



**Shriners Hospitals**  
for Children™

# The Path to Financial Stability

## and the Three Budget Options for 2010

April 6, 2009





# The Challenges Before Us

The economic crisis and steep decline in the stock market have renewed focus on a chronic financial problem as well as a systemic problem in the operation of Shriners Hospitals for Children. The word “crisis” aptly applies to this point in time, as the Representatives at the Imperial Session in San Antonio face a pivotal moment in the organization’s history. One thing is certain – change is required in order to assure both financial and operational viability of the Hospital system.

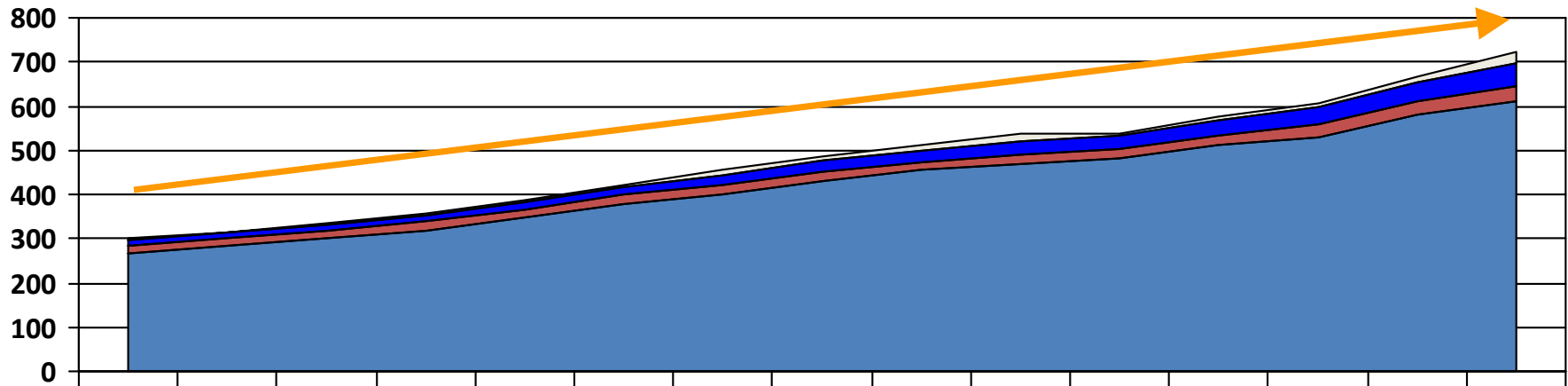
The financial problem can be simply stated. The growth in expenses over time has outpaced the growth in revenues generated. The healthcare environment is in a constant state of flux. New technology, changes in treatment modalities, increased regulatory requirements, and competition in clinical labor markets are some of the contributing factors to the rise in expenses. While on the revenue side, our historical base of financial support – members of the fraternity – has been in decline, resulting in a recent shift in philanthropic effort to external sources for funding.

The graph on page 3 reflects the growth in expenses over the last fifteen years, while the graph on page 4 shows revenues for the same period. As reflected on page 5, operating expenses have exceeded operating revenues and other support in each of the past seven years.



# Expenses – Last 15 years (in millions)

Total expense has grown at an average annual rate of 6.5%.

