

*KaufmanHall*

2017 State of  
Cost Transformation  
in U.S. Hospitals:

**An Urgent Call to Accelerate Action**



## Introduction

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### An Industry Under Pressure—Incremental Changes Not Producing Transformational Results

The consensus is clear: U.S. healthcare costs are unsustainable, and national health outcomes—lower than those in developed countries that spend much less—must be improved. Consumers, employers, the government, and other stakeholders are spurring the industry to meet the challenge of making healthcare more affordable, while improving its quality and access.

This is not business as usual, involving incremental change. Financial realities—lower revenue and nonstop expense, consumer, regulatory, and competitive pressures—demand a new way of providing care. To meet community needs under healthcare’s new business imperatives, and to participate as a “provider of choice” in narrow networks developing nationwide, organizations must have a strong value proposition and a cost position that is significantly lower than competitors.

For most hospitals and health systems, achieving such a position will be a transformational undertaking, requiring extensive effort to dramatically lower costs by 25% to 30% over a five-year period. That effort must start now, not a yet-to-be-determined future date.

The pursuit of lower costs is not a new priority for most healthcare organizations, as the value versus volume discussions have taken root in the industry. But has the talk translated into action? What goals have organizations set to transform costs, what progress are they making, and what impediments must be addressed? Our key survey findings include:

*“We are cost cutting but not really changing the way we operate,” summarized one survey respondent.*

#### **Why the Need to Reduce Costs?**

1. Financial realities make cost transformation an imperative for healthcare organizations and their leaders.
2. Executives recognize the imperative, but organizational commitment to transformational change, goal setting, and progress have been limited to date.

#### **Where Are Organizations Focusing?**

3. Current efforts focus on traditional areas of cost improvement (e.g., labor productivity, supply chain, revenue cycle)...
4. ...while areas that will yield transformative reductions (e.g., clinical redesign, service rationalization, workforce reconfiguration) are not being addressed at a pace that acknowledges urgency.

#### **What Are the Challenges?**

5. Accountability for transforming costs is a concern for most organizations.
6. Data and important processes and tools, such as cost accounting methods, lack credibility.
7. Reliable cost-related data, insights, decision making, and monitoring are required to transform costs.

Cost transformation is urgent but many organizations are struggling to set appropriate reduction goals and start the hard work of reconfiguring their businesses for a much more cost competitive environment.

## About The Report

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This report presents results of an online survey completed by more than [150 senior executives](#) in U.S. hospitals and health systems. The goal of the survey was to gauge where industry participants stand with regard to transforming the cost of care provided by U.S. hospitals and health systems.

This report also describes four actions hospital and health system leaders can focus on to fast-track cost reduction initiatives and accelerate results:

1. Adopt a new mindset and ensure accountability
2. Put in place a cost improvement roadmap, based on data- and analytics-based planning, processes, and tools
3. Rethink the organization's portfolio of businesses and services
4. Redesign the care model and workforce to meet quadruple-aim goals—better care, better health, lower costs, and improved patient and caregiver experience

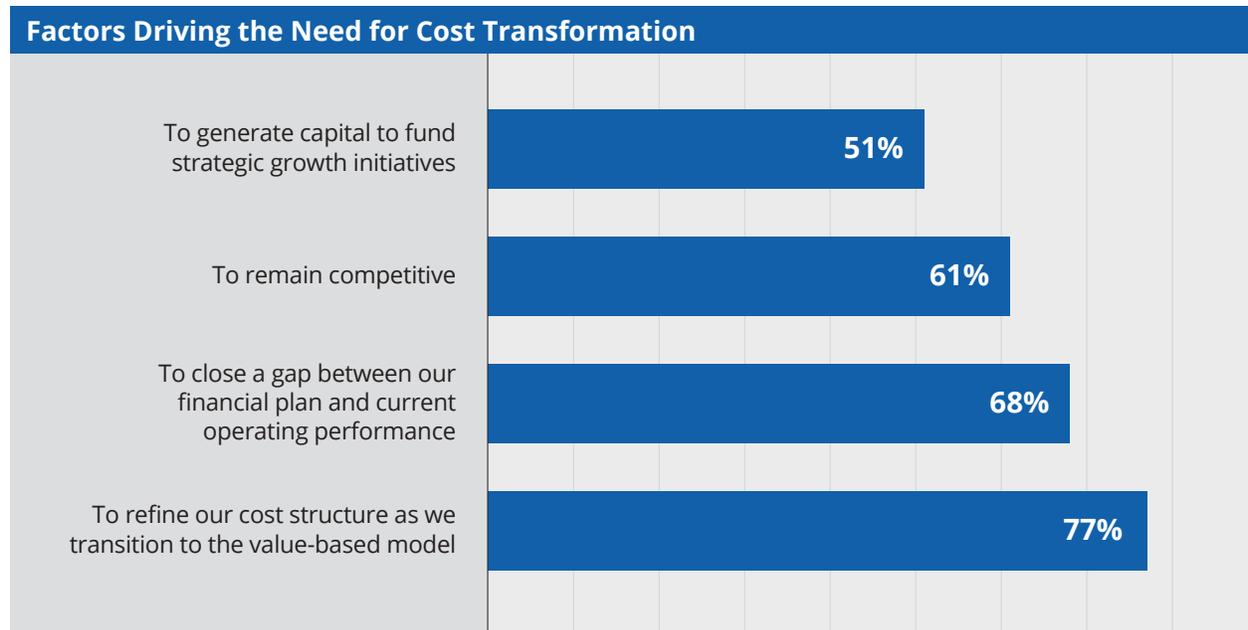
A case study, providing an example of how one health system is tackling cost transformation, is included as well.

The State of  
Cost Transformation:  
**Survey Findings**

## Why the Need to Reduce Costs?

Financial realities make cost transformation an imperative for healthcare organizations and their leaders.<sup>1</sup>

Nearly 80%	cite the need to be proactive in refining the organization’s cost structure during the transition to a value-based business model
Nearly 70%	cite the need to close the gap between their financial plan and their current operating performance



**What’s driving the cost reduction need? Write-in responses include:**

- To ensure the long-term sustainability of our mission
- To offset potential loss of state funding
- To address major changes in payer mix and reimbursement
- To respond to market pressure from employers
- To address transparency and payment pressures from major commercial payers
- To meet our responsibility to develop affordable and effective healthcare
- To improve operating efficiency in healthcare

