of an organization’s operating expenses. Poor alignment of staffing with patient volume, coupled with poor execution of existing staffing plans, are among the more common contributors to high costs. The Sidebar below identifies other staffing and productivity drivers. Examples follow of four different types of cost reduction initiatives recently identified and implemented at hospitals and health systems.

### Key Drivers of Staffing and Productivity Problems

- Inadequate plans/alignment
- Poor execution of staffing plans
- Inappropriate/unclear staffing roles, target workloads, and assignments
- FTEs that “fly below the radar”
- Service and functional redundancy/excess capacity
- Insufficient management controls
- Use of overtime/premium labor

Source: Kaufman, Hall & Associates, Inc.

### Reducing Labor Costs

By addressing both cost structure (doing the right things) and cost management (doing things right), 10 labor cost reduction initiatives were identified and implemented in a multihospital health system. Figure 1 is a high-level mapping of the financial impact of these initiatives.

In the cost management domain, the “aligning staffing plans and schedules” initiative-- #1 in the graph-- ensured that staff work schedules appropriately reflected patient and workload demands and staffing plans. This project yielded extensive financial return and thus appears at the top of the high-impact quadrant for cost management efforts.

Cost structure initiatives, such as “consolidating functions or sites/locations” (#7 in the graph), also yielded a high impact and return. Such initiatives include, among other things, eliminating duplicative services in over-served markets and consolidating the number of lab locations. Similarly, initiatives related to eliminating or cutting back on lower priority/non-value-added functions--#8 in the graph-- provide considerable savings. A structural approach to scrutinize all
work and functions for their cost/benefit “value” was used, looking at both the importance of the functions and how well they were being performed.

![Figure 1. Labor Cost Structure and Cost Management Opportunities](source: Kaufman, Hall & Associates, Inc.)

**Improving Productivity**

Figure 2 illustrates FTE and associated dollar savings opportunities identified for one health system through analysis of internal and external benchmarks and interviews. Productivity improvements could yield between $15 and $22 million of potential savings, with the top 12 departments accounting for 87 percent of the total.

In terms of the composition of this savings, 40 percent of total savings could be achieved by improved execution of existing productivity targets. The organization had appropriate productivity plans and targets, but was not meeting those targets. The involved departments needed to strengthen monitoring, execution, and accountability to drive lower labor cost.

In a similar number of departments, the existing productivity targets were not set at a level sufficient to achieve the required level of financial performance.

The remaining portion of the labor-cost improvements (20 percent) could be directly attributed to a lack of meaningful targets or management controls. Some hospital departments were “flying below the radar” of cost reduction initiatives.
Aligning Staffing Levels to Patient Demand

It is possible to strengthen the relationship between staffing and patient demand. Often, staff schedules are not geared to when patients arrive at the operating room or emergency department, for example. Assumed/planned for staff “flexing” -- i.e., adjustment upward or downward with changes in volume--may not be occurring, as expected. A close review of census-based staffing grids for inpatient nursing units often reveals a less-than-ideal correlation between staffing and volume.

Figure 3 illustrates the results of a concerted effort to more closely align staffing to demand in a hospital’s ICU/CCU. The diamond-shaped points are the values for hours worked by pay period at specific patient-volume levels. The effectiveness of this effort can be seen by the improvement in the statistical alignment of staffing to demand as measured by the correlation (R-squared value) from 73 percent to 83 percent.

In addition to improving the alignment between volume and staffing levels, the data also demonstrate the department’s ability to improve the efficiency of staffing at every volume level. This is illustrated by the fact that the “after” line is lower on the chart than the “before” line. This
productivity improvement/staff alignment initiative saved the organization nearly 600 hours of staffing cost per pay period.

Figure 3. Aligning Staffing to Volume Demand
Source: Kaufman, Hall & Associates, Inc.

Reducing Overhead through Greater “System-ness”

System-level cost reduction opportunities also exist in many organizations. For organizations with multiple facilities or locations, cost savings can be achieved through selective centralization or regionalization of administrative and/or overhead services and functions. These include human resources, accounting and finance, revenue cycle, information technology, marketing, legal/risk management, and materials management, among others. In some instances, functional redundancy across facilities may not be needed and can be rationalized to reduce cost. Consolidation at the appropriate level can improve operations and yield large savings.

For example, Figure 4 illustrates how one multiregional health system reallocated the functions within human resources, resulting in FTE savings and reduced duplication of services and excess capacity. The health system eliminated almost nine FTEs by moving several human resource functions to the regional or system-level offices.
A data-driven and objective evaluation of system services from a “total spend” perspective, regardless of where such services may currently reside, is highly recommended.

Figure 4. Integration of System-wide Human Resource Functions
Source: Kaufman, Hall & Associates, Inc.

**Execute Improvement Initiatives to Produce Results**

To achieve real cost reductions like those in the examples, the savings opportunities identified through the process just described should be included in the organization’s strategic-financial plan, annual budget, and operating plans. Additionally, productivity reporting systems and targeted metrics must integrate appropriately with the organization’s budget. Staffing schedules must align with staffing plans that also are reflected in the budget. If “disconnects” occur between any of these elements, cost efficiencies and reductions will be very difficult to achieve and expenses will be higher than expected or warranted.
Establishment of a strong strategic cost management project infrastructure is critically important throughout the cost reduction development and implementation process. For example, Figure 5 provides a sample cost reduction work plan and timeline, indicating the major steps during a 12-month period and the key deliverables. The tracking of results must be detailed and timely to ensure that targets are achieved. The Sidebar below itemizes key infrastructure elements for a high-quality cost management initiative.

Hospitals and health systems have achieved very significant cost savings through our advisory approach of partnership with the organization to help strengthen, leverage, and complement its internal capabilities to produce needed cost savings.

**Best-Practice Cost Management Infrastructure**

- Alignment of goals and targets
- Development of a work plan and timetable
- Establishment of an oversight structure
- Appropriate management controls
- Stakeholder communication of objectives and progress in meeting targets
- Development of the improvement planning process
- Structuring of steering committee agendas
- Development of improvement plans and progress reports
- Effective tracking of results
The nation’s hospitals and health systems must lower costs and improve bottom-line results in order to fund ongoing and future strategies and to meet the requirements of a value-based business model. Cost structure and cost management improvement initiatives will need to be pursued concurrently. Planning and analysis related to cost reduction and improvement opportunities, followed by seamless execution in achieving such opportunities, are more important now than ever before. These activities will separate those that succeed in bending the cost curve from the rest of the field. Proactive hospital and health system executives are moving forward aggressively to reshape and streamline their costs in anticipation of a very different healthcare environment.

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References