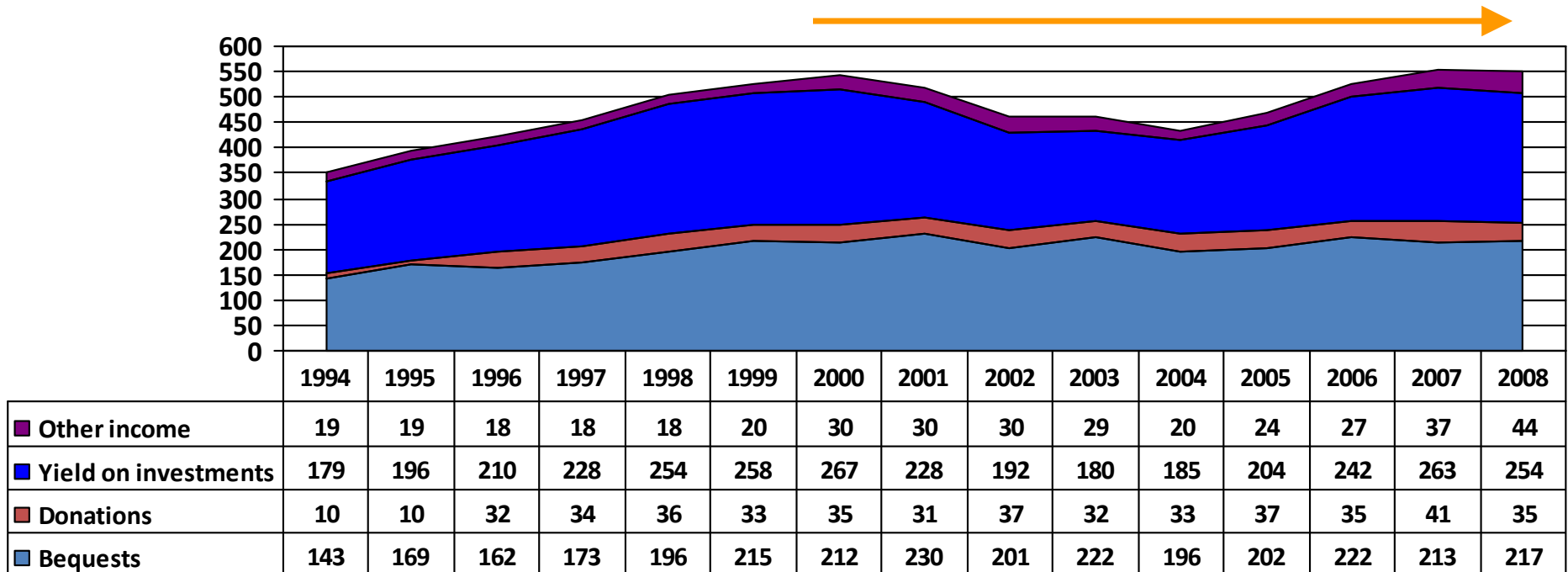


	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
□ Fundraising	4	3	3	3	3	4	15	11	11	16	3	6	8	12	25
■ Admin	11	12	13	14	16	19	20	24	26	29	28	34	37	42	53
■ Research	18	18	19	19	19	20	21	22	21	23	23	25	30	33	33
■ Hospitals	266	282	300	320	347	379	400	430	454	468	482	510	530	579	611



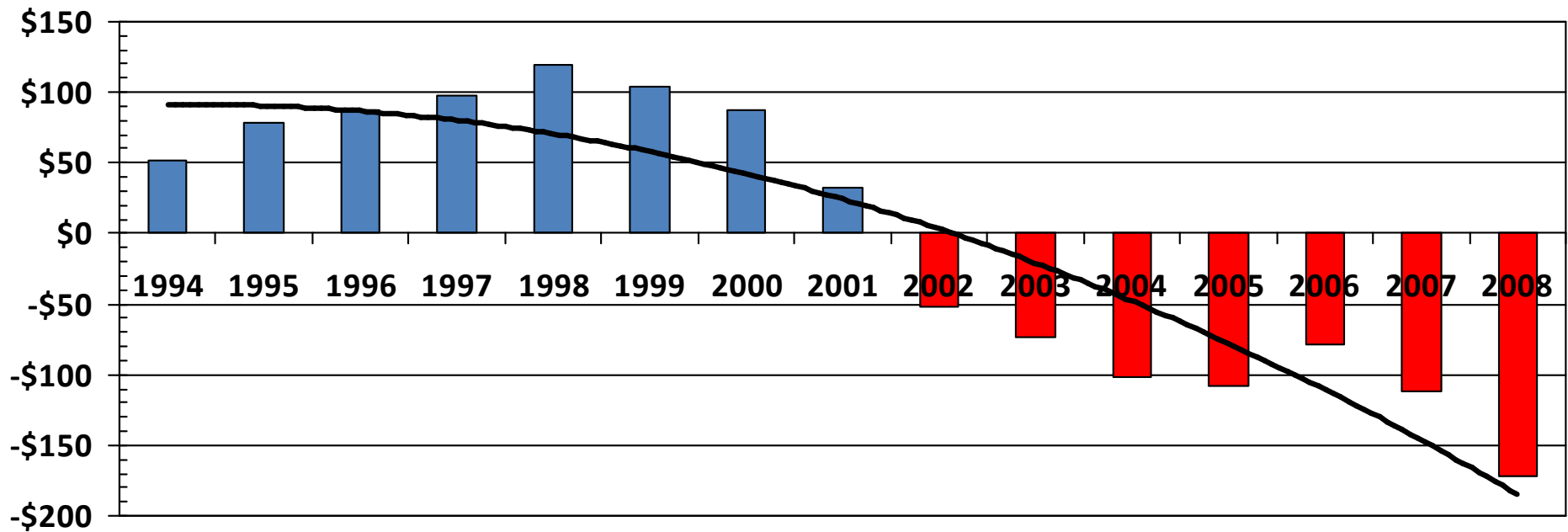
# Revenues – Last 15 years (in millions)

Total operating revenue has been flat, at best, for the last ten years.





