Hospital Financial Analysis 2003 Preview

The Pennsylvania Health Care Cost Containment Council (PHC4) is an independent state agency charged with addressing the cost and quality of health care in Pennsylvania.

In order to maintain a high quality, cost-effective health care delivery system, hospitals and freestanding surgery centers must be financially viable and effectively managed. To this end, the Council has produced a series of annual reports that measure the financial health of the Commonwealth's hospitals and surgery centers and the utilization of their services.

In response to the high level of interest in the financial condition of Pennsylvania's general acute care (GAC) hospitals, the Council is releasing this Preview in advance of its forthcoming Financial Analysis for Fiscal Year 2003, to be released in Spring 2004.

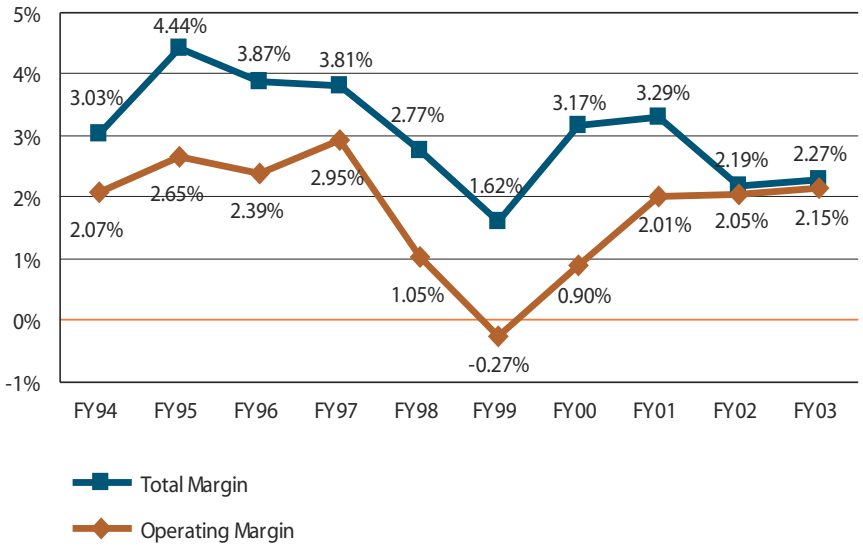
The information summarized in this Preview comes from the hospitals' audited financial statements and additional data submitted directly by the hospitals. The Council wishes to thank the hospitals for their cooperation and timeliness.

More PA Hospitals Lose Money in FY03; Statewide Income Flat

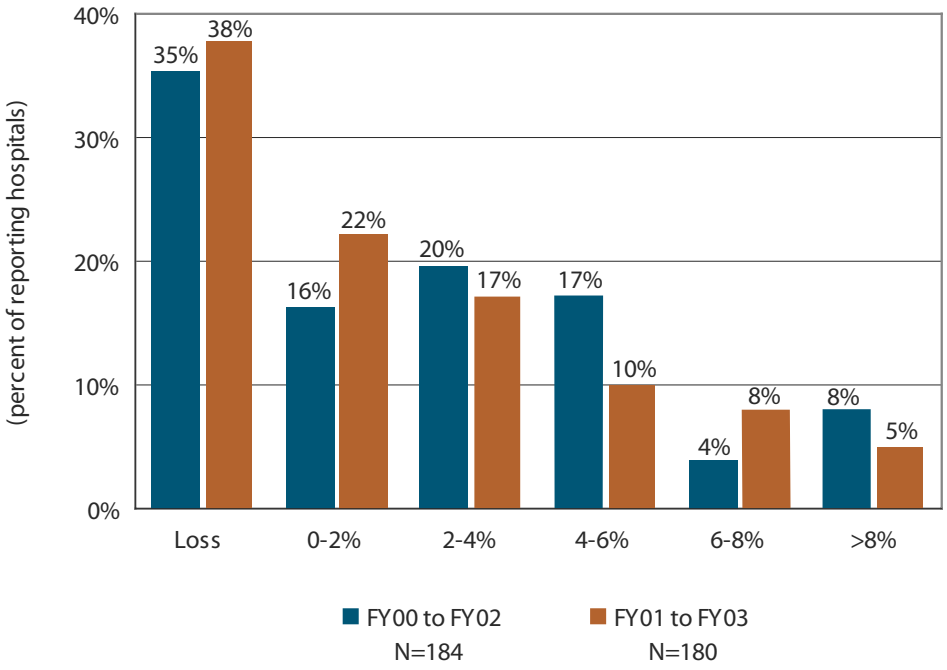
The overall net income realized by Pennsylvania's GAC hospitals edged slightly higher during FY03. The statewide average total margin increased from 2.19% in FY02 to 2.27% in FY03. The total margin reflects the net income hospitals realize from all sources including operations, investment gains and contributions.

The improvement in the total margin was primarily driven by a small rise in the income hospitals produced from operations. The statewide operating margin increased from 2.05% in FY02 to 2.15% during FY03. Operating income improved because, on a statewide basis, hospitals were able to keep the 9.0% growth in operating expenses below the 9.2% increase in revenues. A hospital's operations include patient care as well as a number of other related functions such as medical education, office space, parking and cafeterias.

Statewide Average Total and Operating Margins



Statewide Distribution of Three-Year Average Total Margin



Non-Operating Income Remains Low

During FY02, the GAC hospitals experienced an 88% drop in statewide non-operating income largely due to declines in the income hospitals received from their investments as well as losses in the value of the securities held by hospitals. During FY03, the non-operating income of $30.5 million remained very close to the FY02 levels as hospitals continued to experience losses in the value of their investments and low returns.

