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FEATURE STORY

Thomas M. Schuhmann

can net income from non-patient-care activities continue to save hospitals?

The times when hospitals could rely on non-patient-care activities to offset losses on patient care may be over. Healthcare reform and economic conditions may soon force hospitals to look for ways to deliver high-quality care profitably, despite constrained reimbursement.

From 2005 through 2009, U.S. hospitals lost billions of dollars on their activities directly related to caring for patients—even though that is their core activity. It was only through their significant non-patient-care activities that these organizations were able to able to maintain positive net income. U.S. hospital performance during the recent economic downturn of 2008-09, however, suggests that the ability to rely on these non-patient-care activities to help offset losses on direct patient care may be a thing of the past for the nation's hospitals. And the passage of healthcare reform legislation in March only adds to the uncertainty, as changes in payment resulting from reform could exacerbate the challenges hospitals face in finding ways to deliver patient care profitably.

The downward trend in income from non-patient-care activities was noted in a study that looked at Medicare cost report data to examine U.S. hospital financial performance leading into the economic downturn. Looking at 2,838 U.S. hospitals, the study analyzed the contribution to net income from patient care versus that from non-patient-care activities on a same-store basis during federal fiscal years (FFYs) 2005 through 2009 (see About the Study on page III).

To support their losses from patient care, U.S. hospitals have relied upon a wide variety of non-patient-care activities. Some are specified in the Medicare cost report, such as charging nonpatients for convenience items and services (e.g., parking, laundry, meals, vending machines, gift shops, etc.) and charging for items and services that help to defray certain expenses (e.g., rental space, medical and surgical supplies, and drugs). Many hospitals also receive government appropriations, and most hospitals solicit contributions and donations and maintain endowments and investments that produce investment income. Hospitals also engage in a host of "other"

AT A GLANCE

- A recent study found that U.S. hospitals are losing billions of dollars per year caring for patients.
- Hospitals have been able to offset patient care losses with substantial net income from sources not directly connected to patient care.
- However, this net income declined sharply with the economic downturn in 2008 and 2009, resulting in a decline in overall hospital profitability and putting a cloud of uncertainty over future hospital profitability.

For an additional analysis of variations between hospitals with positive versus negative net income from patient care services, go to www.hfma.org/hfm.

activities not specified in the cost report. The study analyzed the trends in these general categories.

Overall Financial Performance

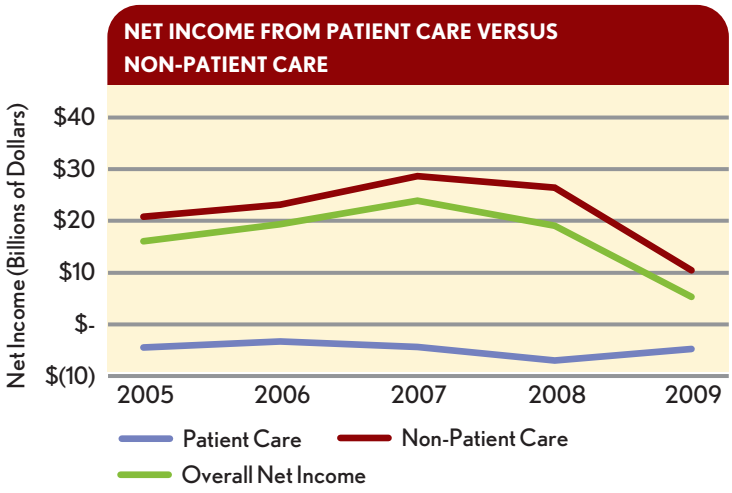
Despite being in business primarily to care for patients, hospitals have been losing billions of dollars every year doing so. In the three consecutive years prior to the economic downturn (2005-07), hospitals lost $4.817 billion, $3.728 billion, and $4.773 billion. Then, as the economy began to struggle, so did hospitals. In 2008 hospital losses from patient care reached a high of $7.406 billion. Patient care losses moderated somewhat in 2009, but were still high at $5.144 billion.

