- **Portfolio return.** A continuously changing capital spending plan essentially creates serial capital review and approval, which diminishes the organization's ability to understand the potential return on investment of the capital investment portfolio.
- **Corporate-based financing decisions.** The lack of a firm capital portfolio diminishes the ability of the chief financial officer (CFO) to make valid financing decisions. If the portfolio changes, financing structure and cost of capital are affected. A basic tenet of corporate finance is the separation of project and financing decisions. This concept reflects the need to optimize access to capital by matching the organization's approved capital requirements to potential means of financing (i.e., debt versus equity). Furthermore, in the realm of tax-exempt financing, debt must be associated with specific, appropriate capital initiatives with quantified useful lives. If an initiative is altered to reflect a short-term change in priorities, the tax-exempt status of debt issued for the initiative could be materially affected.

As other approaches to capital allocation and management are developed over time, they also should be evaluated relative to current best practices. It is vital to understand whether proposed new approaches embody the key tenets of corporate finance; reflect the reality of capital acquisition and financing in healthcare; and support consistent, standardized, and metrics-based decision making that creates accountability and transparency.

CHARACTERISTICS OF A BEST-PRACTICE PROCESS

The recommended approach to allocating capital in healthcare organizations should be no different than that used by many *Fortune* 500 corporations. A best-practice approach has the following objectives:

- To support the mission and strategic goals of the organization
- To match capital availability to financial performance
- To protect or create capital capacity
- To provide uniform criteria for project evaluation
- To maximize transparency and, therefore, accountability
- To maintain the highest possible bond rating (i.e., optimal access to capital)
- To ensure consistent investment in the highest-performing assets

Structurally, best-practice capital management is founded on the following key elements:

- A high level of governance, education, and communication
- A coordinated calendar and planning cycle
- Direct links to a sound strategic and financial plan
- Clear definitions of available capital and capital expenditures
- Rigorous, quantified, and consistent business planning for each investment opportunity
- A standardized, one-batch review of potential investments
- Consistent application of quantitative analysis using corporate finance–based techniques
- Data-driven and team-based decision making
- Rigorous postapproval project monitoring and measurement

All of these characteristics, which shape the contents of the rest of this book, are evident in leading US hospitals and health systems. In many other organizations, progress is being made and pieces of this best-practice process are in place, but they are not yet fully integrated with the entire process or with the other components of the capital management cycle. In yet other organizations, the problematic approaches described earlier result in varying degrees of dysfunction in the management of the organization's capital process and the results it generates.

An ongoing survey of capital management approaches employed by health systems of varying sizes and locations indicates that most systems have processes with similar characteristics, though with some variations as a result of organizational and cultural characteristics (Sussman 2016). Rigor, discipline, transparency, and standardization are present in all systems that consider their capital allocation and management process to be successful.

Common Challenges

Three significant challenges prevent comprehensive application of important principles and practices related to capital allocation and management:

1. **Overconfidence.** Some executives may believe that because their organization already employs many best-practice components (e.g., use of standardized analytics by designated capital committees to review proposals for individual capital projects), nothing needs to change. However, a best-practice capital

management process requires comprehensive implementation of *all* the key components. Even if an organization generates superior project-based analytics, the annual review and allocation of capital using a single-batch approach, as discussed in chapter 6, is vital. This approach prevents an organization from mistakenly approving a reasonable but mediocre project in the first quarter of the year, only to find itself without capital resources to invest in a more deserving opportunity in the third quarter. Furthermore, in this type of serial approval scenario, the organization cannot know the true value of the total portfolio of capital decisions made on a fiscal-year basis until well after the fact.

2. **Politics and management style.** The management style of some leaders can prevent the development and use of a best-practice process. Some CEOs and CFOs find it easier to make unilateral capital decisions than to deal with the politics of a process. They may not want to involve certain constituencies who have favorite projects. In excluding these stakeholders, however, the leaders exacerbate organizational politics while defining themselves as the lightning rods for other capital decisions that have bad consequences. They do not realize that physicians, patients, board members, community members, department managers, and payers can be effective advocates, not just obstacles.
3. **Perceived financial strength.** An organization's perceived financial strength is perhaps the most pernicious of the three common challenges, especially during times of business model change. Leaders of organizations that have achieved strong performance under a volume-based system may believe that a "bureaucratic" structure for managing capital spending is not needed as the organization moves to a population health, value-based delivery system. This perception, whether the result of overconfidence or lack of focus, leaves many otherwise high-performing organizations vulnerable both strategically and financially. Over several fiscal years, inconsistent capital decisions that are not integrated with an organization's overall strategy can transform a cash-rich entity with a high credit rating into a cash-poor entity with a lower credit rating. The organization will face significant pressure to rebuild its balance sheet while also trying to find dollars to pursue strategic capital needs.

A best-practice approach to capital allocation and management has a framework with four elements: (1) objectives; (2) principles; (3) process governance; and (4) connected, calendar-driven planning and decision making. These four elements are discussed in chapter 2.

IMPLEMENTATION CONSIDERATIONS

Redesigning the capital allocation and management process is a significant change initiative. To achieve an organization's vision, knowing where the journey begins is just as important as knowing where it is going. To understand the organization's starting point, ask the following questions:

- What investments are receiving capital resources in the organization? Are the initiatives receiving resources consistent with the organization's strategies? How has this evolved from traditional areas of focus?
- Which approaches to decision making regarding capital investments have been employed in the organization?
- What, if any, best-practice characteristics are part of the organization's existing capital allocation and management process?
- What challenges might the organization encounter in reevaluating its process?

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