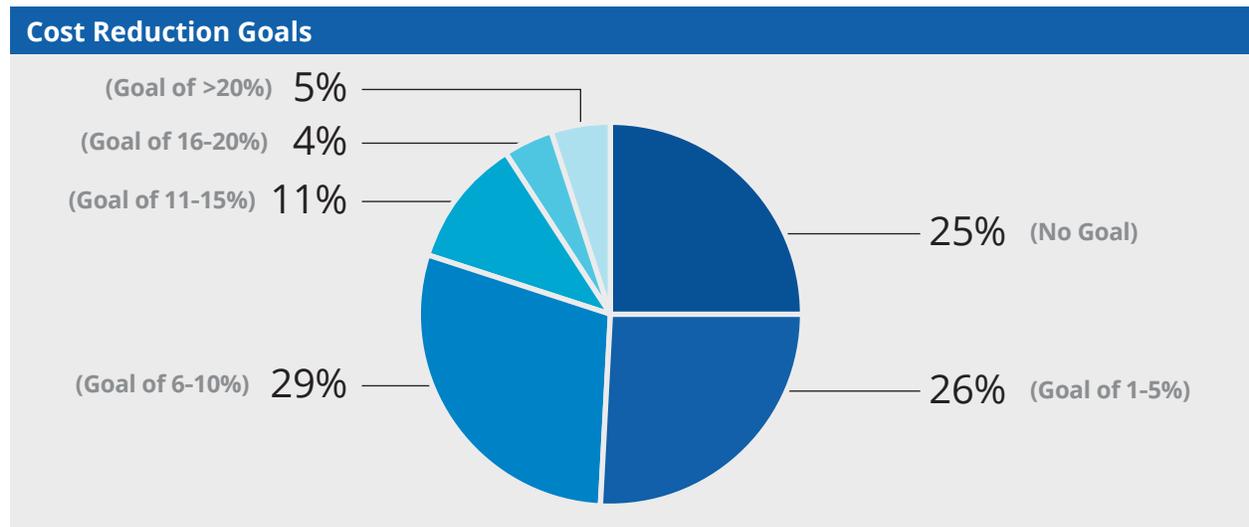
<sup>1</sup> A “check all that apply” option was available.

Why the Need to Reduce Costs? (continued)

Executives recognize the cost transformation imperative, but organizational commitment to transformational change, goal setting, and progress have been limited to date.

There is a large gap between recognition of the imperative and the goals established to meet that imperative.

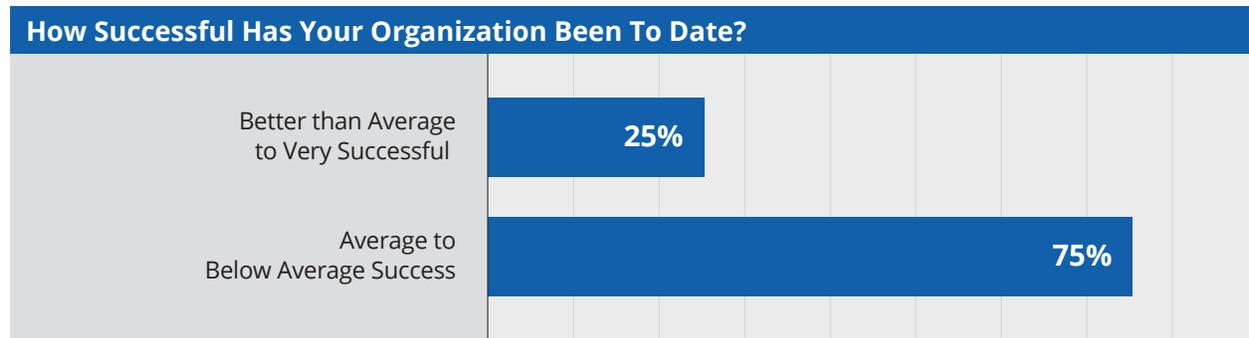
Need is there...	
96%	say cost transformation is a “significant” to “very significant” need for their organization today
Yet, cost reduction targets are absent or nominal.	
>50%	have <b>no</b> goal for the next 5 years, or a goal of only <b>1% to 5%</b> <i>1 in 4 hospitals lacks a cost reduction goal and thus appears not to be trying to lower cost in an organized and deliberate way. Single hospitals are particularly likely to have no goal; more than 40 percent indicated this to be the case.</i>
29%	have a cost reduction goal of <b>6% to 10%</b> for the next 5 years <i>This goal will not transform their cost structure, and in fact, will not even keep pace with annual inflation.</i>
~20%	have a cost reduction goal of more than <b>10%</b>
5%	have a cost reduction goal of more than <b>20%</b>



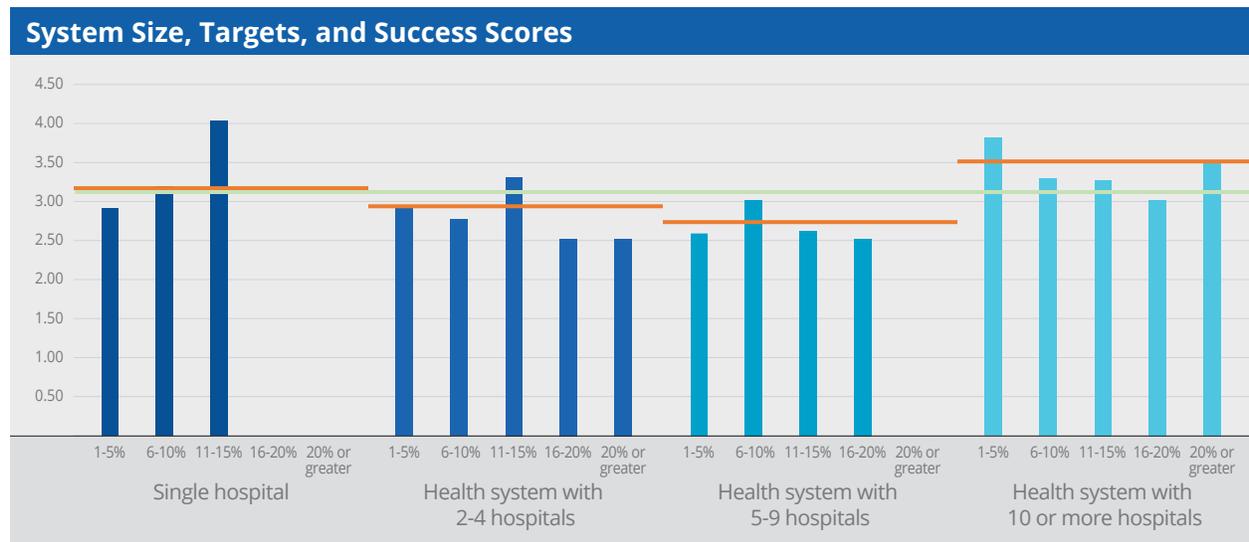
Why the Need to Reduce Costs? (continued)

**Progress toward meeting cost transformation goals has been slow.**

75%	say their cost transformation success is <b>average</b> to <b>below average</b> to date <i>Such ratings were even higher in single hospitals and health systems with 5-9 hospitals—82% and 92% respectively.</i>
25%	say their cost transformation success is <b>better than average</b> or <b>very successful</b> <i>43% of health systems with 10 or more hospitals rated their success as better than average or very successful.</i>



**Larger systems have an advantage. Scale matters.** When analyzing the ability to successfully achieve cost reduction targets both by system size and target percentage, larger systems have an advantage. Not only did systems of 10 or more hospitals have the highest average success score of 3.47 compared to the overall average of 3.10, but larger systems were successful across the range of targets even in the >20% range with an average success score of 3.5. Success at this level for larger systems represents substantial cost reductions. While single hospitals also were successful at achieving their targets, with an average of 3.13, no single hospital responded with targets greater than 15%.



