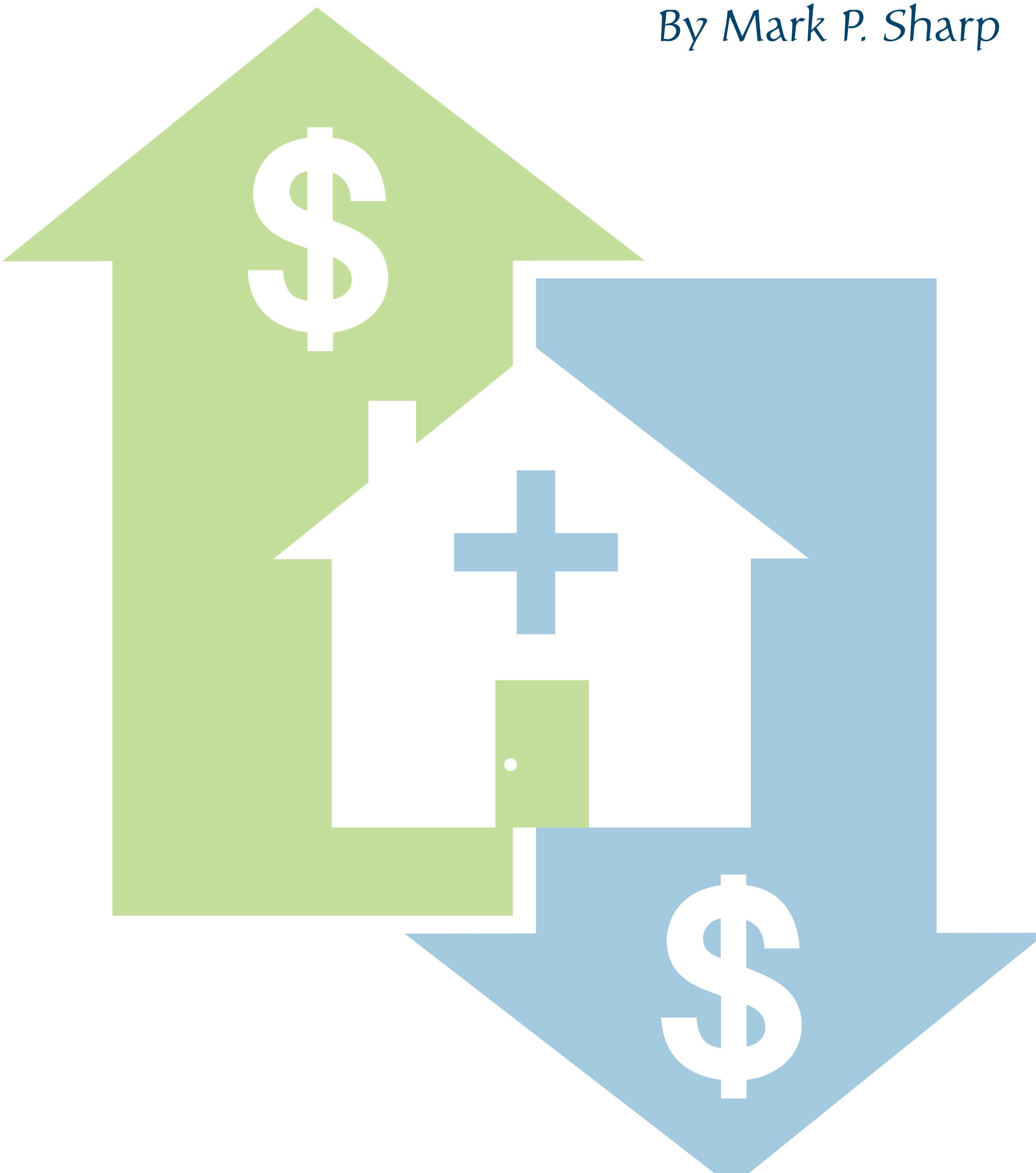
The Power of Flexible Budgeting in Home Care

By Mark P. Sharp



In today's environment, home care and hospice agencies must continually search for new ways to more effectively manage their business. Increased competition, continued threats of Medicare rate cuts, less-than-adequate state Medicaid payments, and heightened regulatory requirements all point to the need for agencies to strive to become more efficient in their operations.

Budgeting is one management tool most businesses use to help plan a successful roadmap for the next year. A budget also is used to compare actual results throughout the year to identify where operations might be veering off course. This monthly budget-to-actual comparison is the often forgotten activity that allows leadership to take timely action to correct any areas of concern.

