

Why Margins are Inadequate Measures of Hospital Financial Performance April 2007

In recent years, some public officials have attempted to draw broad conclusions about the financial health of Pennsylvania hospitals – and even to suggest public policy initiatives – based on their financial margins. While margins are an interesting and potentially useful source of information about hospital finances, they are hardly a definitive measure. Instead, margins reveal just one aspect of hospitals' financial performance and should not be viewed as “proof” of their financial condition.

Margins Defined

A hospital's margin is the ratio of its expenses to its revenue. Two types of margins are commonly cited: “operating margin” generally measures revenue only from patient care and “total margin” generally encompasses patient care revenue as well as revenue from non-patient-care activities such as contributions, government appropriations, investments, parking, gift shops, and other sources.

“No Margin, No Mission”

Hospitals cannot operate only for today, with little or no margin. Instead, they must receive enough money in exchange for their services to cover their costs *and* to earn a reasonable rate of return – their margin. Covering their costs is important – like any enterprise, hospitals have payrolls to make, services to maintain, and suppliers to pay – but covering costs does nothing more than maintain the status quo: it leaves no room for improvements.

Margins are the primary source of funding hospital improvements – for moving beyond the status quo. Margins provide the money to replace equipment, renovate or replace outdated or inadequate facilities, and purchase state-of-the-art equipment; margins provide the money to invest in teaching, education, and research; margins provide the money to support community-oriented activities such as health screenings, support groups, and programs for children and seniors; and margins provide the resources that enable hospitals to provide hundreds of thousands – or even millions – of dollars worth of free care to low-income and uninsured patients.

Together, all of these activities constitute a hospital's mission: the service it aspires to provide to its community. The need to ensure financial health constitutes the foundation of one of the most important maxims in the hospital industry: “No margin, no mission.” Simply put, hospitals that cannot find a way to generate reasonable margins from their operations today probably will not have a tomorrow. To ensure their continued viability and vitality, hospitals must earn a reasonable margin – and within the hospital industry, a reasonable margin is generally thought to be at least four percent. Without such a margin, a hospital's mission is in grave jeopardy.

Managing to Margins

As important as they are, margins at times can be deceiving because in a very real sense, hospitals *manage to their margins* – that is, they make budgeting and spending decisions based on their anticipated financial performance. A hospital that is not performing well financially and that anticipates little or no margin, for example, may choose to cut costs, eliminate a planned purchase or project, or leave vacant positions unfilled to ensure that it has enough money at year's end to pay its bills. As a result, it may maintain a respectable margin or at least avoid a negative margin. Conversely, a hospital that expects to generate significantly more revenue than it has expenses may budget for a major project or expensive renovations, thereby reducing its margin (on paper) while meeting an important need.

A margin's origin can vary from hospital to hospital. While some hospitals have nothing but patient care revenue, others can raise considerable resources through fund-raising activities and others have large endowments or wealthy benefactors upon which to draw for major projects. Both types of hospitals, regardless of their respective resources, manage to their margins. Those with greater resources have more choices about how to operate their facilities and spend their money; those with less resources have fewer options and perhaps harder decisions to make and must focus more carefully on simply covering their costs. But *all* hospitals need reasonable margins if they are to continue serving their communities. Positive margins are essential; negative margins are unsustainable.

A hospital's "official" operating margin frequently reveals surprisingly little about its financial health. Seemingly similar entities with different levels of resources can easily have similar operating margins while functioning nothing like one another on a daily basis. Consider the situations of two families: an upper-income family and a working-class family. Both can have negative or positive margins at the same time yet lead drastically different lives.

The upper-income family, secure with the knowledge that tomorrow's income will more than pay for today's ordinary living expenses, can take large mortgages, buy second homes, and make extensive use of credit to purchase cars and take expensive vacations without fear of the debt that would result. In the end, this family's spending may lead to a negative margin for the year – that is, its expenses were greater than its income – but it has lived life well and improved its quality of life through its choices. The working-class family, on the other hand, might manage its money very effectively on a daily basis but need to purchase a new refrigerator on credit after its 15-year-old refrigerator finally died. This family, too, would have a negative margin, but it would be running this negative margin only to maintain its standard of living, not to improve it, as the upper-income family did.

