

**Report on the Financial Condition of Maryland Hospitals**  
**Fiscal Year 2005**

October 2006  
Health Services Cost Review Commission  
4160 Patterson Avenue  
Baltimore, MD 21215

## **Maryland Hospitals Financial Conditions Report, Fiscal Year 2005**

### **Introduction**

In fulfillment of one of its statutory mandates, the Health Services Cost Review Commission (“HSCRC”) reviews and evaluates the financial condition of the Maryland hospital industry. In carrying out this evaluation it reviews industry performance on a group of selected indicators relative to overall preferred industry target values. The Commission has traditionally concerned itself with the financial performance of the industry overall and indeed the results of this evaluation has lead to policy action by the Commission in the past. It should be emphasized however, that the evaluation and analysis contained in this report is limited to aggregate industry oversight and is not applied at an individual hospital level. Likewise any policy action in response to changes in financial condition is applied at an aggregate industry level. As stated in the original Financial Condition Study (1989), in evaluating and utilizing these targets, “no one target, financial or operating, was intended to be viewed as dominant”. While the Commission reports on overall financial condition, its rate regulatory authority is limited to acute inpatient services and charges (as defined by Medicare) and outpatient facility services and charges provided at the hospital. Gains or losses on unregulated services are outside the responsibility and control of the HSCRC.

### **Report Contents.**

This report presents analysis of trends in selected financial and operating indicators, as well as comparisons of the 2004 and 2005 performance of Maryland hospitals. It contains tables summarizing these indicators by hospital category -- a) Acute hospitals; and b) Specialty and Psychiatric hospitals combined. Unlike the HSCRC’s Annual Disclosure of Hospital Financial and Statistical Data, which focuses chiefly on activities regulated by the HSCRC, this report focuses on all of the activities of the hospital legal entity. With the exception of Appendix Table 2, cost per equivalent admission, which was obtained from American Hospital Association’s “Hospital Statistics”, the data in this report are derived from the audited financial statements of the hospitals.

Although, the definition of what constitutes a “hospital” has changed over the life of this report (which inevitably results in some mis-matching of data elements over time) the HSCRC believes that the report continues to be useful in revealing trends related to the financial condition of the

hospital industry in the State.

**The indicator targets are as follows**

**Operating Margin** –Chart-1- The operating margin is the excess of operating revenue over operating expenditure as a proportion of total operating revenue. Operating margin is the profit/loss from hospital operations, i.e. profitability. It does not include revenue from non-operating sources. It is used by many as a primary test of profitability. Three major uses of operating margin are working capital increase, debt retirement, and fixed asset investment. Therefore, positive operating margins help support growth and expansion of services; to accommodate inflation; to purchase replacement equipment; to acquire new technology; and to maintain modern physical plants.

$$\text{Operating Margin} = (\text{Total Operating Revenue}-\text{Operating Expense})/ \text{Total Operating Revenue}$$

**Excess Margin** – Chart- 2- The excess margin is the proportion of total revenue that exceeds total expenses, (before taxes). This ratio takes into account non-operating revenues such as contributions and income from investments and auxiliary enterprises, as well as other operating sources. It indicates a major source of revenue available to the institution for replacing capital, acquiring technology, and expanding services.

$$\text{Excess Margin} = (\text{Total Revenue}-\text{Total Expense}) / (\text{Total Operating Revenue} + \text{Non - Operating Revenue})$$

**Efficiency or Cost per Equivalent Admission** - Chart 3 - This is the average cost of inpatient admissions plus a conversion of outpatient visits into equivalents. This has been the basic indicator for gauging the success of the Maryland hospital industry performance on the dimensions of hospitals' cost control mechanism, since its inception.

$$\text{Cost per EIPA} = \text{Total Expenditure} / \text{EIPA}$$

**Debt to Capitalization** – Chart -4- This ratio measures the how much a hospital's net worth is accounted for by long term debt. It may also shed light on the borrowing capacity of the industry.

$$\text{Debt to Capitalization} = \text{Long Term Debt} / (\text{Long Term Debt} + \text{Fund Balance})$$

