WEB FEATURE

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5 strategies to ensure the right capital spending decisions

In the face of ever-growing pressure on organizational resources, hospital and health system executives can benefit from having processes in place that help ensure capital allocation decisions align with strategic goals.

AT A GLANCE

Establishing an effective capital allocation process requires five key actions:

- Redefine capital and its role in the planning process.
- Establish clear objectives and principles to frame the allocation process.
- Quantify available capital comprehensively.
- Institute additional planning for high-dollar, multiyear projects.
- Require complete business planning analysis of high-dollar projects.

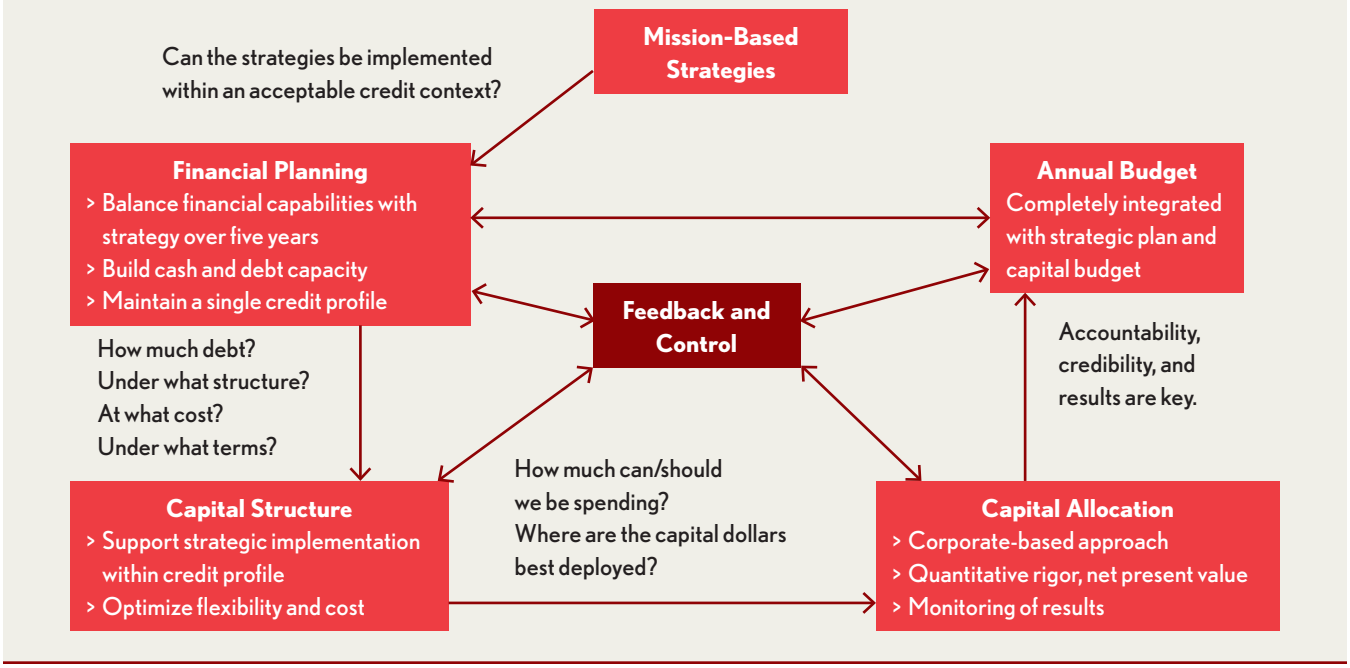
In today's rapidly changing healthcare industry, U.S. hospitals and health systems are contending with tightening margins that conflict with an ever-expanding list of capital needs. Given competing demands on scarce capital resources, an organization's long-term success and sustainability hinges on its ability to make smart strategic investment decisions today. The alignment of capital decisions and capital management with the organization's strategic objectives is critical.[a]

Adopting a thoughtful capital allocation process allows hospitals and health systems to find an acceptable balance between the need for continuing strategic investment and the ability to generate capital capacity. Such an approach brings together strategy, financial and capital planning, and budgeting, as shown in the exhibit on page 2. The process also helps to foster an organizational culture that respects the relationships among strategic objectives, capital capacity (i.e., the capital required to fund strategic and routine capital needs), and financial risk.

With the transition to a value-based payment and care delivery model, now is the time for hospitals and health systems to reassess the capital allocation processes they have in place and make sure they are well designed with these objectives in mind.

a. *Capital allocation* is the planning process for deploying scarce capital resources (cash and debt capacity) for investment in mission and community-based imperatives. *Capital management* is the ongoing monitoring and control function that ensures appropriate application of allocated funds.