## Where Are Organizations Focusing?

Current efforts focus on traditional areas of cost improvement...

**Conventional priorities dominate attention.**

60-70%

cite traditional labor cost/productivity, supply chain and other non-labor cost, and revenue cycle enhancement as a key focus area

Executives have been working on these items for decades. In many organizations, most of the major reduction opportunities likely have been achieved. Further substantial reductions will require pursuit of much more difficult initiatives.

Hard	Harder	Hardest
<b>Traditional Margin Improvement</b>	<b>Business/Service Reconfiguration</b>	<b>Clinical and Workforce Redesign</b>
Labor/Productivity	Service Line Efficiency	Clinical Variation
Supply Chain and Other Non-Labor	Physician Enterprise Management	Clinical Effectiveness
Revenue Cycle	Service Rationalization	Workforce Reconfiguration

**Write-in responses include:**

- We are cost cutting but not really changing the way we operate.
- Length of stay
- IT optimization

*“Our organization is performing in the top quartile or decile on most labor and supply chain metrics. The next layer of costs will need to come from reducing clinical variation and changing work-flow processes. This will require more physician engagement from our relatively unaligned medical staff.”*

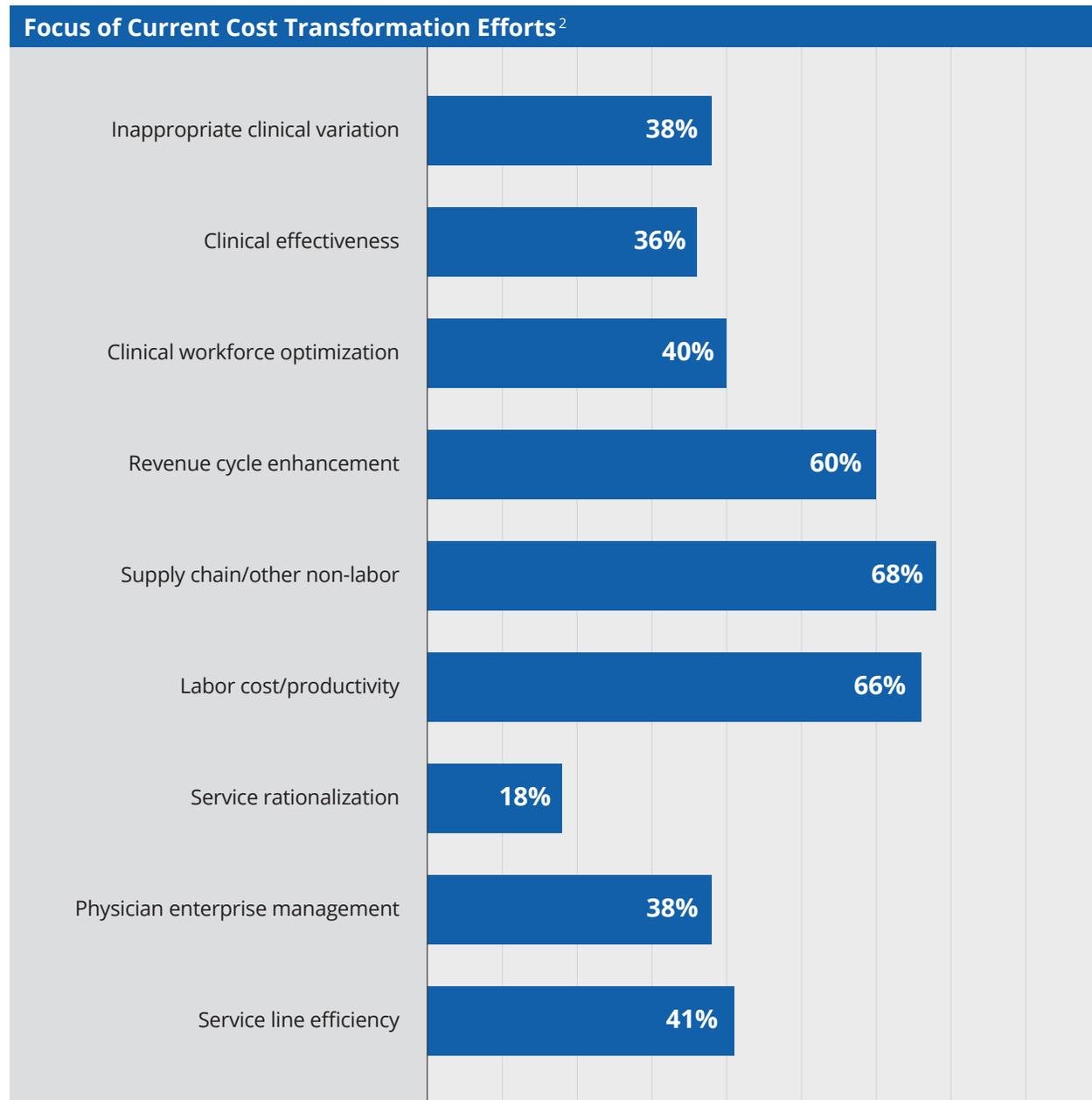
*Where Are Organizations Focusing? (continued)*

...While areas that will yield transformative reductions are not being addressed at a pace that acknowledges urgency.

Progress is slow **because** traditional areas will not yield the magnitude of cost reduction required to transform an organization’s cost structure. Business and service initiatives and clinical and workforce redesign actions are required.

Among business and service initiatives, only:	
41%	cite service line efficiency as a key focus
38%	cite physician enterprise management as a key focus
18%	cite service rationalization as a key focus
Yet >60%	think their delivery networks are not highly efficient or aligned with the needs of the populations served, or are neutral on this issue
Among clinical redesign and workforce reconfiguration initiatives, only:	
40%	cite workforce optimization as a key focus
36%	cite clinical effectiveness as a key focus
Yet >50%	<p>think that their organization is not making effective use of clinical pathways, protocols, and guidelines to develop a common approach to treatment, or are neutral on the issue.</p> <p><i>These data signal concern about clinical quality and cost. Clinical practice guidelines, based on the best research evidence available, minimize inappropriate variations in practice in order to improve efficiency and quality of care.</i></p>

Where Are Organizations Focusing? (continued)



<sup>2</sup> A “check all that apply” option was available.