# Excess Revenue (Expense) - in millions





# The Challenges Before Us

The challenges confronting us are not new. In its report, which was approved by Members of the Colorado Corporation at the Imperial Session in 2005, the Special Study Committee of Shriners Hospitals for Children stated:

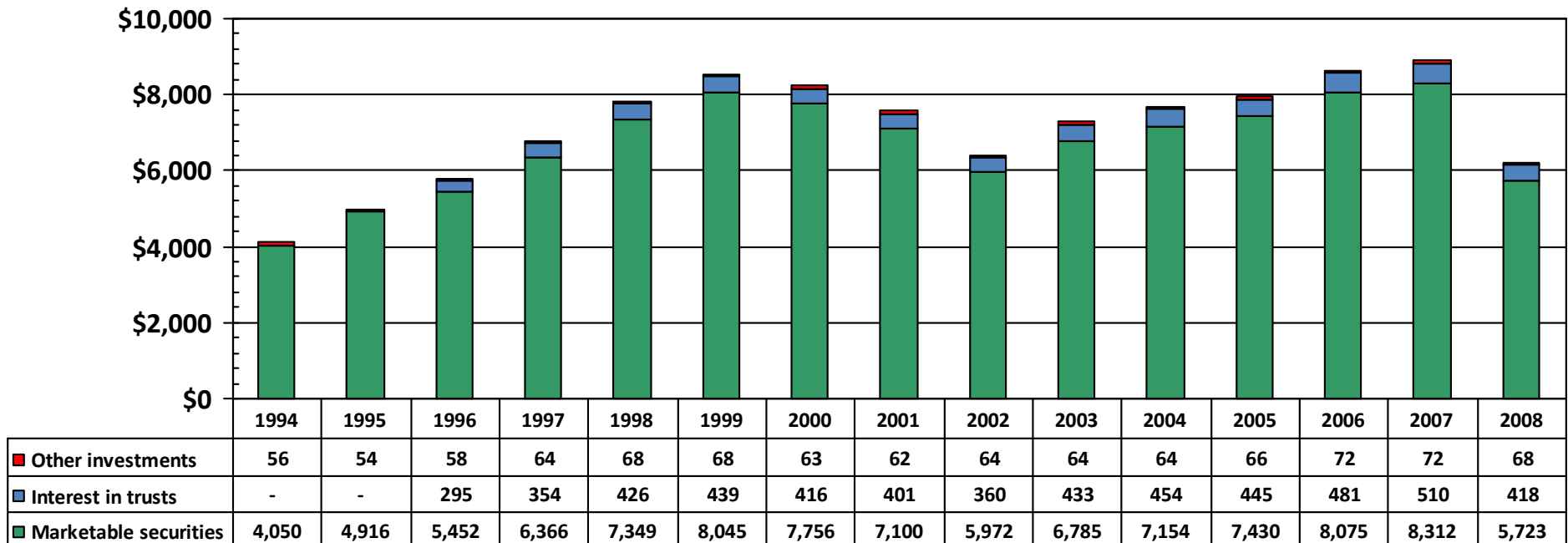
**Our challenge now is to create a financial model that incorporates a reasonable long term rate of return and a system-wide spending rate that will support the operations we ultimately decide to pursue, while increasing our endowment fund at a rate at least equal to inflation and targeted growth. This will ensure our continued existence in the future for our children.**

The report recommended a spending rate on the endowment fund of 7% (due to the fact that bequests were historically designated for endowment purposes) and set a target of building the endowment to \$12 billion by the end of 2014.

The graph on page 7 reflects the value of the endowment fund at the end of each of the last fifteen years. Slightly over \$6 billion at the end of 2008, it would take a return of 12% for each of the next six years for the endowment to reach \$12 billion, well in excess of the 7.5% return anticipated. Equally disturbing is the graph on page 8, which shows a spending rate of 8.8% for 2008, compared to what would be a generally-accepted benchmark of 5%.