INTEGRATED CAPITAL DECISION MAKING



Source: Kaufman, Hall & Associates, LLC

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Evolved Decision Making

Hospitals, health systems, and other providers will continue to experience mounting pressures on their operating margins due to declining payments, the increasing need under value-based payment to reduce care costs and enhance quality, and other forces of change affecting the industry. Demand for more consumer-centric health care is growing as patients and families bear a greater share of their healthcare costs and become more engaged in decisions about their own care. As a result, the capital needs of healthcare organizations are becoming more diverse, often extending beyond traditional spending areas.

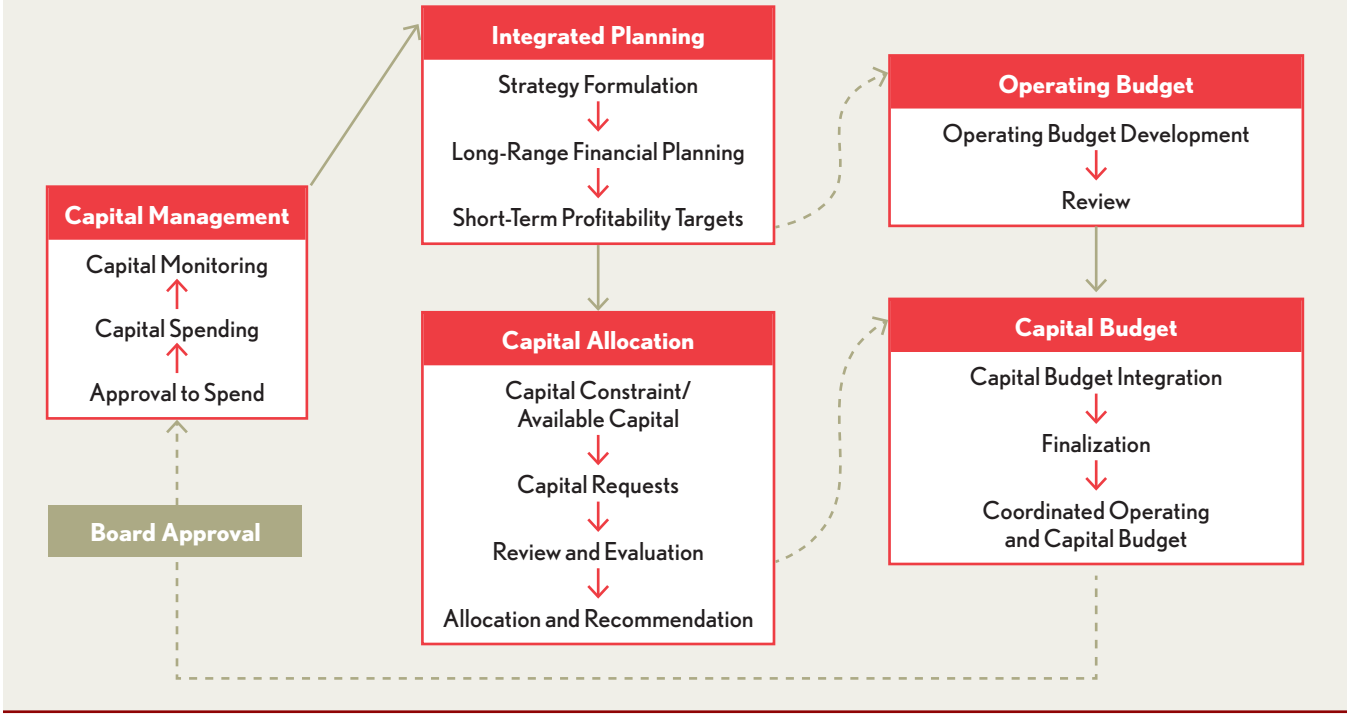
Although strategic investments in areas beyond traditional operations add risk, they can be vital to protecting and/or improving an organization's strategic and financial position. For example, many organizations are pursuing affiliations and partnerships to enhance access and extend their care continuum. These arrangements often require significant capital. Similarly, organizations must build their capital reserves and invest in actuarial expertise to pursue strategies such as capitation contracting, and health plan ownership or partnership.

Given such demands, the capital allocation process now must encompass a broader range of decisions. The following five strategies are key when designing capital allocation processes and procedures.

Redefine capital and its role in the planning process. A new definition of *capital* is required that captures the changing strategic direction of healthcare organizations and reflects a greater breadth of their strategic investments. This definition should include all types of proposed investments that will be subject to the policies, structure, and transparency of the capital allocation process. Investments that should be included in this new definition of *capital* include:

> Facilities, property, and equipment, including IT
> New operating entities/programs
> Business acquisitions and partnerships
> Network development

INTEGRATION OF CAPITAL PLANNING AND MANAGEMENT



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> Managed care investments
> Program start-up subsidies/expansion
> Physician integration
> System initiatives

These and other capital investments should be included in the capital allocation process regardless of the accounting treatment or potential source of financing. For example, equipment acquisitions using lease financing should be considered in an organization's capital allocation decision making, even though historically that has not been the practice.