## What Are the Challenges?

Accountability for cost transformation is a concern for most organizations.

### In many organizations, leaders are not being held accountable for transformation success.

~54%	say their organizations do <b>not</b> have strong processes and structures in place to hold leaders accountable, or are neutral on this issue
21%	find many savings opportunities too politically sensitive to pursue

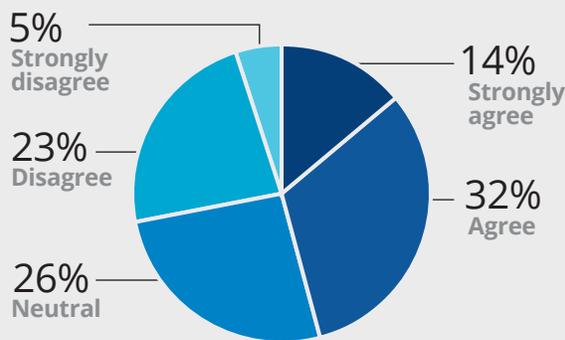
### Rudimentary expectations for accountability and clarity of goals across the organization are not being achieved in many organizations.

47%	say their organizations do not distribute targets across the organization to assist in the achievement of organizational goals, or are not sure
59%	say their organizations set cost reduction targets at the hospital level only, not at the vice president, service line, or department level

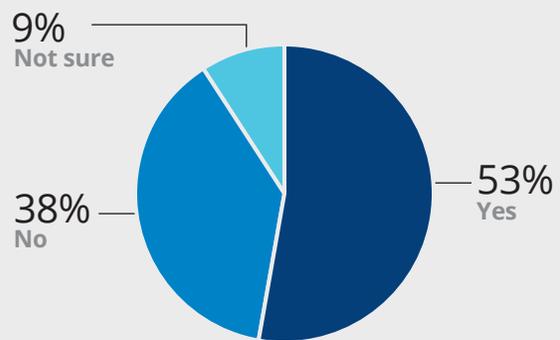
### Large health systems have significantly better leadership accountability.

75%	of health systems with 10 or more hospitals agree or strongly agree that accountability processes and structures are in place
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Response to “Your organization has strong processes and structures in place to hold leaders accountable to performance for cost transformation goals.”



Response to “Have targets been distributed across the organization to assist in the achievement of the organizational goals?”



#### Write-in responses include:

- Getting past the human “default position” of resisting change and believing that we can deliver healthcare differently are impediments
- Cost reduction lacks authority
- Savings opportunities are not controlled locally, but rather, by our national office
- Amidst the too-many initiatives, focus on key ones is undisciplined

*What Are the Challenges? (continued)*

Data and important processes and tools, such as cost accounting methods, lack credibility.

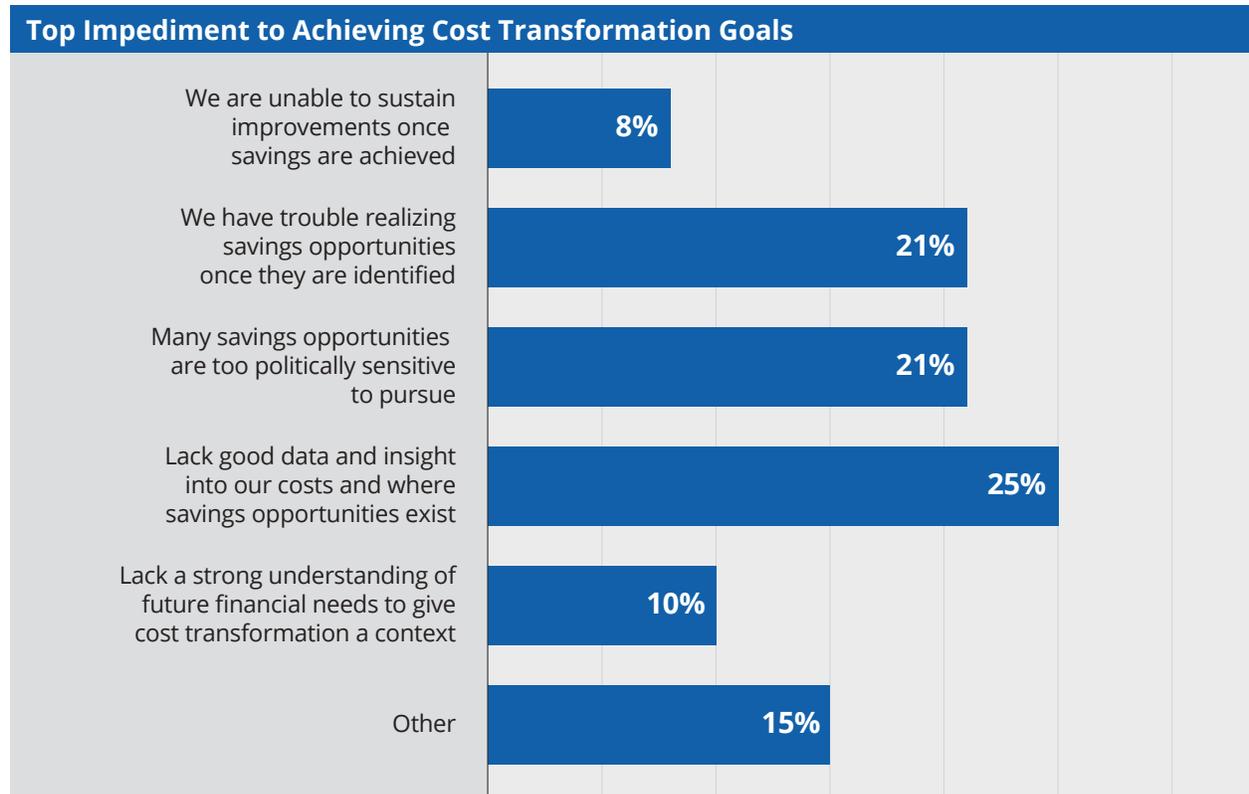
***“Lack of good data and insight into costs and where to focus reduction efforts” is the most commonly cited impediment to achieving cost reduction goals.***

**Four additional impediments include:**

- Political sensitivities related to specific savings opportunities
- Realizing identified savings opportunities
- Understanding of the financial context for cost transformation
- Sustaining improvements once savings are achieved