Budget Variance Analysis

When reviewing the budget-to-actual comparison, management should look for reasons behind any variances in actual results. In the typical static approach to budgeting, there are three types of variances that can cause differences when comparing actual results to the budget. These variances include:

- Volume variances;
- Efficiency/productivity variances; and
- Price variances.

Volume variances are budget-to-actual differences due to changes in the expected volume levels. Efficiency and/or productivity variances are budget-to-actual differences due to achieving lower or higher levels of efficiencies. Lastly, price variances are budget-to-actual differences due to variations in the price of products or labor.

When management identifies budget variances, one of the most difficult tasks is determining the root cause of the variance. It is challenging to isolate the nature of the difference to be able to take corrective action. Often, too much reliance is placed on allowing variances to be explained as volume variances. Volume is one of the most difficult areas to budget accurately and also one of the most difficult areas to promptly affect change.

The Flexible Budget

Most home care and hospice agencies take a static approach to budgeting. In the static approach, the monthly budget numbers used to compare to actual results are generally the annual budget divided by 12 months. Any variances will be due to one or a combination of the three types of budget variances described earlier. It can be very difficult to isolate the reason(s) for the variances when using the static budget approach.

A flexible budget allows management to eliminate volume variances and better isolate the budget-to-actual differences to either efficiency or price variances. Flexible budgeting eliminates volume variances by budgeting revenues and expenses on a per-unit basis for variable items, and then updating the budget for actual volume achieved on a monthly basis. This allows the budget to "flex" the variable revenues and expenses to eliminate the volume variance factor from the equation.

The Process

Generally, the original budget produced from a static approach and a flexible approach are exactly the same. The difference between the two methods comes when you produce the monthly budget to compare to the actual results.

As explained, the flexible budget is adjusted each month for actual volume levels achieved. All revenue and expense items should be identified as fixed or variable in the original budget process. For each item identified as variable, the volume driver must be evaluated and defined. For example, skilled nursing visits drive the direct skilled nursing wages and travel.

Variable revenues and expenses are then budgeted on a per-unit basis in the original budget. Each month when the budget is updated, the actual volume levels achieved adjust the variable items budgeted on a per-unit basis. The adjusted or "flexed" budget amounts are then compared to actual results. Below is an example of the differences between the static approach and the flexible approach.

A Case for the Flexible Budget

XYZ Home Health Agency did not believe flexible budgeting was the approach for them. The following analysis of XYZ's original budget and their first three months budget-to-actual comparisons demonstrates why the flexible budget approach would have provided XYZ with better information to manage their business. The single largest expense item in their operations is wages paid for skilled nursing (SN); therefore this case study focuses on this expense item.

The Original Road Map

XYZ expected to achieve 500 SN visits per month or 6,000 for the year. Based on this projected SN visit volume, management budgeted SN wages as follows:

Original Budget - Static	
Budget basis	
Monthly SN visits	500
Annual SN visits	6,000
SN hours per visit	2.00
SN avg. wage rate	$30
Budgeted SN wages	$360,000

Original Budget - Flexible	
Budget basis	
Monthly SN visits	500
Annual SN visits	6,000
SN hours per visit	2.00
SN avg. wage rate	$30
Budgeted SN wages	$360,000

As described earlier, the annual budget created prior to the beginning of the year is generally consistent between the static and flexible approach. XYZ's budgeted SN wages for the year appears to be an admirable goal based on an efficient productivity standard of two hours per visit and a market-based average wage rate of $30 per hour.

Unwarranted Panic

After the completion of the first month, XYZ's management became alarmed their SN wages were significantly over budget for the month.

Month 1 - Static	
Actual SN wages	$35,000
Budgeted SN wages	$30,000
($360,000/12 months)	
Variance	$5,000

Month 1 - Flexible	
Actual SN wages	$35,000
Budgeted SN wages	$37,500
Actual SN visits	625
Budgeted SN hours per visit	2.00
Budgeted SN avg. wage rate	$30
Variance	($2,500)

The static budget showed XYZ's SN wages were $5,000 over budget and management was in a panic believing the agency was overstaffed and operating inefficiently. However, XYZ actually achieved 625 SN visits in month one, which was 125 visits higher than the originally budgeted 500 visits per month.

Had a flexible budget approach been used, the volume variance would have been removed from the equation, and management would have been pleased their SN wages were $2,500 below budget. Rather than panicking, management would have been praising the nursing staff for their performance.

Oh, It's Just the Higher Volume

Once the panic subsided, management realized its variable expenses would likely be higher than budgeted when volume achieved is more than budgeted. So when XYZ's SN visits were higher than budgeted in month two, management was not concerned that the SN wages were significantly over budget as well.