On the other hand, both families could have modest, positive margins and again have vastly different living experiences. The upper-income family could cover all of its living expenses, enjoy many of the better things in life, and still end the year with modest new savings – a positive margin. The working-class family, though, might decide not to replace its second car when it breaks down beyond repair and instead have one of its breadwinners take public transportation to work so it can begin saving money for the leaking roof that it has repaired on numerous occasions but that it knows really needs to be replaced. This family, too, would end the year with new, modest savings – its positive margin – but would have experienced a reduction in the quality of its living because it no longer has the second automobile.

The same is true for hospitals: hospitals with comparable margins can function at strikingly different levels and with strikingly different day-to-day lives. Hospitals are much like families: they, too, must periodically invest in new beds, new appliances, new equipment, and building repairs that enable them to function effectively from day to day over a period of years.

Safety-Net Hospitals and Their Margins

There is perhaps no better example of the danger of using hospital margins to attempt to draw conclusions about the financial health of hospitals than the situation of safety-net hospitals in Pennsylvania today. In recent years, the margins of these hospitals generally have fallen in the same range as those of their non-safety-net peers – overall, no better and no worse. These safety-net hospitals, however, face such enormous obstacles to their financial health that their ability to produce margins comparable to their peers boldly illustrates the concept of managing to a margin – just as it illustrates the folly of attempting to make unqualified assertions about the financial health of these hospitals based solely on their margins.

Today, the Commonwealth of Pennsylvania pays hospitals less than 80 cents on the dollar for the care they provide to Medical Assistance patients; this means that the more Medical Assistance patients they serve, the more money they lose. Safety-net hospitals care for far more Medical Assistance patients than other hospitals. In addition, hospitals that care for significant numbers of Medical Assistance patients, because of where they are located, care for significant numbers of uninsured patients as well. This means that safety-net hospitals care for far more uninsured patients than other hospitals. With Medicare paying hospitals roughly 100 percent of their costs and private insurers paying hospitals just a little more than cost, hospitals that care for large numbers of Medical Assistance and uninsured patients lose large sums of money and have little choice but to economize at every turn: many must repair when they should replace, understaff their units and offices with underpaid employees, and postpone investments in new equipment and improvements and hope that their patients will occasionally accept the “state-of-yesterday’s-art” in the technology they employ.

This is the challenge that Pennsylvania’s safety-net hospitals currently face, and it often necessitates managing for today – and managing to a margin – rather than managing for today *and* tomorrow. There is considerable evidence, moreover, that the leaders of safety-net hospitals manage more for today alone than the leaders of other hospitals. Between 1996 and 2000, spending per patient per day at safety-net hospitals rose 22 percent. At non-safety-net hospitals, meanwhile, spending per patient per day rose 28 percent during the same period – a rate 27 percent greater than at safety-net hospitals. In comparison to their peers, safety-net hospitals clearly are under-investing in their future. This is invisible, though, to those who look only at margins when considering hospitals’ financial health.

When 75 percent of Pennsylvania’s hospitals spend at one level and the remaining 25 percent – the 25 percent that care for more low-income patients and are far more dependent on Medical Assistance revenue than other hospitals – spend on another, distinctly reduced level, it is reasonable to believe that the 25 percent, the safety-net hospitals, are not keeping pace with their peers. While this ability to limit day-to-day cost increases may be admirable in some ways and might be viewed as resourceful, creative management, such resourceful and creative management alone is not enough to ensure a safety-net hospital’s future. A hospital that tightens its belt effectively today may cover its payroll, keep the bond-rating agencies happy, and keep its doors open next week, next month, and perhaps even next year, but it also is shortchanging its community by putting off spending that it needs to undertake to renew itself and its capital and facilities and stay on the cutting edge of medical care. It may be fulfilling its mission today, but it almost certainly is doing so at the expense of its ability to continue fulfilling that mission tomorrow.

But its margins will still look respectable to the casual observer.

Conclusion

Margins are a useful tool in weighing a hospital’s bottom line. Did it take in more than it spent in a given year? Did it spend more than it earned? But margins tell a very incomplete story about how a hospital performs, how it uses its resources, and how it ensures its ability to serve its community going into the future. As a result, margins are a very inadequate tool for making definitive judgments about hospitals’ financial health and should never be used by themselves in the development and implementation of public policy.