**Write-in responses include:**

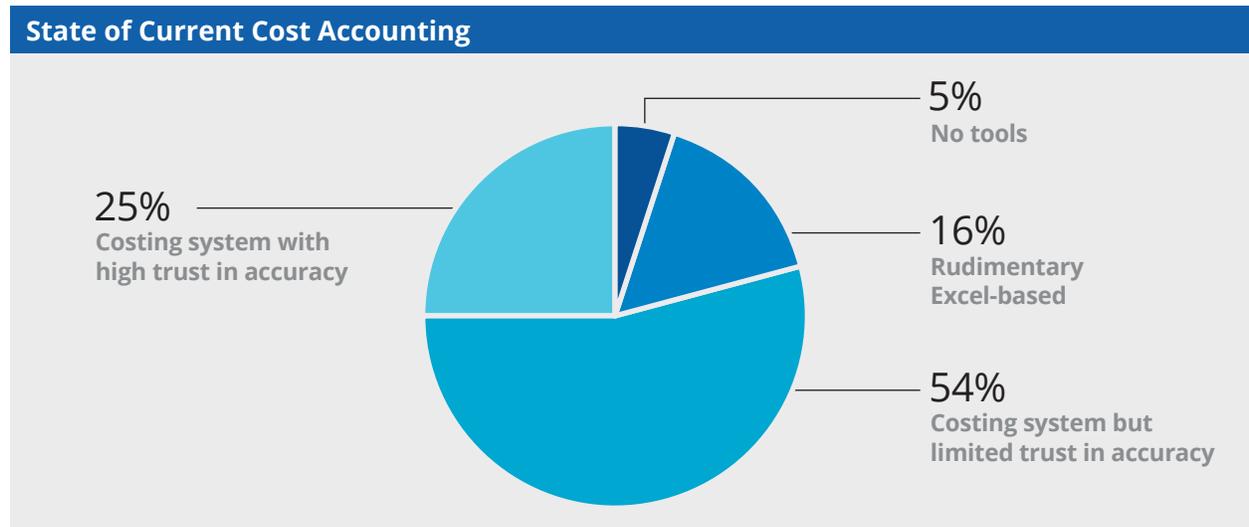
- Having reliable data and putting it in context in order to drive change quickly can be challenging.
- Integrated systems with intuitive end-user interfaces, which pull clinical, quality, and financial data quickly, are needed.



What Are the Challenges? (continued)

91% are using cost benchmarking methods.	
68%	cite external peer group benchmarking
59%	cite internal trending benchmarking
30%	cite intra-hospital benchmarking
9%	cite none of the above

But current cost accounting systems lack credibility.	
Only 25%	have confidence in the accuracy of results of their existing cost accounting solution
54%	cite a cost accounting solution with simplistic methods or results whose accuracy cannot be trusted
16%	use rudimentary, Excel-based methods for costing
5%	have in place <b>no</b> cost accounting processes



Reports on cost and profitability trends are distributed to a limited audience, and not used widely to support decision making.	
63%	of respondents cite no or a very limited distribution and use of patient and service line cost reports to support decision making

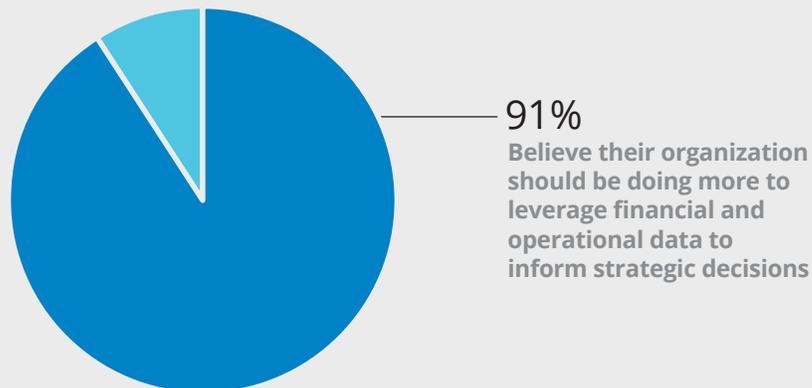
*What Are the Challenges? (continued)*

## Reliable cost-related data, insights, decision making, and monitoring are required to transform costs.

More than others, this challenge could account for the low cost reduction goals set by organizations, and limited progress toward achieving such goals. To succeed in reducing organizational cost structure, executives need a rich set of accurate data that gives them insight into their current costs and allows them to make informed decisions. The data and analytics must extend beyond financials to include clinical and other operational data sets.

Many executives struggle with leveraging data and analytics to know where to focus cost efforts. Having a reliable cost accounting solution, with flexibility and transparency into the costing model, is critical for gathering the proper data needed to drive timely business decisions. A report of survey results released early this year indicates that 91% of CFOs believe their organization should be doing more to leverage financial and operational data to inform decision making.<sup>3</sup>

### Leveraging Data for Better Decision Making



<sup>3</sup> Kaufman Hall: *2017 CFO Outlook: Performance Management Trends and Priorities in Healthcare*.  
[www.kaufmanhall.com/resources/2017-cfo-outlook-performance-management-trends-and-priorities-healthcare](http://www.kaufmanhall.com/resources/2017-cfo-outlook-performance-management-trends-and-priorities-healthcare)

The State of  
Cost Transformation:  
**Actions**

## Actions

### Impediments to Transforming Costs Can Be Removed.

Survey findings identified a number of barriers to cost transformation along with some efforts to overcome those barriers.

Barriers	Challenges	Pushing Toward Solutions
Where to start	Time and attention are limited	Develop a cost transformation plan/roadmap that prioritizes reduction opportunities and assigns accountability
Absence of accountability	Processes and structures not in place	Establish a cost transformation steering committee, working teams, performance reviews, and visibility of effort organization-wide
Lack of clarity	Managers are not sure of reduction targets or how to meet them	Circulate the cost transformation plan with assignment of work teams to develop specific plans to meet targets
Poor data and analytics	Fee-for-service-oriented reporting systems fail to integrate needed clinical, quality, and cost data	Build collaboration between finance and clinical leadership to obtain data and analytics platform for decision making
Absence of trustworthy costing tools	Simplistic systems are not capable of providing reliable results	Ensure a robust cost accounting system that provides data and analytics capability to drive high-quality decision making

**To transform U.S. healthcare costs, leadership action is needed in four key areas:**

1. Adopting a new mindset and ensuring accountability
2. Putting in place a cost improvement roadmap, based on data- and analytics-based planning, processes, and tools
3. Rethinking the portfolio of businesses and services
4. Redesigning the care model and workforce to meet quadruple-aim goals—better care, better health, lower costs, and improved patient and caregiver experience