Month 2 - Static	
Actual SN wages	$38,500
Budgeted SN wages	$30,000
($360,000/12 months)	
Variance	$8,500

Month 2 - Flexible	
Actual SN wages	$38,500
Budgeted SN wages	$36,000
Actual SN visits	600
Budgeted SN hours per visit	2.00
Budgeted SN avg. wage rate	$30
Variance	$2,500

Since actual SN visits in month two totaled 600 compared to the original budget of 500 per month, XYZ explained being $8,500 over budget in SN wages as due to the volume variance. Assuming the volume variance was the only reason SN wages were over budget is a dangerous assumption, and all too often managers do not go the extra step to assess whether or not there were other reasons for being over budget in their expenses.

After removing the volume variance in a flexible budget model, management would have been aware that XYZ's SN wages were still over budget by $2,500 in month two. With this information, XYZ could have had the opportunity to take corrective action for a possible efficiency or price variance, or both.

The False Positive

Following month three, the management team was very pleased its SN wages were under budget for the month. From their perspective, the nursing staff performed very efficiently in month three.

Month 3 - Static	
Actual SN wages	$29,500
Budgeted SN wages	$30,000
($360,000/12 months)	
Variance	($500)

Month 3 - Flexible	
Actual SN wages	$29,500
Budgeted SN wages	$24,000
Actual SN visits	400
Budgeted SN hours per visit	2.00
Budgeted SN avg. wage rate	$30
Variance	$5,500

According to XYZ's static budget, SN wages were under budget by $500. The celebration began. The factor they were missing, however, was the fact actual SN visits in month three were only 400 compared to the budgeted 500 per month. With the information available in XYZ's static budget, management could not assess whether or not the SN wages were appropriate for the reduced volume achieved.

A flexible budget would have indicated SN wages were over budget by $5,500 and the need to take aggressive action to make staffing adjustments. With the volume variance removed, XYZ would have realized they had an efficiency or price variance to manage.

The Evidence Suggests…

As demonstrated in the above case analysis, the monthly budget-to-actual comparison using a static budget can be extremely misleading if the actual volume achieved differs from your budgeted volume. While there are means other than a budget to monitor operations, the flexible budget is an excellent solution to monitoring agency performance on a monthly basis and promptly identifying areas of operations that are not in line with management's expectations. The prompt identification of areas of concern will allow your agency to take timely action to improve performance.

Studying Variances

One of the most critical steps in getting value from your budgeting process is taking time to study undesirable variances from your budget. Budgeting is a fruitless endeavor if your agency is not taking time to analyze and take action on the variances identified in the budget-to-actual comparisons. The flexible budget makes this variance analysis much easier through the removal of the volume variances.

In our case analysis, using the flexible budget approach identified XYZ was over budget in SN wages for both month two and three. Since any volume variance is removed through the monthly budget "flexing" process, the variances in these two months are either due to efficiency or price variances, or a combination of the two.

XYZ's efficiency expectation for SN wages was the budgeted hours per visit of two hours. To assess if there was an efficiency variance in month two and three, the actual hours per visit for SN should be computed and compared back to the budgeted hours per visit. If the actual hours per visit are more than two, then there is an efficiency variance and management may need to take appropriate corrective action to bring productivity back in line with expectations.

Your agency can take a similar analysis approach if a price variance is present. The price expectation in XYZ's budget for SN wages was the budgeted average wage rate of $30 per hour. If the agency's actual hourly wage rate paid was more than $30 per hour, then there is a price variance to be evaluated.

Other Considerations

To make flexible budgeting efforts as effective as possible, your agency should consider several other factors in developing its budget. When establishing your unit basis for the variable expense items, your agency needs to take into account its compensation methodologies and labor mix.

If your agency pays its staff using multiple methodologies, including per-visit pay, it might be wise to separate the costs for wages based on per-visit pay versus salary/hourly pay. Identifying efficiency variances can be very difficult if you combine the two pay methodologies since the per-visit pay method inherently does not have any potential for efficiency variances. If the costs for per-visit pay and the salary/hourly pay are maintained in separate accounts, it also is recommended that you separately track visits performed by per-visit staff versus salaried/hourly staff so you can match the units of service to the applicable costs more accurately for the flexible budget.

The same consideration should be given to your agency's labor mix. If you utilize both–employees and contract workers–for service delivery, your agency should separately track visits performed by employees versus contract workers so the units of service can be more accurately matched to the applicable costs for the flexible budget.

Get Started Now

Budgeting is a critical management tool for organizations of all sizes and in all industries or life cycles. With the uncertain environment in home health and hospice, the flexible budget is one tool agencies should not overlook in their efforts to improve efficiencies and reduce costs. The flexible budget can help management identify where operations are veering off course and efficiently point to the root causes to get back on track.

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