

The Board's Responsibility Regarding Capital Formation
Kenneth Kaufman
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Seminars on finance are typically poorly attended according to Kenneth Kaufman, founder and Managing Partner of Kaufman, Hall and Associates, Inc. This statement was challenged by the increased number of participants registered to hear him speak September 5th at Health Policy Institute's Governance Initiative Briefing held at the University Club in Oakland. Mr. Kaufman addressed *The Board's Contribution to Capital Formation* by asking what he called the Critical Governance Question for 2003 and the coming years: "Is the overall not-for-profit hospital financial performance sufficient to meet accelerating capital requirements brought on by the aging baby boomers and the increasing pace of technological change?"

In an interactive exchange of enlightening dialogue with board members and senior managers, Mr. Kaufman, a financial and capital planning consultant to healthcare organizations nationwide, explained the hospital board's financial responsibility in the current scenario of health care.

Through a demonstration of financial indicators in the not-for-profit healthcare industry, Kaufman stated that median not-for-profit hospital operating margins have decreased from 3.6% in 1997 to 1.7% in 2002, and that debt is now higher than cash -- the cash-to-debt ratio has declined from 102.6% in 1997 to 91.0% in 2002. He declared that hospitals have not yet recovered from the changes in Medicare reimbursement brought on by the passing of the Balanced Budget Act in 1997.

"There is not one hospital board in the United States that does not 'mean well'. However, there is a big gap between 'meaning well' and 'doing well', which needs to be bridged. Hospitals and their boards can only do well if they have a certain level of competence and capability," Kaufman stated. To effectively guide their organizations to a promising and secure future, in addition to appropriate background qualifications, all board members should possess a minimum level of basic financial education and at the very least be able to read and understand a financial statement.

Mr. Kaufman emphasized the need for the board and senior management to develop a financial plan or a governance roadmap at least once each year. He stressed the need to have consistent and constant access to debt markets. In his opinion, "the most important financial decision made each year by senior management and ratified by the board is how much capital to spend and on which initiatives the dollars will be spent."

He stated this is the time for management of sophisticated capital structures, the end of "plain vanilla" finance and the emergence of "big think" transactions. Kaufman believes financial success is directly correlated to the notion of "heavy finance."

Hospitals need to strike a balance between "under investment" and "over investment" and they need to address both their short-term goals and their long-term financial strategies.

He stated that approximately 90 percent of hospitals are in the over investment area, an issue that board members should ask management to account for and adjust.

Kaufman recommended that hospital boards pay close attention to detail when ratifying the proposals of senior management regarding capital allocation. Some of his suggestions include advice to:

- Assure that the portfolio of major capital investment decisions will support the mission and add measurable financial and strategic value
- Provide rational and consistent guidelines for capital investment decisions
- Develop uniform criteria and a formal review process for evaluating the current and long-term impact of all capital investment decisions
- Integrate the financial requirements of the capital allocation process and the impact of approved capital expenditures with the annual operating budget and five-year financial plan
- Support financial benchmarks and enhance the financial strength and integrity of the hospital by improving its capital capacity

In order to better understand the debt structure of their hospital, Mr. Kaufman recommends board members ask capital structure questions that can make a difference, including:

- What is our total amount of debt and what form does this debt take?
- What is the relationship of fixed to variable-rate debt and is that relationship appropriate?
- What is the relationship of “committed” to “uncommitted” debt in our portfolio?
- What is the amortization and maturity structure of our debt and is that structure appropriate to current and predicted cash flow of our organization?
- What is our all-in cost of capital and how does that cost of capital relate to current interest rates and current yield curves?

Kaufman stated that hospitals are currently full of clinical experts, but finance departments are often understaffed. He advised board members to not commit the mistake of “marginalizing” finance and suggested that hospital boards could avoid significant financial defeats by adopting the mantra of “4 A’s: Anticipation, Attention, Analysis and Action.” Boards should refrain from adopting the practice of “incrementalism”- dealing with financial events on a one-by-one basis, and not understanding the implications of the whole portfolio.

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