**Days of Cash** – Chart -5- This ratio measures the number of days an entity could meet its average daily expenditures with existing liquid assets, namely cash and short term investments. Higher values of this ratio imply a more liquid position, other factors remaining constant.

$$\text{Days of Cash} = (\text{Cash} + \text{Short Term Investments} + \text{Long Term Investments}) * 365 \\ / (\text{Total Expenditures} - \text{Depreciation})$$

**Average Age of Plant** –Chart 6 Average age of plant is an accounting measure of the average age of fixed assets in years. Lower values indicate a newer fixed asset base and, thus, fewer needs for near term replacement. Caution must be used in interpreting the significance of the age of plant ratio. The ratio can be altered significantly by the purchase or sale of fixed assets. Also, as with all of the indicators, more credence should be placed on the trend being experienced rather than on a value at a given point in time.

$$\text{Average Age of Plant} = \text{Accumulated Depreciation} / \text{Depreciation}$$

### **General Observations of Financial Performance during 2000 – 2005.**

Maryland hospitals' operating performance showed an optimistic trend with increases in both operating and excess margins from 0.80% to 3.20 for operating margin, and from 2.40% to 4.1 % for excess margin during the 2000-2005 period. The average age of plant increased from 9.10 years in 2000 to 10.31 years in 2005. The debt to capitalization increased from 0.40 in 2000 to 0.46 in 2005 and the days of cash increased to 116 days. During this period the Maryland hospitals' margins of profit and the cost per EIPA remained below the national level. Charts and Appendix tables in the following pages reflect trends in the operating performance of hospital industry in Maryland. Commission action followed its Rate Redesign activity, which involved a move to Charge per case methodology in 2000. Accompanying this methodology were restrictions on annual rate increases that contributed to less than robust financial performance, after a period of record financial performance from 1995 through 1999.

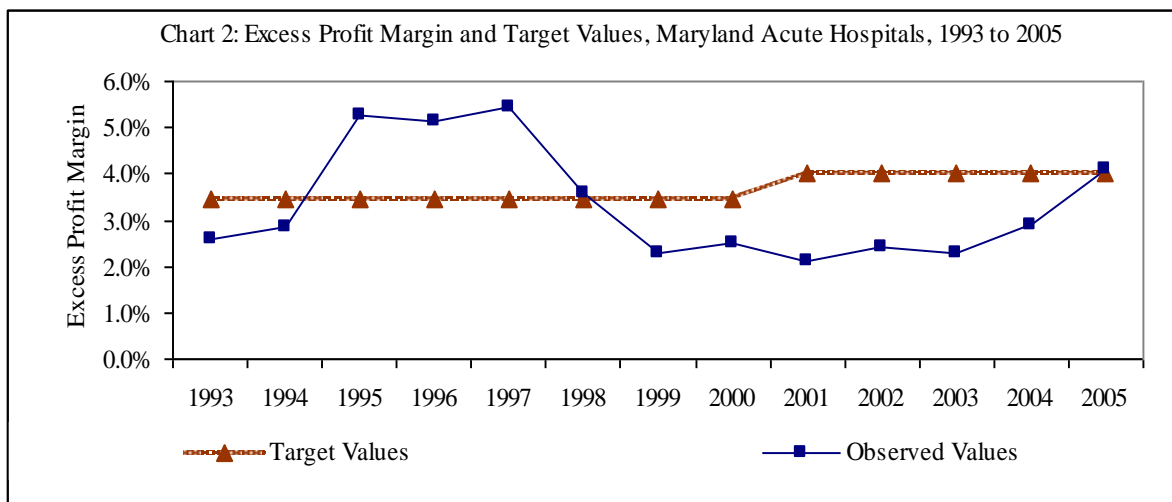
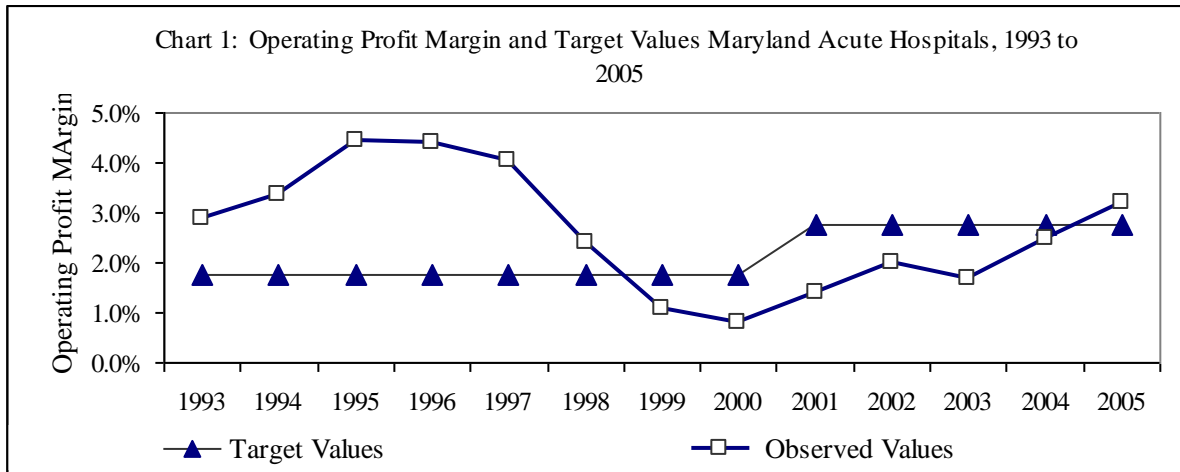
## **Sources of Data and Results**