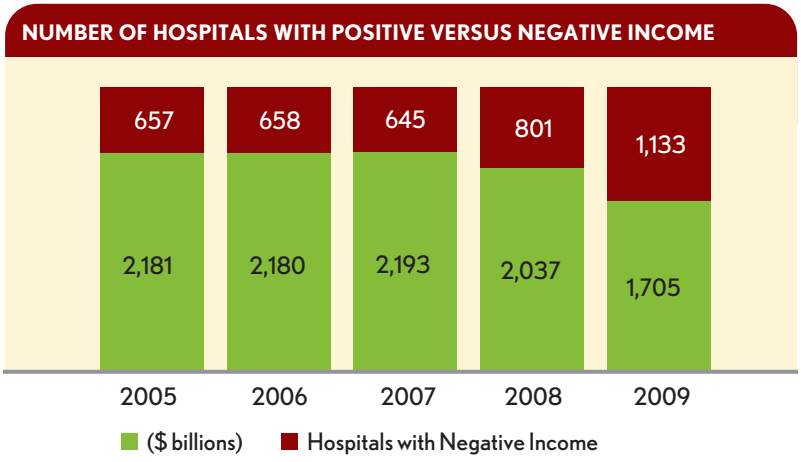
Fortunately, during this period, hospitals were able to maintain many activities in addition to patient care to effectively offset patient care losses. Net income from these non-patient-care activities rose steadily in the years leading up to the economic downturn. However, net income from such activities began to decline in 2008 and dropped off sharply in 2009.

In 2005, hospital net income from non-patient-care activities was $20.471 billion, resulting in overall net income of $15.654 billion for that year. By 2007, net income from non-patient-care activities peaked at $28.315 billion, resulting in an overall net income of $23.542 billion—highest in the study. But as the economy weakened in 2008 and 2009, net income from such activities declined to $26.074 billion in 2008 and sharply declined to $10.095 billion in 2009. The result was a decline in overall net income to $18.669 billion in 2008 and a sharp decline to $4.951 billion in 2009.

These trends in declining overall financial performance were also noted by the Medicare Payment Assessment Commission (MedPAC) in its March 1, 2010, report to Congress, which was based in part on the same data from hospital cost reports as was used for this study. The MedPAC report noted that total all-payer margins for many hospitals fell to their lowest level in more than a decade in 2008 and that many hospitals had significant losses on their investment portfolios and therefore experienced low overall profitability in 2008. It is noteworthy that MedPAC report did not include data from 2009 cost reports, probably because these data were not available to MedPAC in time for its report, so the commission's report did not take into account the sharp decline in the overall financial performance of the hospitals that occurred in 2009.

The decline in net income from non-patient-care activities in 2008 and 2009 resulted in an increase in the number of hospitals with overall net losses, referred to here as "negative income." Prior to 2008, the number of hospitals with negative income was relatively stable at 657 in 2005, 658 in 2006, and 645 in 2007. But the number of hospitals with negative income rose to 801 in





2008 and jumped to 1,133 in 2009. Because the hospitals were studied on a same-store basis, the increase in hospitals with negative income resulted in a corresponding decline in the number of hospitals with positive net income.

This observation is disturbing. To understand it more fully, the study examined the impact of patient care services versus non-patient-care activities on overall hospital financial performance during the study period.

About the Study

The study of hospital revenue sources cited in this article was conducted by Cost Report Data Resources, LLC, using available Medicare cost report data for all hospital cost reporting periods ending in federal fiscal years (FFYs) 2005 through 2009. Medicare cost report data were obtained from the Centers for Medicare & 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 FFY96. The most recent HCRIS dataset available at the time of this study was for the cutoff at Dec. 31, 2009. Data were assigned to each FFY based on the cost report end date.

Medicare cost report data are a useful source of financial information for hospitals. Hospitals that participate in Medicare are required by law to submit an annual report and to attest that it is "a true, correct and complete statement prepared from the books and records." The cost report also provides a consistent format for reporting among hospitals and over time. Any misrepresentation or falsification of cost report information carries severe penalties and would be considered fraud. This study nevertheless applied tests to the reasonability and consistency of hospital information to adjust for any incidences of errors or omissions.

To assess the impact of the recent economic downturn on hospital financial performance, the study focused on trends over the most recent five-year period. Many hospitals have not yet filed their FFY09 cost report. Therefore, the study selected cost reports from FFY05 to FFY09 on a "same-store" basis. That is, hospitals were selected only if a complete 12-month cost report was available for all FFYs studied. Only cost reports that included data from worksheet G-3 (e.g., total patient gross revenue, contractual allowances and discounts and write-offs, net income from service to patients, total operating expenses, income from non-patient-care activities) were included. For the study, 14,190 Medicare cost reports filed by 2,838 hospitals were analyzed on a same-store basis from FFY05 to FFY09.