Best-practice capital allocation and management processes define three capital allocation "pools." The *threshold capital pool* is a centrally managed pool of available dollars for which threshold capital requests compete. A threshold capital request is any proposed expenditure above a dollar amount specified by the organization. Such expenditures require comprehensive business planning analysis and centralized review, as described later. The *non-threshold capital pool* covers capital requests that are below the threshold dollar amount and can be handled on a decentralized basis. The *contingency pool* supports and/or supplements unfunded or unforeseen threshold capital needs.

Both capital allocation and capital management are essential parts of the comprehensive planning cycle. Having an integrated calendar improves decision making throughout the annual management cycle. The importance of integration is depicted in the exhibit above.

Establish clear objectives and principles to frame the allocation process. Objectives should be specific and measurable, and have an established time frame for execution and completion. In setting process-related objectives, key considerations for hospital and health system executives include ensuring that investment decisions are rational and consistent, assessing how the decisions will affect capital capacity and credit rating, and

Key Considerations in Establishing Capital Allocation Principles

- Definition of *capital capacity* and how it is generated
- Ownership and application of organizational capital capacity
- Portfolio-based evaluation of overall capital performance
- Incorporation of qualitative and quantitative data to reflect strategic goals
- Definition and grouping of capital project types based on their cost and relative impact
- Identification of centralized versus decentralized components of the decision-making process
- Identification of requirements for quantitative financial analysis for threshold capital projects
- Implementation of a single batch evaluation structure to support comparative decision making
- Separation of project investment and financing decisions
- Formal management of unspent dollars

establishing a formal review process that uses uniform criteria for evaluating all investment decisions.

Objectives should aim to guarantee that capital allocation decisions are aligned with long-range strategic, financial, and related operating plans, and that they are directly integrated with the hospital's annual budget and multi-year financial plan. Applying a portfolio approach is an effective way to ensure that broad allocation decisions contribute measurable financial and strategic value to the overall organization. Roles, responsibilities, and accountability should be clearly defined.

SOURCES AND USES OF CASH

Sources of Cash	Uses of Cash
Net income plus depreciation	Principal payments
New financing proceeds	External transfers
Existing bond-related construction funds	Carry-forward capital
Cash reserve spend-down	Contingency set-asides
Working capital release	Balance sheet cash reserve
Philanthropy (donor restricted)	Working capital funding

Note: The sum of cash minus uses of cash equals the capital constraint.
Source: Kaufman, Hall & Associates, LLC

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Similarly, organizations should establish solid principles that ensure the decision-making process is focused, consistent, and transparent, and that decisions are aligned with the organization's strategic goals. The sidebar at left outlines 10 key considerations for healthcare leaders in developing such principles.

Quantify available capital comprehensively. A best-practice capital allocation process clearly defines an organization's capital constraint, which is the net cash flow available for spending during a designated time period. To accurately assess a hospital's or health system's capital constraint, the finance leader must account for *all* of the organization's sources and uses of cash based on its multiyear financial plan, as shown in the exhibit below left.

Institute additional planning for high-dollar, multi-year projects. In developing the capital allocation process, a finance leader should remember that large projects often require several phases of planning, review, and approval, and structure the decision-making process accordingly. Although the early stages of large projects typically require limited allocations of capital, it may be necessary to designate "way points" for making allocation decisions before major capital commitments are needed.

Creating a separate preplanning contingency fund for these early efforts ensures that a proper evaluation can be performed to prioritize project concepts and funding. During the concept phase, healthcare leaders should determine a project's strategic fit for the organization, and broadly estimate the costs and how the project might impact facilities.

From there, an approved and broadly scoped project proposal can move into the preplanning phase. Numerous individuals and departments may contribute to planning during this phase, including outside architects or advisers and organizational finance, planning, and facilities staff. Key steps during this phase include performance of a feasibility analysis to detail and

Case Example: Avera Health

Avera Health is a regional health system based in Sioux Falls, S.D. The health system includes more than 300 locations in communities in eastern South Dakota and the surrounding states of Minnesota, Iowa, Nebraska, and North Dakota. A few years ago, Avera's leaders sought to establish a uniform capital allocation process and related methodology that would provide a system view of capital investment. Although each of Avera's six regions had solid capital allocation processes in place, the processes lacked consistency, and there was no established avenue for funding broad, system-based strategic initiatives. Each region essentially managed its own capital resources and needs.

"It was very decentralized," says Mike Olson, Avera's vice president of financial planning. "Each region used a good process, but each was disconnected from the overall system."