The tables 1, 2 & 3 on pages 9 through 11 summarize industry performance relative to indicator targets. Table 1 provides the current financial and operating indicators of Maryland Acute hospitals with their respective target values. Table 2 provides selected statistics for operating and financial indicators. Table 3 contains the financial and operating indicators for the Specialty and Psychiatric hospitals. The current and historical patterns of these indicators are summarized in the following paragraphs. Charts showing trends on financial and operating indicators precede the summary discussion. Data used in producing these charts are provided in Appendix tables 1, 2 and 3. The target indicators used for this study are those approved and adopted by the Commission. The Maryland data used to calculate the financial indicators for 2004 and 2005 are from the hospitals' audited financial statements. The cost per equivalent inpatient admission (EIPA) data for the nation in Appendix tables 2 are from Hospital Statistics. The cost per EIPA data for Maryland hospitals from 1993 through 2000 are from Hospital Statistics. The US hospitals statistics for the year 2005 are not available; therefore, all comparisons of Maryland and the nation are made with data available up to the year 2004. The Appendix discusses the composition and work of the Financial Conditions Work Group. Appendix table 1 presents selected historical and current financial indicators for Maryland hospitals and Appendix table 2 contains cost per EIPA for Maryland and the US. Appendix tables 3 & 4 presents selected indicators by hospital for Maryland hospitals.

## **Operating Profit and Excess Margin**

Operating profit and excess margin are indicators of revenue over expenditure as discussed above. Further the hospitals' actual results are based on regulated and unregulated business. In response to the deteriorating financial performance of Maryland hospitals, the HSCRC began adding a makeup provision to the annual update factor in 2004. These were additional 1% provisions intended to assist the industry recapitalize. This policy change led to improved financial performance in 2005, with operating margins of 3.20% versus a target value of 2.75%, and excess margins of 4.10% versus a target value of 4.00%. Charts 1 & 2 on the following page shows trends in operating and excess margins.

