Introduction

WHY THIS BOOK?

Since the publication of the first edition of this book in 2007, the business model used in healthcare for more than a half century has started a profound transformation. Unsustainable national healthcare costs are driving legislation, regulation, and competitive market responses that are rapidly changing healthcare from a volume-based delivery and payment system focused on illness to a value-based system focused on managing population health.

This transformation is placing unprecedented demands on the nation's hospitals, health systems, and related provider organizations. More than at any time in the past, an organization's long-term success and sustainability hinge on smart, strategic investment decisions being made today and in the time since the business model transformation began. Tightening margins increasingly conflict with an ever-expanding list of high-dollar capital needs related to positioning organizations for success under the new model.

Few healthcare organizations have sufficient capital capacity to meet their comprehensive strategic requirements. Their leaders must make choices. How much capital to spend and on which projects or investments are critical decisions with long-term strategic and financial implications.

Executives in the nation's hospitals, health systems, and other provider organizations frequently struggle with making these decisions. As a result, wide variations exist in the decision-making processes used to allocate scarce capital resources. Many organizations implement portions of the best-practice capital allocation and management process described in this book, and they are very adept at managing those aspects. Few organizations, however, address capital allocation and management comprehensively, likely because of the cultural and organizational challenges associated with developing and implementing a strategic capital decision-making process.

Decision-making authority is often a key issue. At what level should capital decisions be made, and who should be involved in their review and approval? Issues surrounding appropriate decision criteria also are critical. Are criteria defined and consistently applied organization-wide? Technical challenges—such as calculation of capital availability, the qualitative and quantitative metrics required for project analysis and review, and the mechanics of integrating the capital allocation and management process with the organization's strategic and financial planning—are numerous and can present significant roadblocks.

Capital management as an integral component of an organization's comprehensive decision-making process is vital to the organization's ability to optimize both its strategic and its financial position. A fully integrated capital allocation and management process provides complete support for the organization's strategic objectives and its ability to sustain successful performance.

GOALS OF THIS BOOK

An organization's ability to address these issues largely determines its strategic future. The design and implementation of a capital decision-making process in healthcare organizations that embraces a corporate finance–like approach is strongly recommended. America's highest-performing organizations in healthcare and other industries use corporate finance principles to manage the strategic and financial risk of their organizations.

Strategic Allocation and Management of Capital in Healthcare: A Guide to Decision Making provides leadership teams with detailed guidance on making the best strategic investments. Like the first edition, it offers a corporate finance–based framework and approach to disciplined capital decision making and management.

In addition, this revised edition reflects the need for the capital decision-making approach to evolve to meet the new environment. It includes examples of the application of concepts using the experiences of specific hospitals and health systems. Developed through engagements and interviews with senior leaders, this material focuses on strategies used to address the barriers these organizations encountered, thereby helping readers to apply the approach in their own organizations. The new edition also includes on-the-ground guidance for managers responsible for the implementation of each chapter's concepts.

Applicable to all healthcare organizations—from small community hospitals to large healthcare systems and physician organizations—*Strategic Allocation and Management of Capital in Healthcare: A Guide to Decision Making* aims to help healthcare organizations achieve and sustain competitive, strategic financial performance.

CONTENTS OVERVIEW

The nine chapters of *Strategic Allocation and Management of Capital in Healthcare: A Guide to Decision Making* outline a best-practice capital management framework and process. Each chapter covers a distinct topic. Examples of framework and process applications in different settings—such as a community hospital and a small, multihospital health system—are provided, as appropriate. Also included is practical guidance for managers who are responsible for implementing the chapter's concepts.

Chapter 1, "Capital Allocation and Management Essentials," defines capital allocation and management and describes how the process is integrally linked through the capital management cycle with the organization's strategic, financial, and capital planning and budgeting processes. The chapter offers a contemporary definition of capital and identifies the types of investments covered through a corporate finance–based approach. It describes the significance of high-quality capital management, outlines common and emergent approaches to allocating capital in healthcare organizations, and concludes with the characteristics of a recommended process.