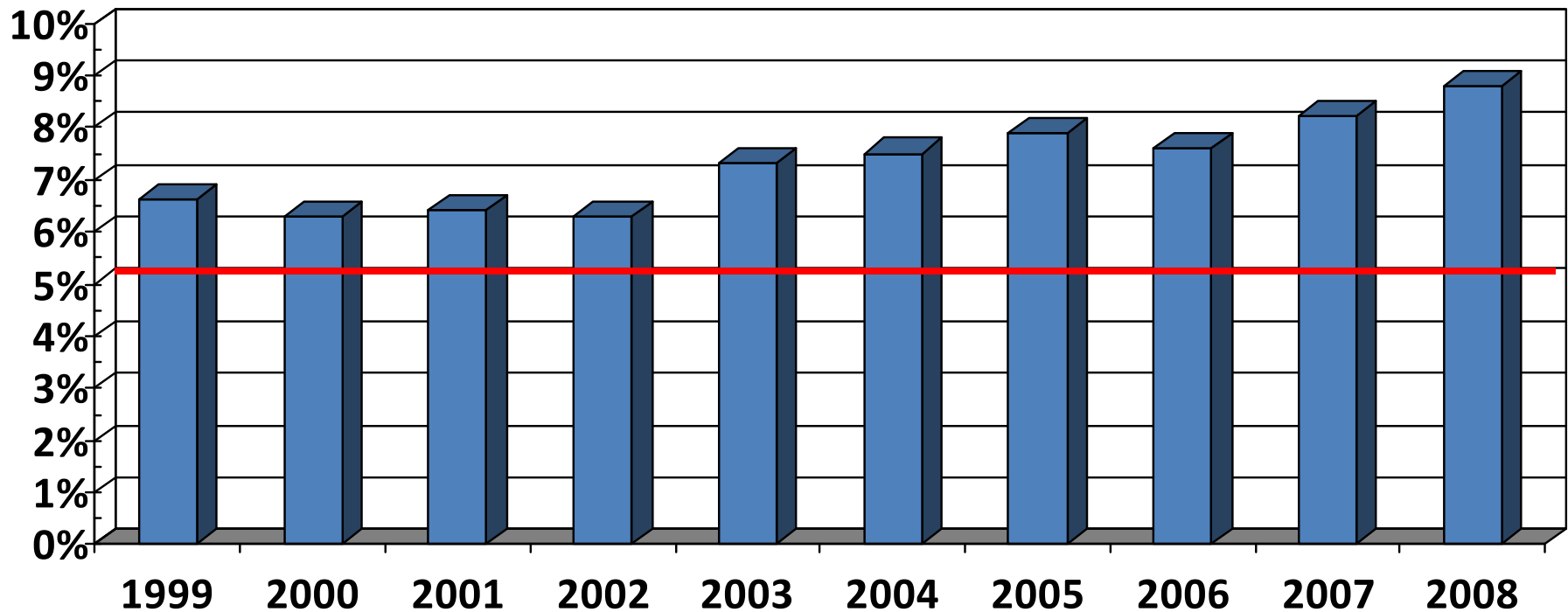
# The Endowment – Last 15 years (in millions)





## Spending Rate on Endowment – Last 10 years

(Based on a moving average of the prior 3 years)





# The Challenges Before Us

The financial challenge that we face has focused attention on a second issue – the excess physical capacity within our Hospital system. The two are inextricably linked, because excess physical capacity brings with it administrative and other overhead expenses which contribute to the financial burden.

Only 31% of licensed beds in our system were occupied on average in 2008. Seventeen hospitals in 2008 had occupancy rates of less than 40%. This is not the result of a decline in inpatient activity, as one might assume. As demonstrated in the table on page 10, the number of inpatient stays in our Hospitals has actually increased over time. Falling census is instead the result of dramatically shorter lengths of stay – a phenomenon that has been broadly demonstrated in the healthcare industry and is not unique to Shriners Hospitals.

If the patient population were condensed into a fewer number of facilities, relatively nominal, incremental costs would be incurred at facilities that admit more patients, while significant fixed costs in maintaining other facilities are avoided. This is the rationale underlying the second budget alternative that is being presented for consideration.