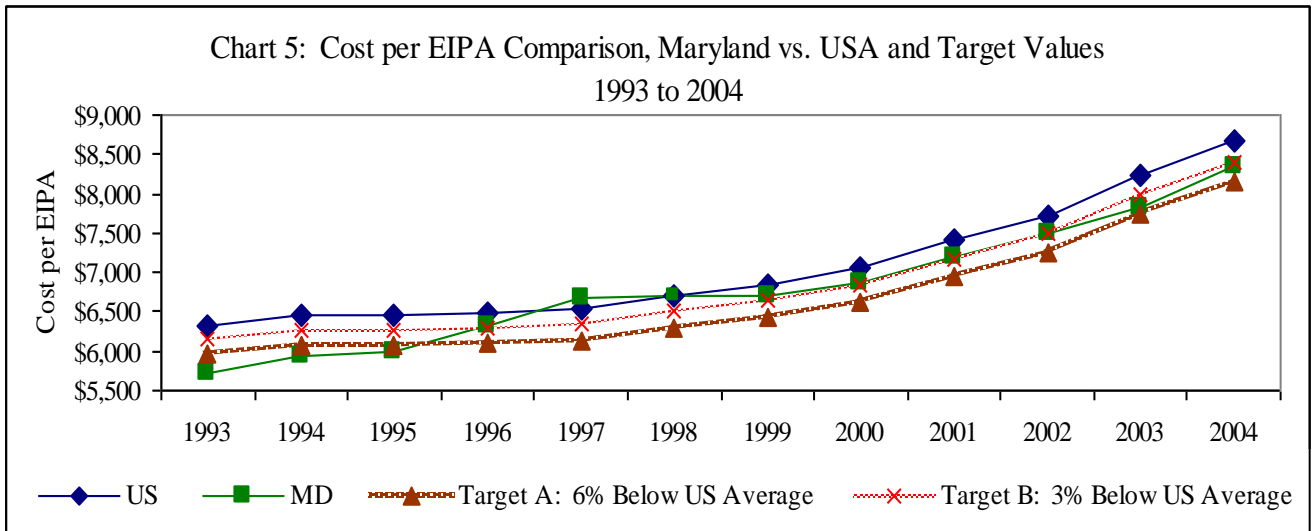
## Maryland Acute Hospital Operating and Excess Profit Margins vs. Target Values<sup>3</sup>



### Cost per EIPA

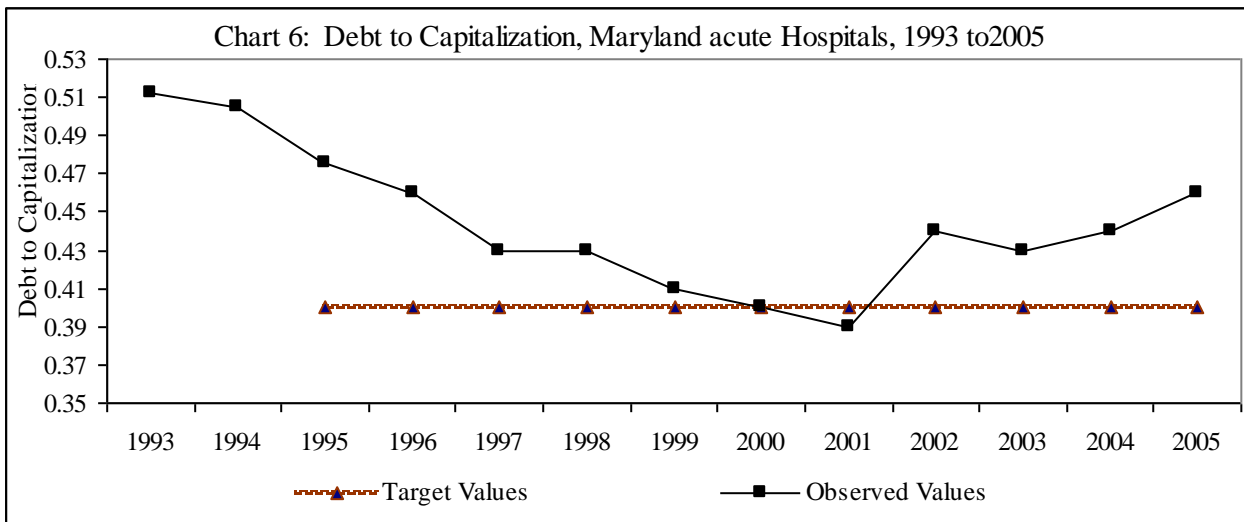
The cost per EIPA, a measure of efficiency, has remained below the US average since 1993 with the exception of 1997 and 1998. The most recent estimate of cost per EIPA, as reported by the American Hospital Association, was \$8,339 for Maryland and \$8,665 for the nation. In 2004, the Maryland cost per EIPA remained within the set target of 3% - 6% below the national average.

