

Hospital Finance Basics: Part 2 Costs

This Health Issues Brief examines hospital costs - the resources necessary to provide high quality health care services. It is the second in a series about hospital finance.

Introduction

Providing hospital care is an expensive, labor intensive and narrow margin business. Hospitals depend on a highly educated and dedicated workforce in order to provide high quality care. Employee salaries, wages and benefits are the largest category of hospital costs.

Hospital Cost Structure

In 2012, Florida Hospital spent about \$2.3 billion in total to fund its operationsⁱ. That is an average of about \$2,500 for each day that a patient spent in the hospitalⁱ. Employee salaries, wages and benefits along with supplies represented over 70% of Florida Hospital's total costs in 2012ⁱ.

Salaries, Wages and Benefits

Labor expenses are the biggest component of hospital costs. Hospitals rely on their highly skilled personnel to deliver advanced levels of health care services. Florida Hospital employs nearly 19,000 people and spent over \$1 billion on salaries, wages and benefits in 2012^{i, ii}.

Supplies

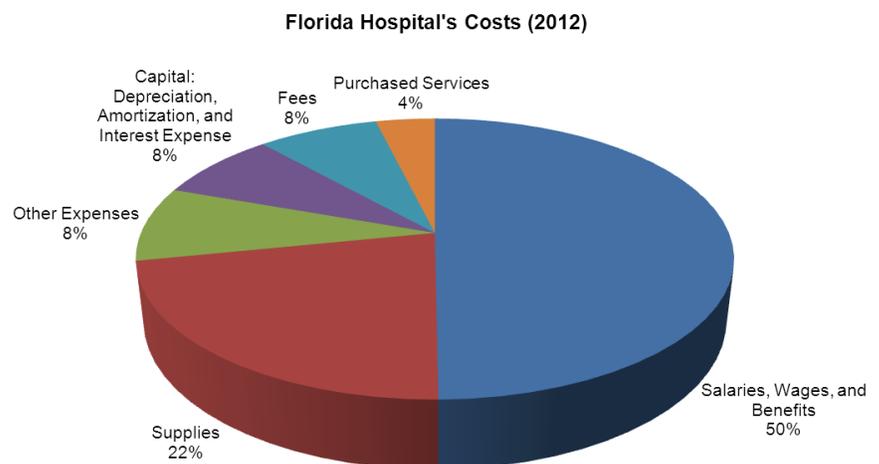
Supplies are the second largest hospital cost category. This category includes medical supplies, drugs, and other supplies such as food and linens. In 2012, Florida Hospital spent about \$351 million on medical supplies, \$107 million on drugs and \$49 million on other suppliesⁱ. Overall, supplies accounted for 22% of Florida Hospital's total costs in 2012ⁱ.

Fees

Hospitals pay fees to a variety of outside entities and individuals for their servicesⁱⁱⁱ. These include physician on-call fees and stipends for medical directors. Additional examples include legal fees and consulting fees.

Capital: Depreciation, Amortization and Interest Expense

Hospitals spread the cost of buildings, major medical equipment and other capitalized assets over their estimated life through accounting processes called depreciation and amortization^{iv}. Additionally, hospitals often finance large purchases and must pay annual interest expenses on these loans. Florida Hospital incurred about \$183 million in depreciation, amortization and interest expenses in 2012ⁱ.



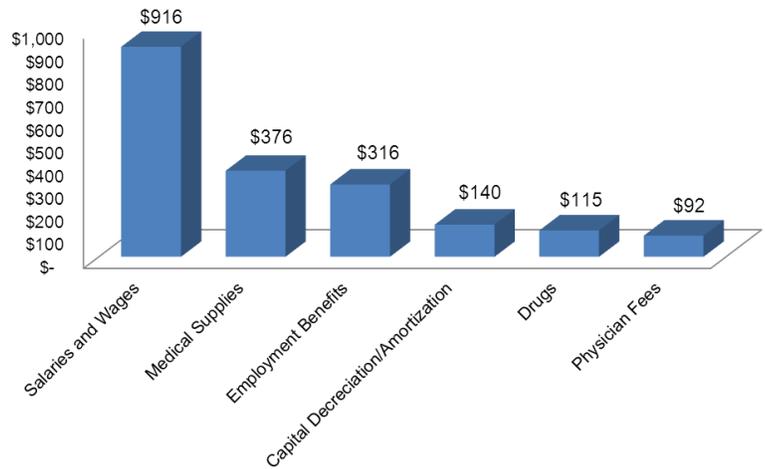
Purchased Services

Purchased services include expenses paid to outside agencies and individuals to complete specific projects or tasksⁱⁱⁱ. Examples of purchased services are repair, maintenance and shipping services.