Net Losses from Patient Care Services

Medicare regulations require hospitals to report revenues and expenses and net income from all of their activities on worksheet G-3. The worksheet contains a section for hospitals to report net income from patient care activities, including gross revenues, write-offs, net revenue, and operating expenses.

The study found that hospitals were consistently able to increase gross revenue from patient care services by about 9 percent per year during the study period. Gross revenue from patient care rose from $817.789 billion in 2005 to $1,169.972 billion in 2009.

However, hospitals were forced to write off much of their gross revenue to contractual allowances, charity care, and bad debts. In 2005, hospitals wrote off about 62 percent of their gross revenues. By 2009, the write-off percentage increased to more than 65 percent. The resulting net revenues did not cover the costs of providing care, which rose about 7 percent per year during the study period, from $316.979 billion in 2005 to $411.660 billion in 2009. The resulting net losses each year from patient care services continued during the entire study period and, more important, began to increase rapidly each year as hospitals were forced to write off more of their gross revenue because of increases in contractual allowances, charity care, and bad debts.

This trend can be expected to continue as Medicare, Medicaid, and other payers continue to ratchet down annual payment increases to hospitals; as the economy reduces patients' ability or willingness to pay their deductibles and coinsurance; and as unemployment reduces the number of people covered by health insurance. The new healthcare reform legislation may eventually relieve some of the pressure on hospitals as more people are able to obtain health insurance coverage under the reform plan, but it is not yet clear how long it will take to significantly impact hospitals and how changes in reimbursement will impact operations. In the meantime, a volatile situation may be developing in which hospitals

NET INCOME FROM PATIENT CARE SERVICES FOR THE 2,838 HOSPITALS STUDIED, FFY05-FFY09 ($ BILLIONS)

	2005	2006	2007	2008	2009
Gross Patient Revenue	$817.789	$897.263	$981.565	$1,071.222	$1,169.972
Write-Offs	$505.628	$562.553	$623.847	$691.841	$763.457
Operating Expenses	$316.979	$338.439	$362.491	$386.787	$411.660
Net Income	**($4.817)**	**($3.728)**	**($4.773)**	**($7.406)**	**($5.144)**

NET INCOME FROM NON-PATIENT CARE SOURCES FOR THE 2,838 HOSPITALS STUDIED, FFY05-FFY09 ($ BILLIONS)

	2005	2006	2007	2008	2009
Specified Activities	$2.897	$3.031	$3.177	$3.337	$3.422
Government Appropriations	$3.367	$3.581	$3.486	$4.032	$4.297
Contributions & Donations	$0.923	$0.862	$0.928	$0.978	$0.930
Investment Income	$2.730	$3.422	$5.496	$4.276	($1.474)
Other Unspecified Activities	$10.555	$11.816	$15.228	$13.451	$2.920
Totals	**$20.471**	**$22.712**	**$28.315**	**$26.074**	**$10.095**

will be struggling to find additional sources of income to offset these losses just when the sources they had previously relied upon for this purpose appear to be disappearing.

Net Income from Non-Patient-Care Activities

In addition to reporting net income from patient care activities, Medicare regulations require hospitals to report other income and expenses not related to patient care on worksheet G-3 of the cost report. Worksheet G-3 was designed in the early years of Medicare for hospitals to report other income and expense items that would facilitate the cost-finding functions elsewhere in the cost report. For example, Medicare requires that certain of the non-patient-care revenues must be offset against certain patient care expenses to determine Medicare allowable costs in the cost report. Most of the lines on worksheet G-3 are used to identify or "specify" the types of other revenues commonly used for cost-finding purposes in the cost report.

Worksheet G-3 has never been significantly changed or updated since it was originally designed in the early years of cost reporting. It has not kept up with the ever expanding and changing activities that hospitals have used to produce net income from non-patient-care activities. There are very few lines for hospitals to report all other types of such activities not specified on the worksheet. As a result, hospitals are forced to lump much of their non-patient-care activities in "unspecified" other categories.

What is clear is that hospitals engage in significant amount of non-patient-care activities. The first three categories (specified activities, government appropriations, and contributions and donations) remained relatively stable during the study period and even increased going into the economic downturn in 2008 and 2009. The other two categories (investment income and other unspecified activities), which are the largest, have fallen off sharply in 2008 and 2009.

Specified non-patient-care activities. As previously stated, these activities are specified on the cost report and include things like parking lot receipts; revenue from laundry and linen service; revenue from meals served to employees and guests, sale of medical supplies, surgical supplies,

and drugs to other than patients; revenue from gift shops and vending machines; and rental of living quarters and other hospital space.