<sup>3</sup> Maryland data for the years 2001 to 2003 are from the HSCRC's Audited Financial Data



### Debt to Capitalization

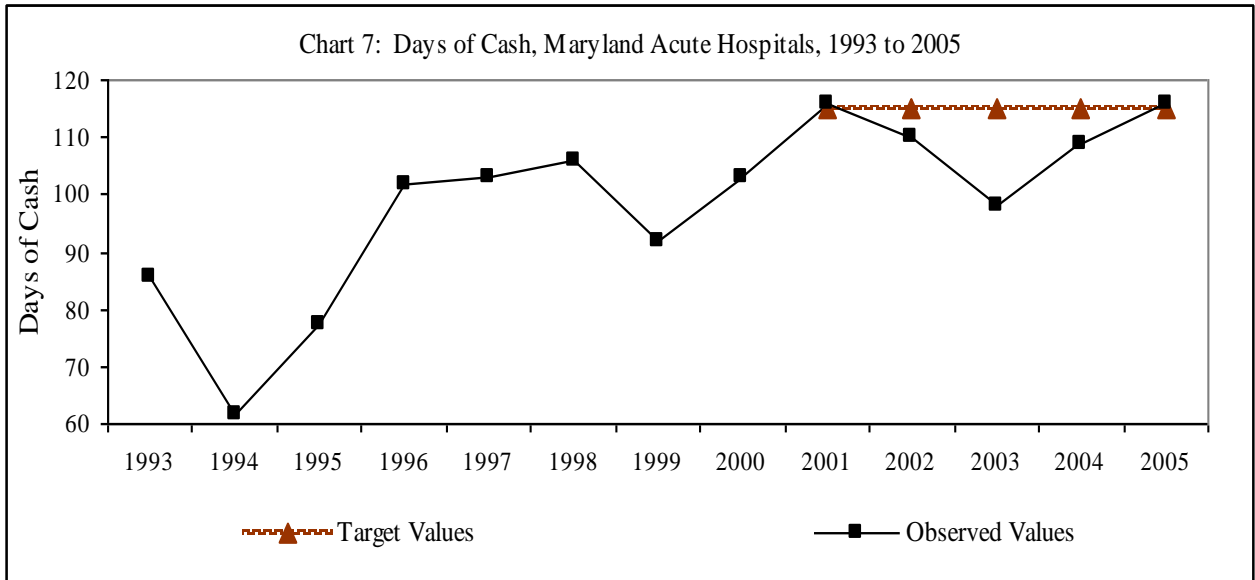
Debt to capitalization, a measure of how much of hospitals' net worth is accounted for by long term debt was 0.46 in 2005, greater than the set target of 0.40.



### Days of Cash

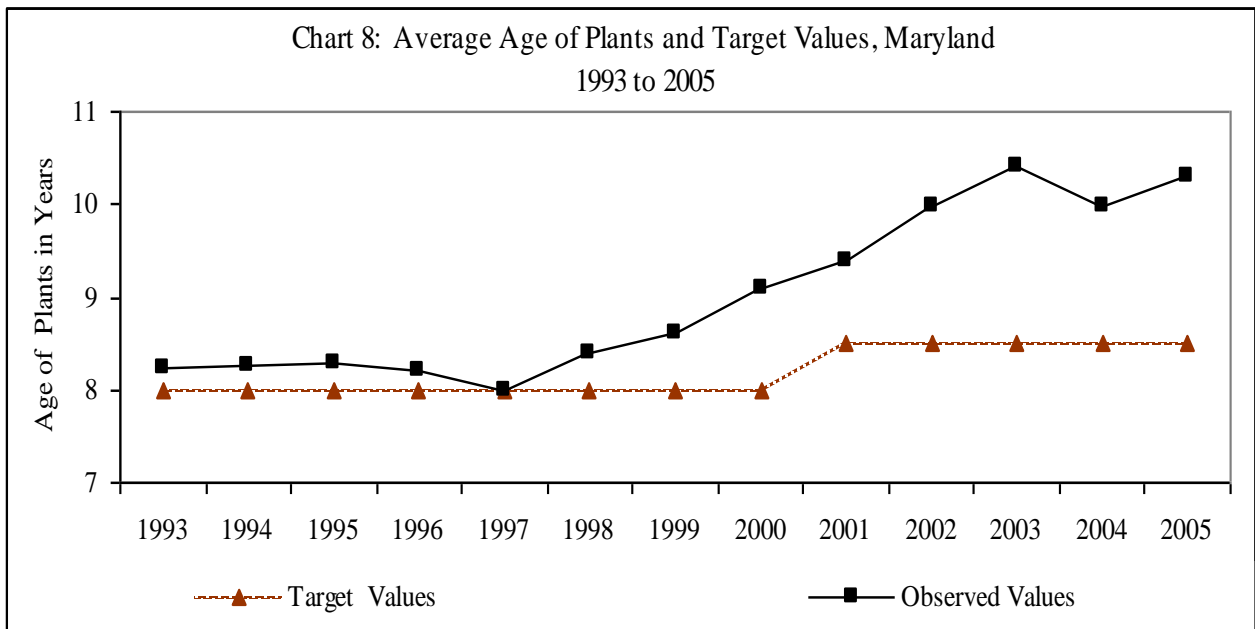
Days of cash, a measure of liquidity, continues its importance to hospital administrator as well as bond rating agencies

