By Jim Porter and Peter Yeh

Investing in a Post-COVID Budgeting Process

Using Past Performance Has Gone Out the Window

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Hospital leaders have acknowledged the need to reimagine their businesses and the importance of focusing on their financial futures — ones that are anything but certain, thanks to the havoc caused by the pandemic. With COVID-19 forcing hospitals to exhaust their resources on critical areas like patient care, the traditional budgeting process for 2021 has been completely shattered. As hospital finance leaders look ahead to reconciling the many unexpected financial highs and lows of the past two years, what is the best method for laying out their organization's expected financial future for the upcoming budget season? The answer is budgeting from scratch, better known as zero-based budgeting (ZBB).

ZBB is an intensive process that examines expenditures in every department from the ground up, as well as the drivers of volume and rate that factor into revenue. It is extremely time-consuming, and requires meticulous detail and often significant staff commitment. ZBB is probably the last thing a hospital finance department, and certainly the operating unit leaders, would want to take on in light of the ongoing operational challenges that hospitals face. But it is effective and should be the number-one choice for hospitals to use this budget season, especially since the financial trends of 2020 are not usable as a reference, and since so much has drastically changed since 2019.

In a Post-COVID World, the Traditional "Incremental" Budgeting Process Is Inadequate

Finance leaders will undoubtedly have their nuanced budgeting approaches and may talk of "looking at every line item." However, the reality of the traditional budget process is that it starts with past performance and considers how it should be modified to build an expectation of the future. Typical steps include taking a prior period's results and adjusting for inflation to create a baseline.

Subsequently, a finance team would overlay the impact of expected initiatives, one-time items that impact the organization's cash flow, profit and loss (*e.g.*, opening, closing a unit, self-insured items, etc.) and balance sheet (*e.g.*, third-party liabilities, pension changes, return of stimulus funds, etc.). Further adjustments are made to reflect government and other payor changes, and changes in financing operational and capital expenditures. As this is an iterative process, it frequently leads to other questions that take deeper consideration.

It sounds simple, but the traditional budgeting process takes time, resources and organization. For most institutions, the incremental method is relatively easy to manage, especially since most department heads are used to the process and need relatively few inputs to create their forecasts.

Here comes the rub: The organization must favor a predictable demand curve for an incremental budget to be an accurate and credible management tool. In other words, there should be "no surprises" to an estimate of patient volume. Historically, this notion has fit squarely with a hospital's business model, but based on recent national reporting on hospital activity, we see far more of a sawtooth pattern in volumes, in part driven by repeated surges in COVID-19 cases.

Operational expenses have also become difficult to budget based on historical data. For example, many hospitals are experiencing shortages in staff, leading to an increase in temporary labor costs. This staffing pattern does not appear to be a short-term issue and needs to be understood from the ground level.

These are new times; the predictability of patient volume has disappeared. This phenomenon was heavily discussed as the pandemic unraveled and was a vital component of the Pandemic Impact Mitigation Strategy.[1] There remains an unprecedented likelihood of exceeding the budget when you consider the uncertainty over such items as the need to repay certain Coronavirus Aid, Relief and Economic Security Act stimulus funds and Medicare advances, managing Federal Emergency Management Agency applications, management of hazard pay, conditions around infrastructure spending, and loss of staff driving excessive agency spend on nursing and *locums*.[2] Depending on the state of their reserves, this error could be fatal for the hospital and community.

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1 Richard Becker, M.D., Jim Porter & Peter Yeh, "Hospital Liquidity in the COVID-19 Pandemic: Impact and Mitigation Strategies," ToneyKorf Partners LLC (April 29, 2020), *available at* toneykorf.com/wp-content/uploads/2020/04/Hospital-Liquidity-in-the-COVID19-Pandemic.pdf (unless otherwise specified, all links in this article were last visited on Sept. 22, 2021).