Hospitals were able to maintain stable net income from these activities throughout the study period, and even increased net income slightly in 2008 and 2009 in spite of the economic downturn. It is interesting to note that the 1,608 not-for-profit (voluntary) hospitals included in the study represent only 57 percent of the hospitals studied, yet accounted for more than 80 percent of the net income from specified activities during the study period. The 561 government and 669 for-profit (proprietary) hospitals studied do not appear to rely on net income from these activities as heavily as voluntary hospitals.

Government appropriations. As expected, government hospitals received most of the government appropriations during the study period. Appropriations to these hospitals were relatively stable before the economic downturn but increased significantly to $3.400 billion in 2008 and $3.667 billion in 2009. It may be that increases in government appropriations were requested and approved in direct response to the needs of those hospitals during the failing economy.

Proprietary and voluntary hospitals do not rely as heavily on government appropriations, but voluntary hospitals do receive a fair amount. Appropriations to voluntary hospitals remained stable during the study period at around $600 million per year.

Contributions & donations. As expected, the voluntary not-for-profit hospitals received most of the contributions and donations during the study period. Contributions to government and proprietary hospitals, though relatively insignificant, did not drop off in 2008 and 2009 with the economic downturn. Contributions to voluntary hospitals actually increased slightly in 2008 to $775 million, but fell back about 14 percent in 2009 to $668 million, perhaps due to the economy.

It is interesting to note that income from contributions and donations was a relatively minor part of the total net income from non-patient-care activities carried on by the hospitals studied.

Investment income. The economic and investment crisis in 2008 and 2009 had a profound impact on the investment income of the hospitals studied. What little income government and proprietary hospitals were able to achieve during

NET INCOME FROM SPECIFIED NON-PATIENT-CARE ACTIVITIES FOR THE 2,838 HOSPITALS STUDIED, FFY05-FFY09 ($ BILLIONS)

Type of Control (No.)	2005	2006	2007	2008	2009
Government (561)	$0.356	$0.388	$0.442	$0.395	$0.405
Proprietary (669)	$0.183	$0.169	$0.172	$0.171	$0.161
Voluntary (1,608)	$2.357	$2.474	$2.563	$2.771	$2.856
Totals (2,838)	**$2.897**	**$3.031**	**$3.177**	**$3.337**	**$3.422**

NET INCOME FROM GOVERNMENT APPROPRIATIONS FOR THE 2,838 HOSPITALS STUDIED, FFY05-FFY09 ($ BILLIONS)

Type of Control (No.)	2005	2006	2007	2008	2009
Government (561)	$2.769	$2.917	$2.901	$3.400	$3.667
Proprietary (669)	$0.001	$0.058	$0.003	$0.003	$0.003
Voluntary (1,608)	$0.597	$0.606	$0.583	$0.629	$0.627
Totals (2,838)	**$3.367**	**$3.581**	**$3.486**	**$4.032**	**$4.297**

Knowledge of industry financial performance is vital for hospitals to understand changes to payment policies made by Medicare and other payers.

the study period was all but wiped out in 2009. But voluntary hospitals experienced an even more profound loss on investments in 2009.

Net income from investments for voluntary hospitals rose steadily from $2.261 billion in 2005, to $2.820 billion in 2006, then to a high of $4.492 billion in 2007. But with the economic downturn, net income from investments for voluntary hospitals dropped to $3.355 billion in 2008 and plummeted to a loss on investments of $1.486 billion in 2009.

The steep decline in net income from investments and the losses were probably the result of hospitals having to write-down the value of their underlying investment assets as the stock and bond markets dropped during the economic downturn. This is a profound and worrisome trend.

Other unspecified activities. It is important to note that due to the limitations of worksheet G-3 discussed above, hospitals reported more than 50 percent of their non-patient-care revenues and expenses in "other" unspecified categories. Although it is not possible to know exactly what these activities were from the data, they are important to observe as a barometer of what hospitals have experienced before and during the current economic downturn.

The cost report does include a distinction between "other income" and "other expense."

Net income from these activities remained relatively stable for government hospitals during the study period. Other income reached its high of $5.016 billion in 2007, dropped to $4.585 billion in 2008, but bounced back to $5.166 billion in 2009. Although other expenses increased every year during the study period, the increases were not enough to seriously erode the net income government hospitals produced from these activities.