The average days of cash in 2005 was 116 days, higher than the set target of 115 days.



**Average Age of Plant**

The average age of plant, measuring the average age of fixed assets in years, has increased from 8 years in 1997 to 10.31 years in 2005, higher than the set target of 8.5 years.





## Summary of Maryland Acute Hospitals' Performance 2005 versus 2004

In 2005 the operating and excess profit margins for were 3.20% and 4.10% respectively. This compares to their respective values of 2.54% and 2.90% in 2004. Their respective targets were 2.75% and 4.00%. The operating margin's current position is 13.0% above the desired target of 2.75% while the excess margin is slightly above the target of 4.0%. The current position is 4.10%. The median values for operating and excess margins for 2005 were 2.98% and 3.63%.

- The average age of plant was 10.3 years. The current position is above the desired target of 8.5 years. The median value was 10.8 years.
- The debt to capitalization ratio was 0.46, above the target of 0.40. The median value was 0.41.
- Days of cash on hand was 116 days, below the target of 115 days. The median value was 93 days<sup>2</sup>.
- In 2004, the cost per EIPA for Maryland acute hospitals was \$8,339 as compared to \$8,665 for the US. This falls within the set target of 3% to 6% below the national average.

**Table 1: Maryland Acute Hospitals' Financial and Operating Indicator Performance<sup>3</sup>**

Financial Indicator	Target Value	Observed Value
Operating Margin	2.75%	3.20%
Excess Margin	4.00%	4.10%
Average Age of Plant	8.5 Years	10.3 Years
Debt to Capitalization	0.40	0.46
Days of Cash	115 Days	116 Days
Efficiency: Cost per EIPA (AHA data FY 2003)	3.0% to 6.0% Below the US \$8,405 \$8,145	US \$8,665 MD \$8,339

2. The HSCRC believes that because of the systematic transfer of cash from some Maryland hospitals that are members of health systems to the parent organization , as well the use of strategies by some hospitals and health systems to manage to a particular target number of days of cash calculations as shown in this analysis are significantly understated.

3. Source Appendix Tables 1 and 2.

**Table 2: Maryland Acute Hospitals' Operating and Financial Indicators, Selected Statistics<sup>4</sup>**  
**Fiscal Year 2005 versus Fiscal Year 2004**

<b>Selected Statistic</b>	<b>Operating Margin</b>	<b>Excess Margin</b>	<b>Age of Plant (In Years)</b>	<b>Debt to Capitalization</b>	<b>Days of Cash</b>
State Average 2005	3.20%	4.10%	10.31	0.46	116
2004	2.54%	2.90%	9.97	0.44	109
Median 2005	2.98%	3.63%	10.81	0.41	93
2004	1.94%	2.88	10.94	0.40	91
High Value 2005	8.21%	9.95%	25.70	1.36	349
2004	8.54%	8.93%	22.38	1.43	289
Low Value 2005	-9.25%	-7.42%	4.24	0.02	2
2004	-7.85%	-7.62%	4.27	0.01	2

**Summary of Maryland Specialty and Private Psychiatric Hospitals 2004 versus 2003<sup>5</sup>**

- The operating margin decreased in 2005 to 1.38% from 2.63% in 2004
- The excess margin decreased in 2005 to 2.54 from 4.04% in 2004
- The average age of plant was 8.23 years, lower than 8.86 years in 2004
- The debt to capitalization ratio was 0.37, lower than 0.39 in 2004
- The days of cash on hand were 93 days, lower than 109 days in 2004.