Chapter 2, "Establishing the Framework," provides guidance on constructing a framework that supports best-practice capital allocation and management. The framework has concrete objectives—consistency, standardization, transparency, known timing, and use of analytics—and it follows core principles, such as equal access to dollars, one-batch review, and portfolio decision making. The chapter also describes how organizations can design or redesign their existing processes and establish a successful governance structure and process calendar that will drive integrated planning and decision making organization-wide.

Chapter 3, "Determining the Capital Constraint," describes the approach executives can employ to quantify the level of capital their organization can afford to invest in the near term and long term. The chapter details the mechanics involved in calculating the capital constraint (net cash available for capital investment), which include determining cash flow, debt proceeds, philanthropic funds, working capital, principal payments, carryforward capital, cash reserve requirements, and other sources and uses of cash. The chapter concludes by explaining why the capital constraint must be defended from common challenges such as those posed by equipment leases; broadened information technology; and new-era calls on capital, such as risk reserves, partnerships, and physician practice acquisitions.

Chapter 4, "Defining the Capital Pools," describes how executives should determine the pools into which the total capital dollars available for investment will be divided. The chapter recommends an approach using three pools: (1) threshold capital, defined as the pool for any capital expenditure above a certain dollar amount that requires comprehensive analysis and centralized review; (2) nonthreshold capital, defined as the pool for requests with associated costs below the threshold dollar amount; and (3) contingency capital, defined as the pool that supports and provides reserves for projects occurring through the other two pools. In addition, the chapter outlines methods for funding and managing the pools.

Chapter 5, "Allocating and Evaluating Nonthreshold Capital," provides a recommended approach to allocating nonthreshold capital, which is typically managed on a decentralized basis, for requests with costs below the threshold dollar amount. The chapter explains how to handle allocation to revenue-generating units as well as to nonprofitable, non-revenue-producing, and small operating units. It also provides information on evaluating nonthreshold capital projects using standardized capital request templates supported by a flexible software tool, an approach that enhances an organization's ability to review the appropriateness of estimated costs and timing and to explore opportunities to combine requests to gain purchasing power and efficiency. A sample template is provided.

Chapter 6, "Evaluating Threshold Capital Investment Opportunities," describes the benefits of using a formal, one-batch process with consistent evaluative criteria to review requests for and allocate capital to large-dollar, threshold capital initiatives. The chapter outlines the key elements of the business plan or standardized project review form that should accompany each request. Corporate finance–based techniques for quantitative return-on-investment analysis are described in detail, including net-present-value analysis and expected-net-present-value analysis. The chapter explains how to quantify qualitative measures and appropriately weight both quantitative and qualitative criteria. Of particular note is the discussion on how to handle large, multiyear projects in an annual process.

Chapter 7, "Selecting Threshold Capital Projects Using a Portfolio Approach," describes how organizations can combine the information obtained through quantitative and qualitative analyses to select a portfolio of threshold projects that balances margin and mission. The chapter outlines the processes involved in constructing both quantitatively based and qualitatively based rankings of projects and in uniting these rankings to select a portfolio of initiatives that will ensure the organization's continued competitive performance.

Chapter 8, "Managing the Postallocation Process," describes what should occur after allocation decisions are made. Activities covered in the chapter include funding review and revalidation, which ensures the integration of new data or information obtained after project approval; decision making regarding the timing of capital spending; handling of any budget deficits or surpluses; addressing emergency and off-cycle requests; ongoing monitoring of project performance; and taking appropriate actions based on performance results.

Chapter 9, "Making It Happen and Keeping It Going," describes the prerequisites for the successful implementation of a high-quality capital allocation and management process. These requirements include education, use of high-quality tools, communication and transparency, and a disciplined implementation plan with a realistic time frame.