2 "A *locum*, or *locum tenens*, is a person who temporarily fulfills the duties of another; the term is especially used for a physician or clergyman." *See* Wikipedia, *available at* en.wikipedia.org/wiki/Locum.

Financial leaders must now give more credence to the chance of an unknown issue having a significant impact on the institution's volume and cost base. Absent further external stimulus, most health care organizations will no longer have the cushion that they have today to accommodate any material adverse financial impact. For example, a subsequent surge from a new coronavirus variant may prove challenging to health care organizations. Health care organizations will need to understand how to better treat patients in order for the provider to remain financially viable. Modest operational improvements will not be enough. The list of potential issues to consider, and the risk associated with each issue, has grown dramatically. For example, what happens if there is a new public health crisis or if patient flows reverse with volumes returning in greater-than-expected numbers, perhaps from the failure of a competitor? How can you use risk-assessment in the budget process to enable, rather than paralyze, the organization?

Minimize the Risk of Uncertainty

The mindset inherent in a successful ZBB approach is to "assume nothing." This means beginning with a blank template. Therefore, for the operational leaders responsible for the execution of the budget, this can feel more like a restructuring of the organization than a forecasting process. However, by budgeting from scratch, leaders will have a better grasp of their departmental profit-and-loss statements, uncover legacy costs and have the opportunity to optimize operations.

In addition, ZBB will better prepare organizations for obtaining board approval and leadership buy-in, and will lead them to actionable steps while supporting the CEO's vision for success in this new world. Externally, companies will need to take into account how they are partnering with other organizations, such as specialty outpatient services, where they will need to demonstrate and leverage their expertise on the likely volume and cost impact the partnership will have on each organization. Finance leaders may have already determined that the key challenges they face, such as reducing or eliminating services, including the impact of these changes, are undoubtedly better than the "wait and see" approach. ZBB will bring direction and credibility to management decisions.

Another concept for minimizing budget risk is to reduce the time frame under consideration in the forecast. For example, consider quarterly reforecasting and maintaining a robust and routine refresh process instead of having the budget approved, then locked for the year. While no one wants to do quarterly budgeting, this will enable the organization to focus on narrower time frames and have a better grasp of the budget at a detailed level. A major downside of this approach is an "even greater" time commitment to the budget process overall, but the upside is the ability for timely decision-making to minimize the risks of disastrous financial results.

The Board's Role

Hospital boards of directors should be more interested in the process of budgeting than they have been in the past. They are responsible for performing their duties as directors to the best of their ability with the degree of diligence, care and skill that a prudent person would exercise under similar circumstances. This includes appropriate financial planning and relying on suitably competent management and professionals to help them form their opinions and discharge their duties. New questions should be, "How have you flexed your projections? How sensitive are your volume assumptions? What external information supports where you came out? What organizational changes does the forecast suggest are necessary? Have you considered the costs of these changes? How do reserves, such as days cash on hand or the quick ratio, change in this projection?"

At the end of the day, the leadership team will need to present a unified and well-considered set of projections to its board clearly articulating the risks and any implied impact on the organization. A narrative should not only say "What?," but also, "How, Why, What If and So What?"

Practicality of ZBB

As a practical matter, finance leaders and restructuring professionals should be familiar with the concept of ZBB. This article justifies the need for additional resources to be invested in the budgeting process because of the escalating importance of this tool toward guiding organizations. Key issues include the preparation and education of the entire team responsible for the execution of the budget, but these additional efforts need to present the additional return on investment.

Financial leaders now have the opportunity to highlight the use of the budgeting process to define the necessary organizational changes that must overcome the traditional and significant latency and resistance often seen in health care. A humorous CFO once said, "When volume goes up, all costs are variable. When volume goes down, all costs are fixed until you run out of money, then all costs become variable again." Although technically incorrect, all practical finance operators have felt this way at some point. Now is the time to make the budget a tool integrated into a successful operating strategy rather than a source of tension or, perhaps worse, a worthless desktop exercise. abi