One hundred sixty-eight (168) of the 185 GAC hospitals are operated as non-profit corporations. Consequently, Pennsylvania's GAC hospital industry relies heavily on non-operating income such as investment income and contributions to sustain its operations. In FY00, non-operating income represented 67% of all of the income realized by hospitals. In contrast, non-operating income represented about 16% of total hospital income during FY03.

Since total margin is still positive, the industry as a whole is realizing enough revenue to pay its expenses. However, at the current statewide total margin of 2.27%, many hospitals in Pennsylvania may continue to find it difficult to replace worn-out or obsolete equipment and to finance improvements to their facilities and equipment.

A Larger Percentage of GAC Hospitals Lost Money in FY03

Despite the slight improvement in the statewide total margin, the percentage of hospitals that lost money during FY03 grew to 48% compared to 42% during FY02 and 34% in FY01. Eighty-seven (87) of the 182 reporting GAC hospitals reported negative total margins for FY03.

The percentage of hospitals that sustained average losses over the past three years also increased from 35% during FY02 to 38% in FY03. There was a more dramatic reduction in the number of hospitals that posted three-year average total margins in the 2% to 6% range. The reduction in the number of hospitals in the 2% to

6% range was offset by increases in the number of hospitals that had a three-year total average margin below 2%. This is a clear downward trend in the medium-term (3-year average) income of hospitals. The deterioration of investment income and the decline in the value of hospital investments are major contributors to the decline in overall hospital income.

Act 77 (Tobacco Settlement Act) Requires a New Methodology for Calculating Uncompensated Care Levels

In order to meet its responsibilities under Act 77 of 2001 (Tobacco Settlement Act), PHC4 has modified the manner in which uncompensated care data is captured and reported. To implement the recommendations of the Advisory Committee established by Act 77, PHC4 has required hospitals to report bad debt at full charges for FY03.

Prior to FY03, PHC4 utilized the bad debt amount posted in each hospital's audited financial statements. For some hospitals, the bad debt reported in the financial statement is a combination of charges and foregone revenue. Prevailing accounting standards give hospitals discretion in reporting bad debt. Historically, charity care has been submitted to PHC4 on a charge-basis. Now that bad debt and charity care are both being reported as charges, uncompensated care is reported on a uniform basis by all hospitals. Therefore, PHC4 can now present uncompensated care revenue by utilizing each hospital's revenue-to-charge ratio. This ratio is based on the average overall reimbursement hospitals received from all payors including commercial health insurers, Medicare, Medical Assistance and patients.

Using New Methodology, Uncompensated Care Levels Fall During FY03

On a statewide basis, GAC hospitals provided $2.4 million less in uncompensated care in FY03. This decline in uncompensated care coupled with the increase in statewide net patient revenue (NPR) resulted in a decline in the portion of unreimbursed hospital care (as a percent of NPR) from 2.27% in FY02 to 2.07% in FY03.

The following table shows statewide uncompensated care calculations using the new methodology compared to the prior methodology. For FY03, the previous methodology would have shown more than $1 billion of uncompensated care because a substantial portion of that calculation was based on charges instead of revenue. In addition, the previous method-

Comparison of New and Previous Methods of Calculating Uncompensated Care

	FY01	FY02	FY03
Uncompensated Care Revenue – New Method (millions)	$429*	$460*	$457
Uncompensated Care Revenue – Previous Method (millions)	$867	$966	$1,080
Percent of Uncompensated Care – New Method	2.29%	2.27%	2.07%
Percent of Uncompensated Care – Previous Method	4.62%	4.77%	4.89%

* The uncompensated care levels for FY01 and FY02 are estimates based on the assumption that hospitals did not change their accounting procedures for bad debt between FY01 and FY03.

ology would have shown the "Percent of Uncompensated Care" remaining relatively constant at 4.89% during FY03, while under the new method, uncompensated care levels fell. The previous method would have inflated the increase in uncompensated care because statewide charges grew more than twice as fast as statewide NPR during FY03.

Why the Uncompensated Care Levels and Rates are Lower with the New Methodology

Prior to FY03, PHC4 was unable to determine the portion of each hospital's bad debt that was posted as either charges or revenue. By comparing bad debt reported at full charges to the bad debt reported in financial statements, PHC4 can now determine that, on average, about 96% of the bad debt posted by hospitals was based on charges. Consequently, the previous method for calculating uncompensated care was essentially comparing uncompensated care on a charge-basis to statewide NPR.

How Uncompensated Care is Calculated

The "Percent of Uncompensated Care" reflects the portion of all care that was written off as either bad debt or charity care. This percentage is calculated as the ratio of statewide bad debt and charity care reported as charges to the total charges for all care provided by GAC hospitals.

"Uncompensated Care Revenue" provides an estimate of the amount of revenue hospitals lost due to bad debt and charity care. This foregone revenue reflects what hospitals would have received if they had been reimbursed for uncompensated care. The estimate of foregone revenue is based on the average overall reimbursement hospitals received from all payors including commercial health insurers, Medicare, Medical Assistance and patients.

All services and materials that are provided to the general public under an established fee are eligible to be included in uncompensated care. Consequently, the costs of important public health programs may not be included. Hospitals frequently report these activities separately.

Some hospitals include the difference between the reimbursement they receive from government-funded programs, such as Medical Assistance, and their customary fees or charges as a component of charity care in their audited financial statements. These differences are NOT included in the uncompensated care levels reported to PHC4. However, if a patient fails to pay a required co-payment, or receives care beyond the range of services covered by a third-party payor, these foregone revenues may be included in charity care or bad debt.

PHC4

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