Smart approaches to top-level decision making

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Redefining Capital and Its Role in the Planning Process

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Numerous forces affecting hospitals are contributing to the need to reassess traditional definitions of capital.

Hospitals and health systems across the country are seeing tightening margins that increasingly conflict with an ever-expanding list of capital needs. Given competing demands on scarce capital resources, an organization's long-term success and sustainability hinge on making smart, strategic investment decisions today. The first step in developing a thoughtful capital allocation process is ensuring that the organization's definition of capital is aligned with its evolving needs amidst a rapidly changing healthcare environment.

The alignment of capital decisions and capital management with the organization's strategic objectives is critical. *Capital allocation* is the planning process for deploying capital resources (cash and debt capacity) for investment in mission and community-based imperatives. These may include:

> Existing service line growth
> New businesses/ventures
> Routine infrastructure
> Information technology

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> Building cash reserves to fund a competitive liquidity and credit position
> Strategic, operational, and functional repositioning for the new healthcare era

Capital management is the ongoing monitoring and control function that keeps the allocation decision process "honest" and ensures appropriate application of allocated funds.

Moving Beyond Traditional Capital Allocation Decisions

Numerous forces affecting hospitals and health systems are contributing to the need to reassess traditional definitions of capital. These forces include declining payments, mounting pressures to reduce care costs and enhance quality, and rising demand for more consumer-centric healthcare as patients and families bear a greater share of their healthcare costs and become more engaged in care decisions. Healthcare organizations are seeing increasingly diverse capital needs as a result, many of which extend beyond traditional spending areas.

While 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. Other areas requiring investment include physician enterprise strategies, health plan ownership or partnership, and capitation contracting—which requires organizations to establish capital reserves and invest in actuarial expertise.

Given these demands, the capital allocation process now must manage a broader range of decisions.

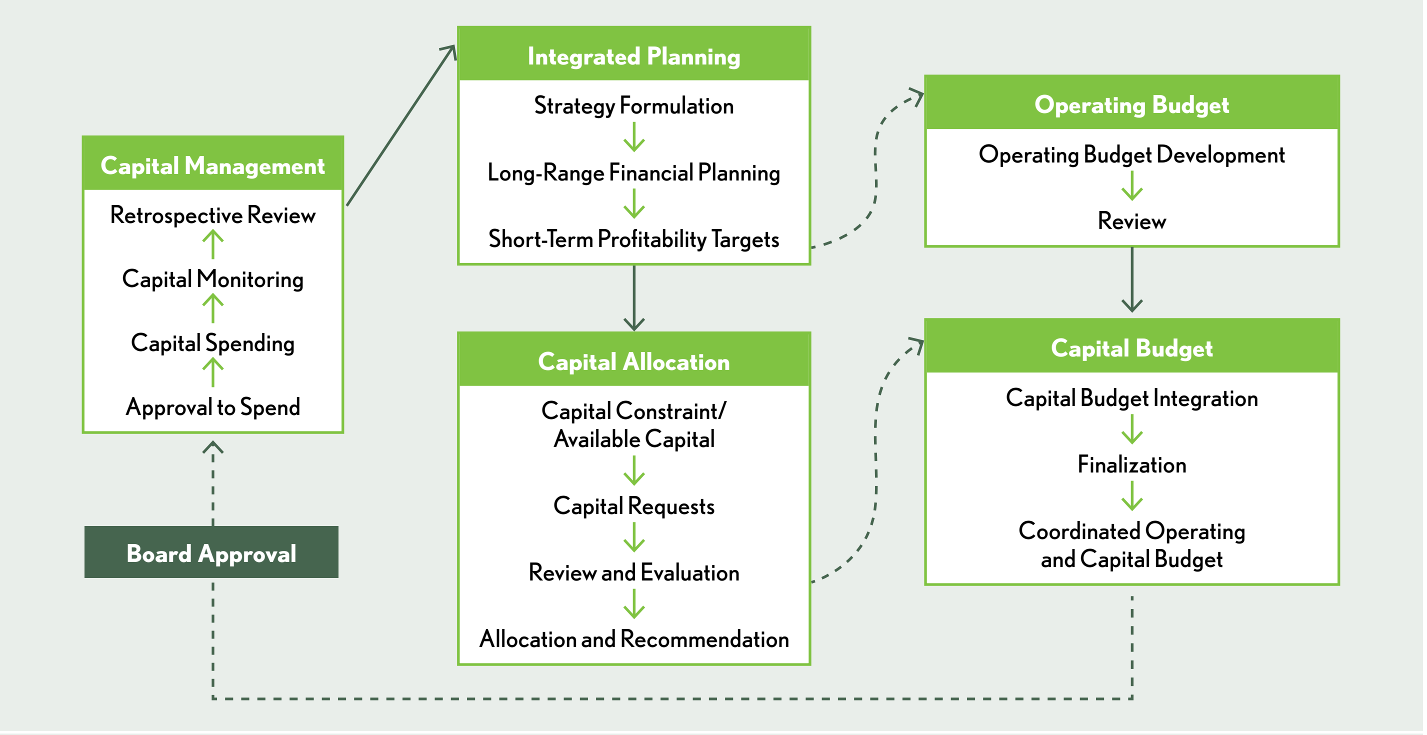
Aligning Processes with New-Era Needs

The definition of "capital" must evolve to capture an organization's changing strategic direction and reflect a greater breadth of 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. Examples of investments that should be included in a current definition of capital include:

> Facilities, property, and equipment, including information technology
> New operating entities/programs
> Business acquisitions and partnerships
> Network development
> Managed care investments
> Program start-up subsidies/expansion
> Physician integration
> System initiatives

These and other capital investments must 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 included in an organization's capital allocation decisions, although they often have not been historically.

Capital Planning and Management Should Be Continuously Integrated



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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. These expenditures require comprehensive business planning analysis and centralized review. The *nonthreshold capital pool* covers capital requests that are below the threshold dollar amount and can be handled on a decentralized basis. Lastly, the *contingency pool* supports and/or supplements unfunded or unforeseen threshold capital needs.

Both capital allocation and capital management must fit into the comprehensive planning cycle. Having an integrated calendar will improve decision making throughout the annual management cycle (see figure on the previous page).

Adopting a Portfolio Approach

Armed with a broader definition of capital, hospital and health system leaders can shape their capital allocation processes using a portfolio approach that weighs the organization's many different needs. This involves development of a comprehensive catalog of proposed capital allocation investments, so that each can be considered relative to other priorities. A structured process for review and comparison is best practice, and is especially vital in times of uncertainty, because it highlights inconsistencies, quantifies changes in portfolio value on a real-time basis, and provides a means to address evolutionary and innovative needs.

Capital allocation processes should be transparent and—like definitions of capital—should evolve over time to meet changing needs. Ultimately, the capital allocation discussion should focus on the trade-offs among mission, strategy, and financial return for the entire portfolio. //

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