Other Expenses

Keeping a hospital running smoothly requires a number of routine expenses that are often classified as “other.” These include items such as utilities, telephones, insurance, rents, and leases.

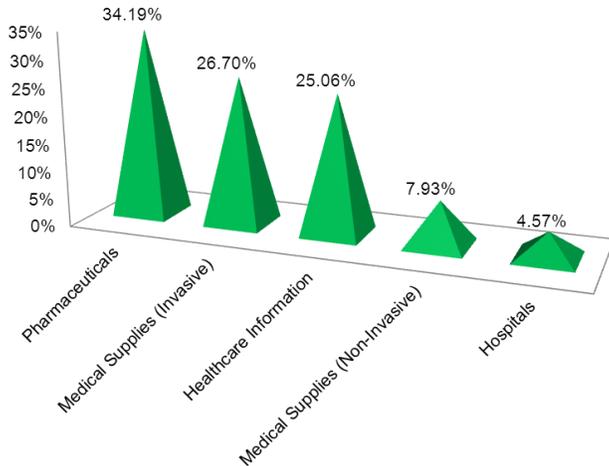
The Six Largest Hospital Expense Items for a Day of Patient Care
Florida Hospital (2012)



Hospital Operating Margin

Hospital operating margin represents the difference between revenues collected and operating costs^v. Providing hospital care is a narrow margin business. According to a recent Truven Analytic report, the average operating margin for U.S. hospitals was 4.57% in 2012^{vi}. Hospital margins are very slim compared to other health care sectors such as pharmaceuticals, medical supplies and health care information. As of January 2013, these industries had operating margins of 34.19%, 26.70% and 25.06% respectively^{vii}.

Operating Margins By Industry Sector



Money earned from providing health care services enables hospitals to invest in crucial resources. Hospitals earning inadequate margins may be forced to accumulate unsustainable levels of debt, delay hiring needed personnel or postpone investing in facility improvements^{viii}. This can jeopardize community access to care.

Key Takeaway

Providing hospital care is an expensive, labor intensive and narrow margin business. Hospitals rely on their highly skilled and dedicated workforce in order to provide advanced levels of health care services. Employee salaries, wages and benefits make up about half of Florida Hospital's total costsⁱ. In 2012, supplies accounted for another 22% of costsⁱ.

As discussed in Part One of this series, continuous payment cuts can create an unsustainable business environment for hospitals. Much discussion at the federal, state and local level has focused on efforts to slow the growth of U.S. health care expenditures. Florida Hospital fully supports responsible efforts to improve quality and reduce health care spending. In order to achieve meaningful savings, structural improvements must be made to the U.S. health care system to be more efficient and to avoid preventable hospitalizations in the first place.

The next brief in this series will examine the future needs of high quality hospitals.

ⁱ Florida Hospital Orlando Market Data, Florida Hospital Finance Department. 2013

ⁱⁱ Florida Hospital Orlando Market Data, Florida Hospital Human Resources Department. 2012

ⁱⁱⁱ Hospital Costs in Context: A Transparent View of the Cost of Care, Massachusetts Hospital Association. 2010

^{iv} A Community Leader's Guide to Hospital Finance, Sarah Lane, et al. The Access Project. 2001

^v Get the Basics on Minnesota Hospital Financing, Minnesota Hospital Association. 2013

^{vi} Hospital Financial Trends, HealthLeaders Media. 2013

^{vii} According to analysis by Dr. Aswath Damodaran, Professor of Finance at the Stern School of Business at New York University. 2013

^{viii} "How Much Profit Should We Target?," William Cleverley, PhD. Cleverly + Associates. 2007