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Thomas M. Schuhmann

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Medicare margins trending downward

A recent study of hospital margins indicates Medicare margins for services paid under the Inpatient Prospective Payment System (IPPS) are declining precipitously. The study found that Medicare inpatient margins have dropped from 12.8 percent to −4.6 percent over the past eight years, while total operating margins and total net income percentages have remained relatively stable.

AT A GLANCE

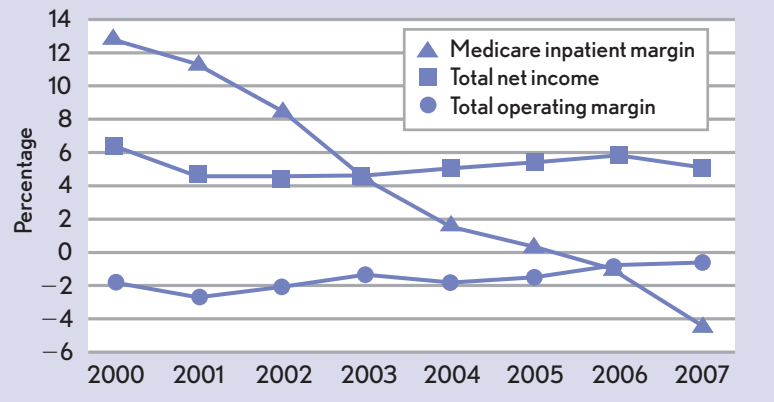
> Data indicate U.S. short-term acute care hospitals' Medicare inpatient margins have declined from 12.8 percent to −4.6 percent over the past eight years.
> During the same period, these hospitals' total operating margins have remained negative.
> Only net income percentages for the nation's short-term acute care hospitals have remained positive during this time.

Overall Margin Pressures

The study broadly examined three types of hospital margins (see the sidebar on page 32):

> Medicare inpatient margin percentages
> Total operating margin percentages
> Total net income percentages

TREND IN HOSPITAL MARGINS FOR IPPS HOSPITALS



The findings disclosed that both total operating margin percentages and total net income percentages—both indicators of the overall financial health of a hospital—have remained relatively stable over the past eight years, while Medicare inpatient margins have steadily declined. Despite the relative stability in overall margins, however, the Medicare inpatient margins have markedly declined.

Total operating margins have remained negative from federal fiscal year (FFY) 2000 to midway through FFY07, according to the data, although the trend has improved slightly in recent years. That means hospitals are losing money on their core business of providing patient care. The net income percentages, however, have remained positive for all periods indicating that hospitals are reinforcing the margins for direct patient care through other activities. It is troublesome to think that hospitals must focus on other business activities to sustain their core competencies.

Meanwhile, the decline in Medicare inpatient margins versus relatively stable total margins indicates that payers other than Medicare are subsidizing more of the

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costs of treating Medicare beneficiaries. Cost shifting has become a necessity as Medicare payment policies increasingly create financial pressures. If the trend continues, Medicare's payments to hospitals may become inadequate to ensure beneficiary access to high-quality inpatient care.

The Medicare Payment Advisory Commission (MedPAC) reported in March 2007 that overall Medicare margins have declined dramatically from FFY97 to FFY05 and are expected to continue to decline into 2007. This study confirms MedPAC's finding and verifies the continuing decline.

Medicare Margin Pressures

Medicare IPPS margins for urban hospitals have declined more than those for rural hospitals, the study findings show, but both reached comparable negative margins by FFY06. Healthier Medicare IPPS margins vanished in the five years from FFY00 to FFY05.

Also, the number of hospitals with negative margins more than doubled during the study period, from 27.4 percent in FFY00 to 66.0 percent in FFY07. Although more than 72 percent of hospitals had positive margins in FFY00, only 34 percent had positive margins in the first half of FFY07.