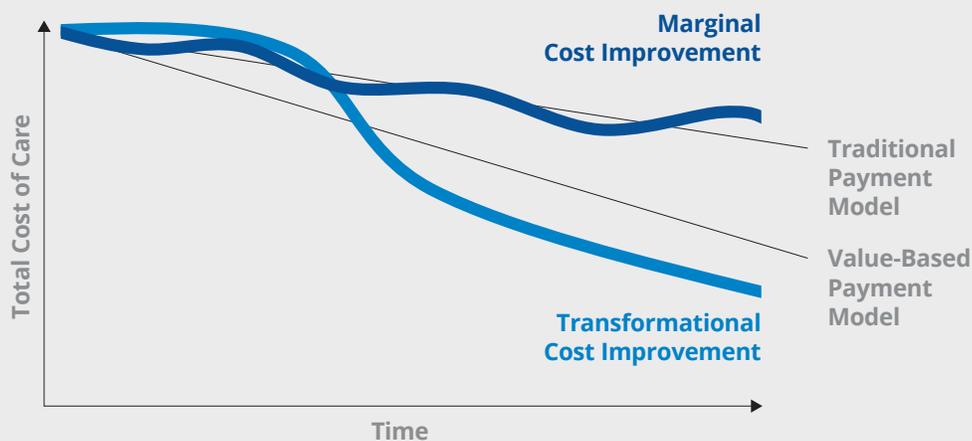
*Actions (continued)*

## 1. Adopt a New Mindset and Ensure Accountability

A new mindset is required for the kind of extreme shift and lowering of costs that will distinguish an organization into the future. That frame of mind is characterized by:<sup>4</sup>

- Leadership commitment and ability to think differently about the purpose and design of the organization, while holding true to nonnegotiable values related to quality, access, the patient experience, and others as defined
- No tolerance for incrementalism and political sensitivities, but rather, a laser-focus on building organizational agility through cost transformation
- Willingness to focus on the full cost transformation agenda and incorporate lessons learned in other organizations and industries, while drawing upon experience in leading similar cost improvement initiatives
- A cost transformation steering committee structure and processes, empowered by system executives with the authority to make tough and politically charged decisions about divesting, converting, or closing facilities and programs that do not have sufficient volume or are otherwise unable to perform up to necessary financial or clinical standards
- Executives and physicians throughout the organization who are held accountable to transparent measures of performance
- Tenacious organization-wide improvement teams that don't give up and are motivated by team relationships and the desire to achieve a greater good for the organization

### Affecting the Total Cost of Care Requires a New Way of Thinking



<sup>4</sup> For more information, see Kaufman, K: "Getting Serious About Costs." *Kaufman Hall Report*, Summer 2017. [www.kaufmanhall.com/resources/summer-2017-kaufman-hall-report-getting-serious-about-costs](http://www.kaufmanhall.com/resources/summer-2017-kaufman-hall-report-getting-serious-about-costs)

*Actions (continued)*

## 2. Put in Place a Cost Improvement Roadmap, Based on Data- and Analytics-Based Planning, Processes, and Tools

Systematic planning and best-in-class processes and tools will be key to success. Recommended practices follow.

### **Tackle the total cost of care**

A long-term, cost improvement plan provides the framework for how to move from immediately accretive operational improvements to clinical cost transformation.

### **Tie cost goals to an integrated strategic-financial plan**

Cost goals are set in the context of the organization's overall financial picture over a five-year horizon. A cost reduction goal of at least 8% in the first year and 25%–30% over five years is appropriate and viable for most organizations.

### **Combine top-down and bottom-up planning**

A balance of top-down and bottom-up planning ensures leadership direction and effective implementation. Staff should be empowered with the tools to own the process through cost data and analytics training.

### **Identify cost reduction opportunities and appropriate targets for those selected for pursuit**

Set targets at multiple levels (organization, VP executive, each department), and track and trend progress to identify if efforts are directionally correct and when to implement changes.

### **Ensure robust data and analytics, and trustworthy cost accounting tools**

A reliable cost accounting tool offers insightful analytics, is integrated with the organization's strategic-financial planning software, and delivers the right information in an actionable format.

*Actions (continued)*

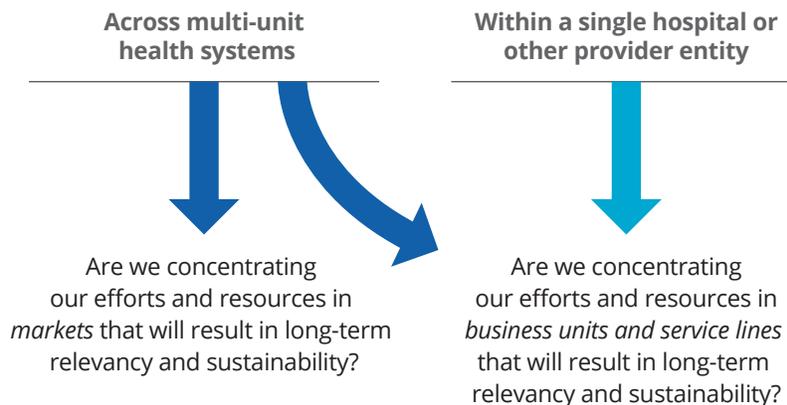
### 3. Rethink the Organization's Portfolio of Businesses and Services

Forward-thinking healthcare organizations are evaluating all aspects of their business in light of requirements for future success. Recommended practices follow.

#### Use a structured approach to evaluate each business unit, service line, and facility

The approach should consider mission, nature of operations, market environment/competitive position, financial performance, and compatibility with new business model requirements.

Leaders should review demand for and performance of every facility and service. Inefficient services and facilities stress an organization's clinical, technological, human, and capital resources, making the organization less viable as a value-based provider. Risk of poor patient outcomes are high in low-volume services and hospitals.<sup>5</sup>



#### Answer the critical questions for defining the organization's new position

- What services should we be offering in each location, and at what scope and scale?
- Are services provided in multiple locations that could or should be concentrated at fewer sites in order to ensure best-possible outcomes and lower costs?
- Are there services that require broader access (e.g., primary care) and services that should be covered in lower-cost settings?
- If we were able to start fresh, what would be an optimal care delivery network across inpatient, outpatient, and virtual offerings?

#### Take action to reconfigure the delivery network based on these insights

Tough, fact-based decisions will need to be made and executed by hospital and health system leaders. They must be willing to consolidate services that are performed at multiple locations in close proximity. They must be willing to divest service lines that are not delivering value for the organization and community.

<sup>5</sup> Sternberg, S., Dougherty, G.: "Risks Are High at Low-Volume Hospitals." *U.S. News & World Report*, May 18, 2015.

*Actions (continued)*

## 4. Redesign the Care Model and Workforce to Meet Quadruple-Aim Goals

Redesign of care delivery holds great promise to improve quality/outcomes, enhance patient and care provider experience, and reduce costs. Recommended practices follow.