The goal of redesigning the process was to develop a structure and discipline that would allow for greater transparency and enable systemwide alignment of capital allocation decisions with Avera's broader strategic goals—thereby ensuring that capital would be invested where it was needed most. These factors were increasingly important as Avera expanded and acquired new hospitals, prompting questions about how to invest in new regions and in non-acute care, and how to focus on systemwide initiatives, among other concerns.

With the full and critical support of Avera's CEO, the CFO championed development of a systemwide capital allocation process. The first step was to evaluate Avera's current processes. Multiple opportunities to enhance efficiencies were identified. For example, making equipment purchase decisions for items such as computed tomography scanners or intravenous infusion pumps at the system level, as opposed to the individual region level, would allow Avera to better coordinate and achieve greater purchasing power.

Identifying the objectives of the capital allocation process early on and delineating the principles under which the process would operate were essential. System leaders defined the key objective as establishing a process that was highly integrated with system and regional strategies and operating budgets.

In terms of principles, executives determined that all cash flow generated within the system should be owned by the system, rather than individual regions. This approach would allow for sharing of capital among entities. For example, funds might be transferred for a physician alignment opportunity in a smaller region, even if that region's internally generated capital capacity could not support the total investment.

A multidisciplinary workgroup was formed, including members of Avera's executive team and leaders from each region in the system, among other key stakeholders. The workgroup assessed Avera's total available capital and determined how much might go to each of the regions versus how much should be dedicated to systemwide efforts.

As part of the initiative, Avera Health implemented new capital allocation and management software tools systemwide in 2013. Uniform software provided numerous benefits, such as a standardized set of analytics and data collection, and a common format for conducting evaluations and communicating results to the capital committee. It also allowed finance executives to standardize how different types of projects were categorized and classified across the system. The software's automated process for reviewing proposed projects ensured that similar information was provided for each proposed investment, and with a sufficient level of detail to enable informed decision making. The tools also enabled consistent use of objective financial and qualitative measures with which to evaluate projects.

With the initiative now in its third year, uniform processes have brought multiple benefits to Avera Health. Leaders throughout the system have clear visibility into where capital is being invested. That visibility facilitates better management and monitoring of approved investments, and drives initiatives that enhance individual regions and the system as a whole.

Strong support from senior administration and broad representation on the workgroup were critical to the initiative's success. "It was important to have key stakeholders intimately involved in developing the process," Olson says. "It wasn't forced on them; they had real buy-in to what the process was going to look and feel like."

Developing a process that is somewhat fluid also was critical to allow improvements to be made over time as the organization evolves. For example, Avera redesigned its rating scale for proposed projects in the second year, after its initial scale introduced too much variability. Under the current system, stakeholders rank projects on a simple three-point scale according to need.

"With the increasing scrutiny on margins in health care and the pressures that all providers face, we are very fortunate that we have a capital allocation process in place to help Avera Health address the changing dynamics of the healthcare industry," Olson says.

more clearly define the capital required and facilities impacts, and completion of a business plan.

Require complete business planning analysis of high-dollar projects. With an effective capital allocation process, the dollar amount of the proposed investment should trigger the appropriate level of analysis and review. Again, as part of the process, leaders must set a threshold dollar amount for projects, with the requirement that any proposed expenditure above that threshold undergo more rigorous evaluation, including comprehensive business planning, analysis, and centralized review.

Consistently applying standard analytic procedures based on tried-and-true corporate finance techniques is a key to successful capital evaluation and allocation. Analytic requirements should be universal and understood throughout the organization.

Structured analysis of both qualitative and quantitative measures enables leaders to thoroughly assess capital priorities. Qualitative measures are changing as the definition and uses of capital expand. Currently, such measures may include a proposed project's relationship to mission, safety and quality of care, physician alignment, and workforce development. Evaluating these criteria is increasingly important in identifying an effective portfolio of investments to meet new-era demands.

A Structured, Portfolio-Based Approach

As hospital and health system leaders shape their capital allocation processes, it is important that they take a portfolio approach. Leaders should develop a comprehensive catalog of capital allocation needs, so that each can be considered relative to other priorities. A structured process for review and comparison is best practice, and is especially important in times of uncertainty, because it highlights inconsistencies, quantifies changes in portfolio value on a real-time basis, and provides a means to address continuing and developing needs.

The capital allocation process should evolve over time to meet changing requirements. Ultimately, the capital allocation discussion should focus on the trade-offs among mission, strategy, and financial return for the entire portfolio. This process will be effective only if all proposals are evaluated on an apples-to-apples basis, and the ultimate portfolio of projects selected has a positive expected net present value, creating sufficient financial returns to support the organization's mission in its community going forward.

One final point bears emphasis: Capital decision making should be transparent, enabling management to reinforce support for all aspects of organizational strategy as reflected in the selected portfolio of capital investments. ■

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