According to an earlier MedPAC analysis published in August 2003, one-fourth of the variation in hospitals' Medicare inpatient margins is associated with factors included in the IPPS. Most of this explained variation is attributable to three policy adjustments:

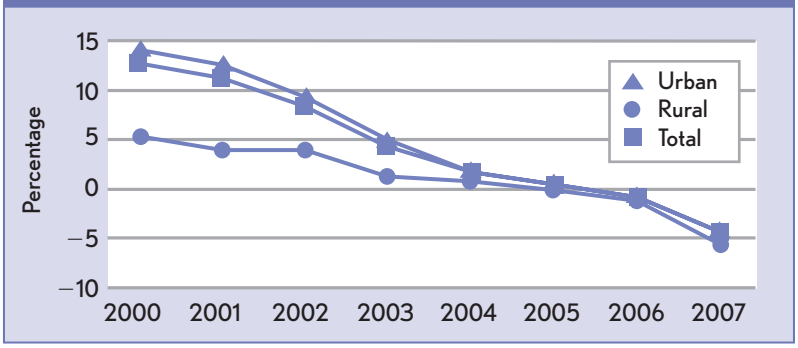
> Payments for indirect medical education (IME) costs
> Payments for treating a disproportionate share of low-income patients
> Additional payments for certain rural hospitals

As subsequent statistics demonstrate, these same factors cause variability among types of hospitals and continue to drive declines in Medicare IPPS margins.

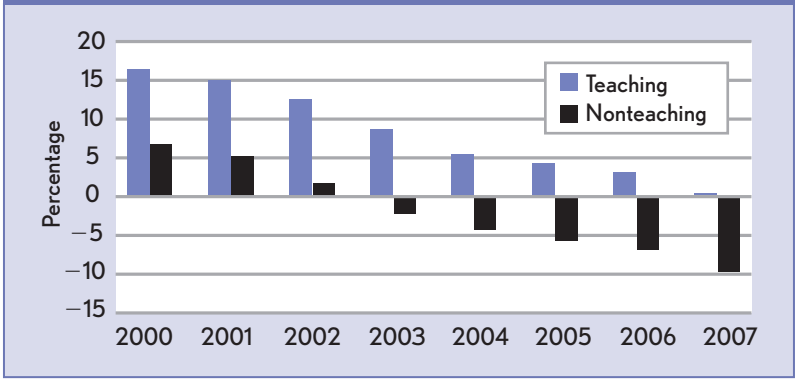
The study results disclosed that teaching hospitals (those receiving IME payments) fared much better than those that did not. Margins for teaching hospitals have remained positive for all periods, while nonteaching hospitals are approaching double digit negative margins. Since IME adjustments were intended to compensate teaching hospitals for higher costs, it appears that these adjustments may have been made to the detriment of nonteaching hospitals.

A similar pattern was noted for hospitals that receive disproportionate share (DSH) payments versus those

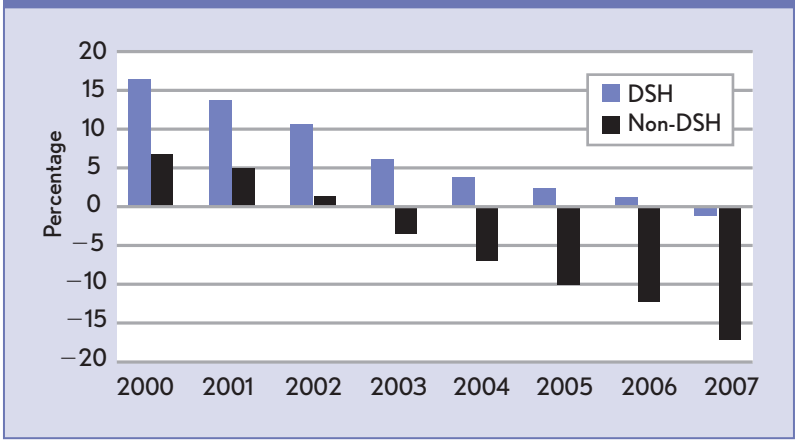
TREND IN MEDICARE IPPS MARGINS FOR URBAN VERSUS RURAL HOSPITALS



TREND IN MEDICARE IPPS MARGINS FOR TEACHING VERSUS NONTEACHING HOSPITALS



TREND IN MEDICARE IPPS MARGINS FOR DISPROPORTIONATE SHARE (DSH) HOSPITALS VERSUS NON-DSH HOSPITALS



that do not. Margins for DSH hospitals have remained positive for all periods except 2007, while non-DSH margins have dropped from 6.31 percent positive in FFY00 to 17.14 percent negative by FFY07. Although DSH add-on payments were intended to compensate hospitals for the perceived higher costs of treating low-income patients, the DSH payment policy appears to have enabled DSH hospitals to maintain much higher margins than non-DSH hospitals.