### **Redesign the sites of care and how care is provided**

- Engage front-line clinicians in clinical improvement/redesign through local clinical leadership and best practices identification
- Develop virtual, community, and home-based services to meet patient convenience and access expectations
- Use advanced data and analytics to identify and eliminate unwarranted care variation and improve overall performance
- Consider how to match staff, information and clinical technology, physical space, and policies and procedures to meet the needs of defined patient groups in organizational settings<sup>6</sup>

### **Build a flexible workforce to serve the organization going forward**

- Match staff expertise to the tasks at hand to optimize every unit and facility, looking beyond the traditional department-centric approach
- Standardize staffing practices, procedures, and scheduling workflows
- Shrink core staff and grow flexible staff to account for increasing census variation, decreasing inpatient census, and growing use of virtual services

<sup>6</sup> Bohmer, R.M.J.: "The Four Habits of High-Value Healthcare Organizations." *The New England Journal of Medicine*, Dec. 11, 2011.

The State of  
Cost Transformation:  
**Example of Advanced Practices**

## Example of Advanced Practices

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### Building the Structure and Processes for Cost Transformation at Hallmark Health System<sup>7</sup>

To illustrate how the concepts described in this report can be put into action, the following pages highlight how Hallmark Health System initiated its cost transformation journey.<sup>8</sup>

#### Leadership Focus

In early 2016, the leadership team of Medford, Massachusetts-based Hallmark Health System articulated the goal of driving long-term organizational performance improvement and growth through the identification and pursuit of strategic and financial opportunities. Like many community hospitals, the system had been experiencing a demanding operating environment, including stiff competition, reductions in payment, and other financial challenges. Its leaders recognized the need to proactively improve financial performance through significant cost reduction.

#### Getting Started

To achieve a common understanding of their current situation, Hallmark completed a system-wide assessment of three areas:

- Margin improvement through optimizing labor, non-labor, revenue cycle, and other “core” costs
- Business and service line right-sizing and right-siting to optimize the delivery network
- Clinical transformation to enhance care delivery efficiency and quality

This assessment provided the fact base upon which a quantification of savings opportunities was derived. Hallmark used four strategic steps to develop a performance improvement target, and then organized, designed, and executed a structured approach to achieving the target.

<sup>7</sup> For more information, see Doherty, W.J., Connelly, M., Neese, K., and McDermott, G.: “Exploring Opportunities for Transforming Cost Structure.” *hfm* magazine, June 2017. [www.hfma.org/Content.aspx?id=54268](http://www.hfma.org/Content.aspx?id=54268)

<sup>8</sup> Kaufman Hall deeply appreciates the willingness of William J. Doherty, M.D., FACHE, Executive Vice President and COO, and Michael Connelly, CPA, FACHE, Executive Vice President and CFO, of Hallmark Health System, and the Healthcare Financial Management Association, in allowing us to include this material.

*Example of Advanced Practices (continued)*

## 4 Steps in the Cost Transformation Journey

### 1. Using Assessment Findings to Set the State for Improvement

Overall, the assessment identified an opportunity to improve core-cost financial performance in the Hallmark enterprise by \$8.3 million to \$33 million. Significant opportunities existed to improve labor productivity and span of control, among other expense areas, despite these costs having been trimmed in the past. Additionally, beyond the initial assessment's scope, Hallmark's leaders also saw that financial improvements could be achieved through operational and productivity gains within the physician enterprise, service line development and growth, brand strengthening, and strategic partnership opportunities.

### 2. Getting Organized at the Leadership Level

To identify the improvement goal and start the work of achieving that goal, in August 2016 Hallmark leadership established a steering committee with approximately 20 representatives. Members included senior-level divisional executives in clinical operations and five physician leaders. Physician and nurse leader participation was critical on the front-end due to the likely impact of decisions to downstream operations. These leaders could communicate the cost improvement challenges to divisions organization-wide and serve as ambassadors and champions for the changes that would be implemented.

### 3. Gaining Consensus on the Financial Goal Enterprise-wide and By Division

The steering committee determined that vice presidents should be accountable for achieving the targets for their divisions, and should be afforded flexibility to move only departmental targets within their divisions, *not* their overall divisional targets. The vice presidents identified cost improvement opportunities in their areas, commencing with cost center opportunity ranges based on assessment findings, and potential impacts and risks of specific initiatives.

### 4. Making Operational Improvement Part of the Organization's DNA at the Cost Center Level

Hallmark wanted its initiative to help foster a culture in which a focus on operational improvement would permeate every level of the organization. Thus, with the targets established by the steering committee at the vice president level, the next step was for the vice presidents to move the divisional targets down to their cost centers.

The steering committee determined that department managers and directors, who were the operational subject-matter experts in each Hallmark division, should first receive cost intelligence education and tool training that would help guide and inform their efforts.