NET INCOME FROM CONTRIBUTIONS AND DONATIONS FOR THE 2,838 HOSPITALS STUDIED, FFY05-FFY09 ($ BILLIONS)

Type of Control (No.)	2005	2006	2007	2008	2009
Government (561)	$0.241	$0.171	$0.183	$0.192	$0.211
Proprietary (669)	$0.014	$0.006	$0.010	$0.011	$0.050
Voluntary (1,608)	$0.668	$0.685	$0.735	$0.775	$0.668
Totals (2,838)	**$0.923**	**$0.862**	**$0.928**	**$0.978**	**$0.930**

NET INCOME FROM INVESTMENTS FOR THE 2,838 HOSPITALS STUDIED, FFY05-FFY09 ($ BILLIONS)

Type of Control (No.)	2005	2006	2007	2008	2009
Government (561)	$0.425	$0.535	$0.913	$0.839	$0.005
Proprietary (669)	$0.044	$0.068	$0.090	$0.083	$0.007
Voluntary (1,608)	$2.261	$2.820	$4.492	$3.355	($1.486)
Totals (2,838)	**$2.730**	**$3.422**	**$5.496**	**$4.276**	**($1.474)**

NET INCOME FROM OTHER UNSPECIFIED NON-PATIENT-CARE ACTIVITIES FOR THE 2,838 HOSPITALS STUDIED, FFY05-FFY09 ($ BILLIONS)

Type of Control (No.)	2005	2006	2007	2008	2009
Government (561)					
Other Income	$3.194	$3.546	$5.016	$4.585	$5.166
Other Expense	$0.877	$0.937	$1.216	$1.318	$1.835
Net Other Income (Loss)	$2.317	$2.609	$3.801	$3.266	$3.331
Proprietary (669)					
Other Income	$0.629	$0.649	$0.729	$0.681	$0.750
Other Expense	$0.725	$0.643	$0.919	$0.940	$1.070
Net Other Income (Loss)	($0.097)	$0.007	($0.191)	($0.259)	($0.320)
Voluntary (1,608)					
Other Income	$10.625	$12.844	$14.705	$14.467	$11.877
Other Expense	$2.290	$3.642	$3.087	$4.023	$11.968
Net Other Income (Loss)	$8.335	$9.201	$11.618	$10.444	($0.091)
Total All Hospitals (2,838)					
Other Income	**$14.448**	**$17.039**	**$20.450**	**$19.733**	**$17.793**
Other Expense	**$3.893**	**$5.223**	**$5.222**	**$6.282**	**$14.873**
Net Other Income (Loss)	**$10.555**	**$11.816**	**$15.228**	**$13.451**	**$2.920**

The unspecified activities of proprietary hospitals during the study period were not significant and resulted in net losses to the hospitals in all but one of the years studied. The losses increased in 2008 and 2009 mainly due to increases in other expenses of these activities.

The trends for the voluntary hospitals are surprising. Other income from these activities was strong, rising from $10.625 billion in 2005 to $14.467 billion in 2008, only slightly down from the high of $14.705 billion in 2007. But in 2009, other income for voluntary hospitals fell to $11.877 billion, down 18 percent from the previous year.

Even more startling, other expense for voluntary hospitals rose from $2.290 billion in 2005 to $4.023 billion in 2008, but skyrocketed to $11.968 billion in 2009. This resulted in a net loss of $0.091 billion from these activities in 2009 for voluntary hospitals. The unusual increase in other expenses had to be difficult for these hospitals. The double-digit billion dollar net income from these activities in 2007 and 2008 was wiped out in a single year.

This phenomenon does not appear to be restricted to just a few voluntary hospitals. The study looked at the increase in other expenses from other unspecified non-patient-care activities for all voluntary hospitals.

All but one region of the country experienced an upturn in these expenses in 2009. The change in four of the regions was remarkable:

- The East North Central region (Illinois, Indiana, Michigan, Ohio, and Wisconsin) increased from $0.743 billion in 2008 to $2.676 billion in 2009.
- The Middle Atlantic region (New Jersey, New York, and Pennsylvania) increased from $0.113 billion in 2008 to $2.771 billion in 2009.
- The Pacific region (Alaska, California, Hawaii, Oregon, and Washington) increased from $0.375 billion in 2008 to $1.338 billion in 2009.
- The West North Central region (Iowa, Kansas, Minnesota, Missouri, North Dakota, Nebraska,

OTHER EXPENSES FROM OTHER UNSPECIFIED NON-PATIENT-CARE ACTIVITIES FOR THE 1,608 VOLUNTARY HOSPITALS STUDIED, FFY05-FFY09 ($ BILLIONS)