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<sup>4</sup> Source: Appendix Tables 3 and 4

<sup>5</sup> Specific indicator targets were not established for these hospitals

Table 3: Financial and Operating Performance Indicators, Maryland Specialty and Private Psychiatric Hospitals', Fiscal years 2005 vs. 2004

<b>Financial Indicator</b>	<b>Fiscal Year 2005</b>	<b>Fiscal Year 2004</b>
Operating Margin	1.38%	2.63%
Excess Margin	2.54%	4.04%
Average Age of Plant	8.23 Years	8.86 Years
Debt to Capitalization	0.37	0.39
Days of Cash	93 days	109 Days

### **Conclusion**

In 2005, Maryland acute hospitals reached and even exceeded most of the financial and operating targets. Thus, the HSCRC's Rate Redesign Arrangement has achieved one of its major objectives, i.e., to "make substantial progress on current financial deficiencies." Both operating and excess margins increased in 2005 over 2004 and were higher than the set targets. It should also be noted that hospitals' operating margins on HSCRC regulated activities increased substantially in 2005, to 4.91%, which significantly exceeded the target of 2.75%. These gains, in both regulated and overall hospital profitability, were achieved through a combination of rate enhancements by the Commission and continued cost containment by hospitals. It is hoped that the rate incentives in the system along with continued cost constraint will enable hospitals to continue to increase their profitability over the period 2005 through 2006 and use these profits to reinvest in their asset base. The HSCRC will continue to monitor the success of these initiatives through this annual financial condition report.

## APPENDIX

## **FINANCIAL CONDITION WORK GROUP**

In 2000, the HSCRC refined and formalized its Charge per Case System through a Rate Redesign initiative, a process that resulted in a series of Rate Policy changes supported by both payer and hospital representatives. Many recommendations resulted from the efforts of the Rate Redesign Work Group, one of which was that the HSCRC revise and publish its report on financial conditions and the associated financial performance targets in accordance with existing industry trends and financial market standards. The Work Group also suggested that the HSCRC continue to monitor various indicators of hospital performance. Similar to the original Financial Conditions Work Group recommendations, the Redesign Work Group recommended these indicators be “evaluated over time, and collectively, to allow for an assessment of industry performance on the dimensions of efficiency, quality, and financial stability.” The Redesign Work Group recommended the report examine the “Maryland hospital industry’s overall financial condition (including regulated and unregulated services) and how regulated services have contributed to this overall condition.”

*In the summer of 2001, the Commission convened a Financial Condition Work Group comprised of representatives from Maryland hospitals, payors, HSCRC staff, the Maryland Hospital Association and many other interested parties. This group diligently reviewed, evaluated, and suggested revisions to the Commission’s financial indicators/targets. The Work Group sought the advice of experts to facilitate analysis, and made recommendations to the Commission for approval of target indicators. Three sets of revised targets were presented to the Commission, one from the HSCRC staff, one from Maryland hospitals and one from the payors. Staff’s recommendations were subsequently approved and are, therefore, used in the analysis of Maryland hospitals’ financial performance indicators.*

The Work Group developed the targets based on the general consensus that Maryland hospitals had experienced erosion in operating performance and balance sheet position, resulting in reduced investment in property, plant and equipment particularly, and a corresponding increase in average age of plant. The targets were established according to several guiding principles:

- Targets should be realistic and demonstrably achievable, and should be viewed in the context of current Commission policy (i.e. the Charge per Case Methodology, the current Inter-Hospital Cost Containment Policy, and the Rate Redesign Update Formula).
- The revised targets should reflect the desire of the Commission, the hospital community, payers and patients to facilitate gradual improvement in the financial condition of Maryland hospitals. This is particularly true, given the recent deterioration of hospital financials both in Maryland and the nation.
- This improvement should be accomplished over a time period of three to five years.
- Targets should take into consideration consistent interrelationships among the targets. For example, efficiency targets should be realistic and help create operating and excess profit margin goals in the context of current rate setting policy. Additionally, operating and total profit targets should be consistent with the achievement of capital and cash targets.