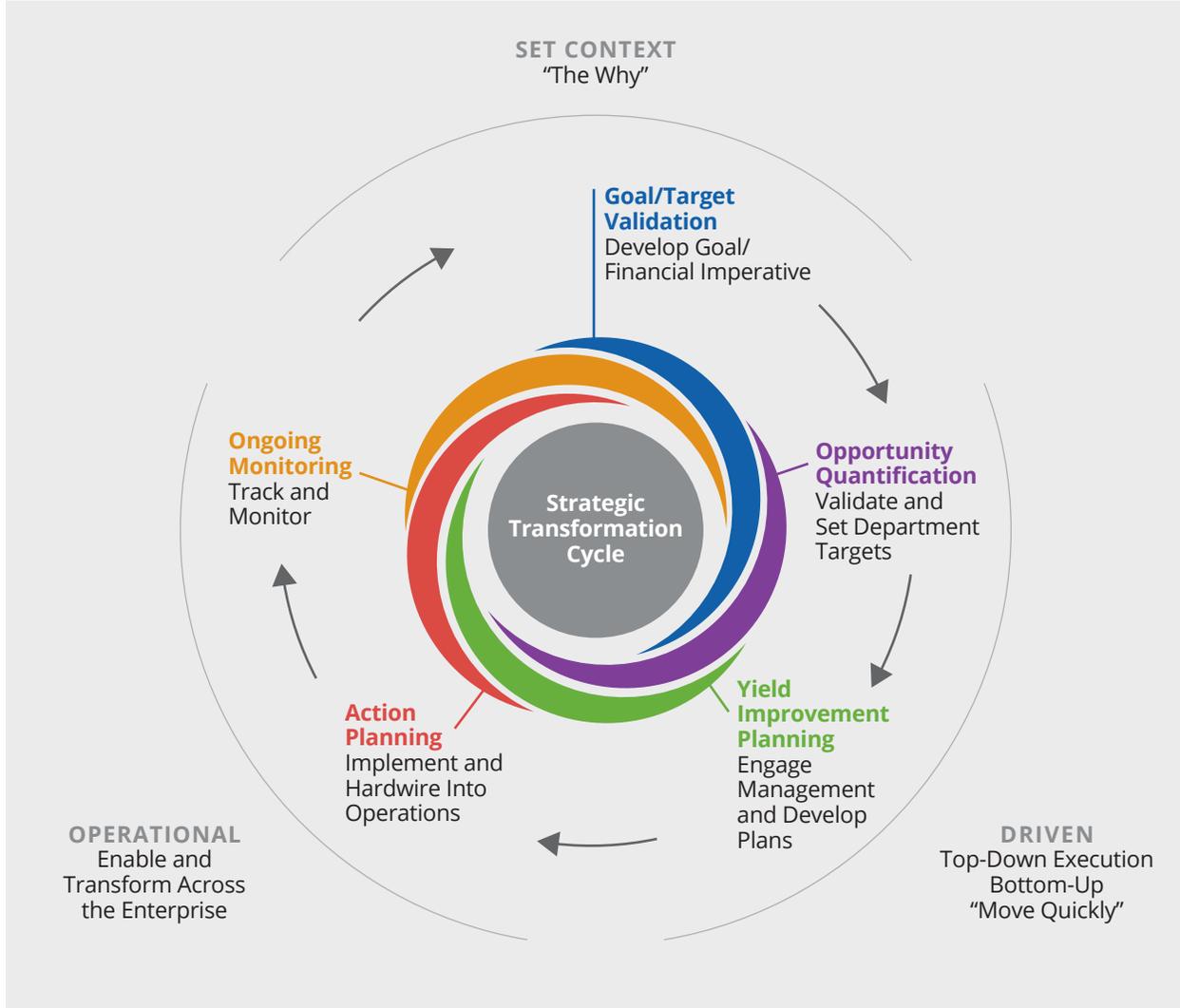
Small- and large-group cost planning sessions with managers followed to launch detailed initiative planning. More than 300 specific initiatives were identified, vetted, validated, approved, budgeted, and launched. Hallmark's human resources, finance, and operations improvement staff provided hands-on support throughout the process and helped to identify, quantify, and implement quick wins. Example initiatives included standardizing packs for hips and knees in Surgical Services, replacing clinical associates with medics in the Emergency Department, and consolidating contractors in the Maintenance Department.

Example of Advanced Practices (continued)

## Positioned for Success

Hallmark’s leadership successfully initiated a strategic cost transformation cycle, bringing operational improvement across the enterprise with top-down driven targets, and bottom-up plan development and execution (Exhibit). Comprehensive training related to cost intelligence and tracking and a thorough communication plan that provided consistent, clear messaging and support are enabling the organization to lower its cost structure for more efficient and effective delivery of care. Leadership successfully embedded into Hallmark’s DNA a structure and process that is enabling it to continuously improve financial performance.

### The Strategic Cost Transformation Process

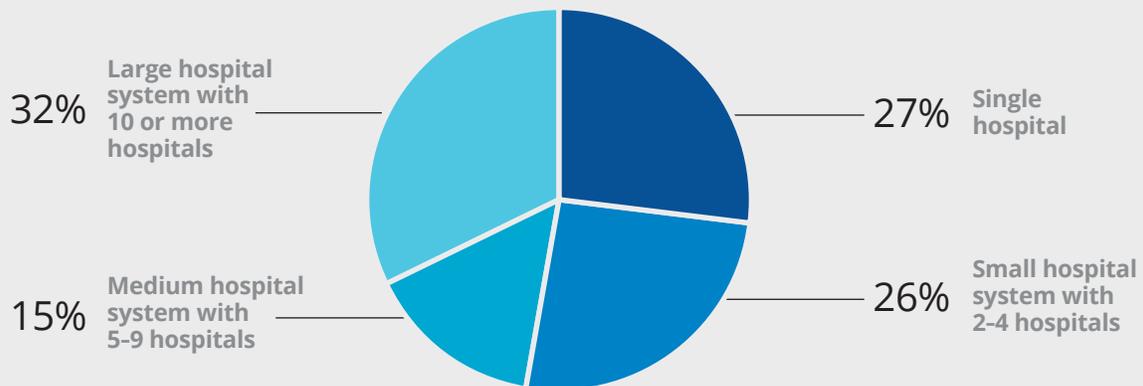


Source: Kaufman, Hall & Associates, LLC

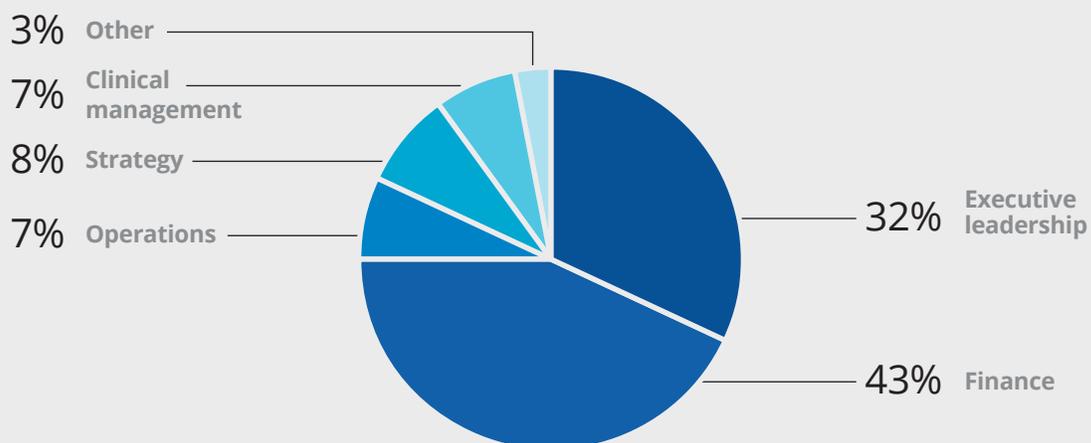
## Respondent Detail

- Executives from more than 150 hospitals and health systems participated
  - 30% from a health system with 10 or more hospitals
  - 14% from a health system with 5-9 hospitals
  - 51% were either from a single hospital (26%) or a small health system with 2-4 hospitals (25%)
  - The remainder were from health plans or other types of organizations
- Three-quarters of respondents were in executive leadership or finance roles; the remaining one-quarter were individuals in operations, strategy, and clinical management

### Hospital Size



### Business Discipline



2017 State of Cost Transformation in U.S. Hospitals:  
*An Urgent Call to Accelerate Action*

*For more information, please contact  
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