Geographical Regions	2005	2006	2007	2008	2009
East North Central	$0.559	$0.772	$0.536	$0.743	$2.676
East South Central	$0.113	$0.166	$0.024	$0.079	$0.225
Middle Atlantic	$0.096	$0.312	$0.186	$0.113	$2.771
Mountain	$0.256	$0.232	$0.190	$0.240	$0.420
New England	$0.018	$0.009	$0.022	$0.027	$0.079
Pacific	$0.242	$0.323	$0.232	$0.375	$1.338
South Atlantic	$0.444	$0.353	$0.472	$0.580	$1.185
West North Central	$0.324	$1.101	$1.197	$1.554	$2.796
West South Central	$0.238	$0.376	$0.226	$0.312	$0.479
Totals	**$2.290**	**$3.642**	**$3.087**	**$4.023**	**$11.968**

and South Dakota) increased from $1.554 billion in 2008 to $2.796 billion in 2009.

Although the cost reports do not disclose exactly what these expense increases in 2009 were related to, the magnitude and timing of the expenses suggests that they could very well be related to the unfavorable economic conditions experienced by hospitals in 2009. Perhaps these hospitals were forced to record unusual impairment charges relating to the decline in value of noninvestment assets and operations due to the economic downturn. In any event, if these expense increases continue into 2010, voluntary hospitals could be facing crisis conditions.

What's Next?

Although the study findings do not conclusively establish that the trends observed were caused by the 2008-09 economic downturn, these trends were most certainly concurrent with the downturn. And although common sense would suggest a clear correlation, it is helpful to see the impacts across U.S. hospitals as evidenced in financial reporting. A hospital might know its own financial situation, for instance, but it is quite another thing for the hospital to know how the industry as a whole has performed during the economic downturn. The financial reporting provides a clear and valuable record of that performance.

Individual hospitals should also be aware that MedPAC and other payers rely in part on the financial information in Medicare cost reports to recommend payment policies. Therefore, knowledge of industry financial performance is vital for hospitals to understand changes to payment policies made by Medicare and other payers.

Hospitals know that they cannot sustain patient care losses indefinitely without the ability to subsidize those losses with net income from non-patient-care activities, and this ability was severely reduced for many hospitals during the economic downturn. If net income from non-patient-care activities continues to decline, it seems clear that hospitals will be forced to find other solutions by focusing back on their core business purpose: providing patient care. And that is why MedPAC recommends constraining annual payment increases and why other payers are of a like mind: to force hospitals to keep costs down while continuing to deliver high-quality care. The extent to which hospitals can do so is still uncertain.

Hospitals should double their efforts to avoid waste and improve efficiencies in the way care is delivered in their facilities. Although this undertaking is challenging, many hospitals have found unexpected economies. Hospitals have had incentives to control costs since the introduction of prospective payment, but the time for many

Hospitals are facing a "new normal" that requires a reexamination of the way things were done in the past and a commitment to sustain quality and efficiency despite declining revenues.

has come to formalize their efforts to make substantive improvements. The organization's survival may depend on such efforts in the face of the economic environment and the pressures of health reform.

Studies show that the average cost for treating a particular condition can vary dramatically among hospitals and that average costs may be twice as high in some hospitals. This variability indicates that some have found ways to operate more efficiently than their peers. The variability indicates that there are widespread opportunities for improvement, and it is unwise to ignore them.

At the same time, hospitals that have experienced unusual fluctuations in other non-patient-care income and expenses should assess the likelihood of such fluctuations continuing into 2010 and beyond and ascertain the potential impact of those fluctuations on overall profitability. These hospitals should also assess the degree to which such activities can be sustained or improved.

The stark reality is that conditions will probably never return to the way they were. Hospitals are facing a "new normal" that requires a reexamination of the way things were done in the past and a commitment to sustain quality and efficiency despite declining revenues. Payment levels from both public and private sources will be held as low as possible going forward and quality measures will continue to be introduced by payers to ensure that hospitals find efficiencies without compromising the quality of care.

Hospitals also need to do a better job getting the word out to their local communities and to their elected state and federal representatives that they are already losing money from direct patient care and that net income from other sources is declining. As cuts are made to Medicare, Medicaid, and other payments as a result of the recent healthcare reform legislation, it will become even more imperative for hospitals to get the word out quickly as to how they will be affected. Otherwise, the public will never be completely informed as to the total impact of healthcare reform on our nation's hospitals. ●

About the author

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

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