There has been a clear erosion of Medicare margins for all types of hospitals over recent years, resulting in negative margins for 66 percent of all IPPS hospitals so far in 2007. The curious effects of Medicare policy and the relentless decline in IPPS margins mean that hospitals are being further pressured to reduce costs in a climate of continuing efforts by CMS to control payment increases. Though these dramatic declines cannot continue forever, it is unclear where they will stop. The industry can only hope that they will not continue until there are hospital failures or compromises in the levels of quality and service afforded.

What Can Hospitals Do?

Hospitals should make certain that their elected representatives understand the serious problems being experienced due to recent Medicare program policies. Studies and press releases based on total net income give the public impression that hospitals are actually profiting from Medicare when, in fact, the majority of hospitals are losing money.

Affected hospitals should share their own experience with legislators at both local and national levels. Where possible, information should be presented for the entire legislative area and other hospitals should be encouraged to help in communicating their concerns. Legislators should be aware that Medicare cuts are forcing hospitals to increasingly shift their costs for treating Medicare beneficiaries to other payers and to supplement their revenue with income from sources other than direct patient care.

Hospitals should also continue to find ways to improve efficiency in order to reduce costs. Given the continuing declines in Medicare margins, however, it will become increasingly difficult to sustain operations as the numbers of Medicare patients increase over the next decade. ■

Thomas M. Schuhmann, JD, CPA, is senior vice president, finance, Cost Report Data Resources, LLC, Louisville, Ky. (tschuhmann@costreportdata.com).

ABOUT THE STUDY

The study of Medicare margins was conducted by Cost Report Data Resources, and was based on available cost report data for short-term acute care hospitals paid under the IPPS. Hospital cost reporting periods ending in federal fiscal years (FFYs) 2000 through 2007 were analyzed even though only about half of the reports for 2007 were available. It was believed, however, that preliminary data for FFY07 would be important to determine whether trends were continuing into the most current year. Critical access, rehabilitation, long-term, and other IPPS-exempt hospitals were not included.

Various types of hospital margins are used to examine relationships among Medicare inpatient and total margins for hospitals. Margins indicate the difference between revenue and costs, expressed as a percentage of revenue. For purposes of this study, the following margins were examined.[a]

Medicare inpatient margin percentage. IPPS revenue was determined from Worksheet E, Part A, Line 8 (total payment for inpatient operating costs) + Line 9 (payment for inpatient program capital) + Line 10 (exception payment for inpatient program capital). IPPS total program inpatient costs (operating and capital) were from Worksheet D-1, Part II, Line 49.

Total operating margin percentage. The total operating margin percentage includes only a hospital's total revenues and costs related to direct patient care. Revenues include all payer sources (e.g., Medicare, Medicaid, other government, and private payers). Total patient care revenues and total operating expenses were determined from Worksheet G-3, Lines 3 and 4, respectively.

Total net income percentage. The total net income percentage includes a hospital's total revenues and costs for all activities from all sources. For example, revenues include other income such as contributions, income from investments, and rental income. Total net income was determined from Worksheet G-3, Line 31, and was expressed as a percentage of the total patient care revenues used in the computation of the total operating margin percentage above.

Not surprisingly, total net income percentages are higher than total operating margin percentages.

a. All margins were computed from Medicare cost report data obtained from the Centers for Medicare and Medicaid Services (CMS). The Healthcare Cost Report Information System (HCRIS) dataset contains the most recent version (i.e., as submitted, settled, reopened) of each cost report filed with CMS since federal fiscal year (FFY) 1996. The most recent HCRIS dataset available at the time of this study was for the cutoff at June 30, 2007. Margin computations were assigned to each FFY based on the cost report end date. This study looked at more than 24,000 Medicare IPPS cost reports from FFY00 to FFY07.

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