**Please note: The following tables detail the chronological results of the calculation of key financial indicators and targets for the Maryland hospital industry. Definitional or data element changes adopted by the Financial Condition Work Group are reflected in the results displayed in the following tables.**

**Appendix Table 1: Selected Financial and Operating Indicators<sup>4</sup>****Maryland Acute Hospitals, 1970 to 2005**

<b>Year</b>	<b>Operating Margin</b>	<b>Excess Margin</b>	<b>Age of Plant</b>	<b>Debt to Capitalization</b>	<b>Days of Cash</b>
1970	-0.18%	1.83%	7.22	0.22	NA
1971	0.30%	2.43%	7.27	0.22	NA
1972	1.00%	2.94%	7.04	0.23	NA
1973	-0.13%	2.33%	7.72	0.28	NA
1974	0.03%	2.06%	8.20	0.27	NA
1975	-0.49%	0.90%	8.54	0.29	NA
1976	0.06%	1.41%	8.52	0.34	NA
1977	0.46%	1.75%	8.78	0.38	NA
1978	0.50%	2.17%	8.18	0.43	NA
1979	0.87%	2.40%	7.94	0.45	NA
1980	0.81%	2.69%	8.11	0.50	NA
1981	-1.71%	0.47%	7.79	0.49	33
1982	-1.73%	1.15%	8.09	0.49	31
1983	1.72%	3.43%	8.11	0.46	27
1984	0.96%	2.64%	8.30	0.43	28
1985	0.29%	1.93%	8.35	0.44	23
1986	2.26%	3.82%	7.90	0.40	26
1987	2.45%	3.79%	8.18	0.40	28
1988	0.51%	1.32%	8.02	0.41	26
1989	1.26%	2.85%	8.40	0.41	27
1990	0.95%	1.89%	8.49	0.45	34
1991	1.02%	1.80%	8.78	0.49	34
1992	0.00%	2.77%	8.48	0.51	79
1993	2.88%	2.59%	8.22	0.51	86
1994	3.35%	2.83%	8.26	0.51	61
1995	4.43%	5.28%	8.29	0.48	77
1996	4.41%	5.13%	8.20	0.46	102
1997	4.04%	5.44%	8.00	0.43	103
1998	2.40%	3.60%	8.40	0.43	106
1999	1.10%	2.30%	8.60	0.41	92
2000	0.80%	2.50%	9.10	0.40	103
2001	1.40%	2.10%	9.40	0.39	116
2002	2.00%	2.40%	9.98	0.44	110
2003	1.70%	2.30%	10.40	0.43	98
2004	2.50%	2.90%	9.97	0.44	109
2005	3.20%	4.10%	10.31	0.46	116

<sup>4</sup> NA: Cash not reported

Source of all other data: Audited Financial Statements

**Appendix Table 2: Cost per EIPA 1992 to 2004  
Maryland versus the US<sup>5</sup>**

<b>Year</b>	<b>US Average</b>	<b>MD Average</b>	<b>6% Below US</b>	<b>3% Below US</b>
1993	\$6,333	\$5,714	\$5,953	\$6,143
1994	\$6,454	\$5,927	\$6,067	\$6,260
1995	\$6,463	\$5,997	\$6,075	\$6,269
1996	\$6,498	\$6,331	\$6,108	\$6,303
1997	\$6,530	\$6,674	\$6,138	\$6,334
1998	\$6,702	\$6,711	\$6,300	\$6,501
1999	\$6,840	\$6,697	\$6,430	\$6,635
2000	\$7,045	\$6,855	\$6,622	\$6,834
2001	\$7,403	\$7,205	\$6,959	\$7,181
2002	\$7,717	\$7,496	\$7,254	\$7,485
2003	\$8,233	\$7,824	\$7,739	\$7,986
2004	\$8,665	\$8,339	\$8,145	\$8,405