# Inpatient Activity

<u>Measurement</u>	<b>1996</b>	<b>2000</b>	<b>2004</b>	<b>2008</b>
<b>No. of Discharges</b> ↑	<b>22,305</b>	<b>26,942</b>	<b>27,489</b>	<b>29,041</b>
<b>Avg. Daily Census</b> ↓	<b>482</b>	<b>472</b>	<b>416</b>	<b>316</b>
<b>Avg. Length of Stay</b> ↓	<b>7.9 days</b>	<b>6.5 days</b>	<b>5.7 days</b>	<b>4.0 days</b>



# Three Budget Options

Three alternative operating budgets are being presented for consideration by the Representatives in July. The options have four elements in common:

1. The budget for operating revenues and other support are identical under each option.
2. All the alternatives include an expense line item for \$3 million to explore the implementation of third party pay. (This line item would be removed should the proposed amendment be voted down.)
3. All three options anticipate the recovery of financial markets, along with revenue enhancements from third party pay and philanthropic efforts over time. (See the graph on page 14.)
4. None represent a balanced budget for 2010; that is, total budgeted expenses exceed total budgeted revenues in each scenario. (See the note below.)

❖ Financial models utilizing Options 2 or 3 result in a balanced budget in the year 2014. However, should financial conditions continue to deteriorate, or should assumptions with respect to revenues fail to materialize, further cost reductions would be necessary.



# The Revenue Budget

There are two significant changes in the revenue budget for 2010:

1. Historically, a line item labeled “investment return” was used as a device to balance the budget. Over time, it has come to represent investment income (dividends, interest, rents, royalties, etc.), gains on investments, and in recent years the erosion of endowment principal. Beginning in 2010, projected investment income, along with associated management fees, will be substituted. This treatment will be consistent with the financial statement presentation that has been approved by the Finance & Audit Committee and our external auditors.
2. Unrestricted bequests have historically been designated by the Board of Directors for endowment purposes. These will now be included as a line item in the operating budget, which is consistent with actual cash flows in the course of doing business as well as how they will be presented in the audited financial statements.

The budgets for operating revenue and other support for 2009 and 2010 are presented on page 13.



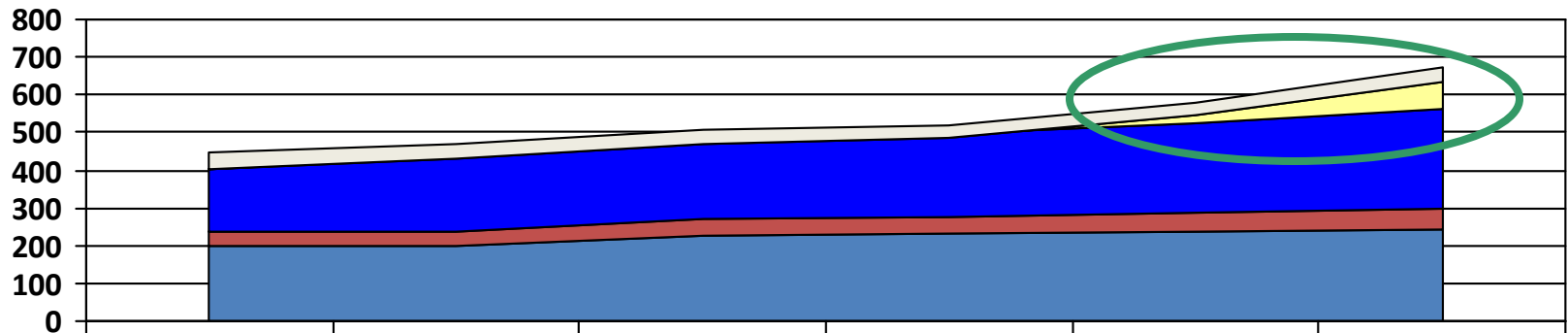
## Operating revenues & other support

	2009 BUDGET (St. Louis)	Adjustments	2009 REDUCED BUDGET	2010 PROPOSED BUDGET	% Chg from 2009
Investment return	667,045	(32,949)	634,096	0	-100.0%
Interest income			0	115,000	
Dividends			0	75,000	
Other investment income			0	25,000	
Investment management fees			0	(20,000)	
Bequests			0	200,000	
Donations	55,000	(15,000)	40,000	40,000	0.0%
Fund raising and special even	32,822	354	33,176	28,000	-15.6%
Hospital assessments	1,716		1,716	1,700	-0.9%
Canadian reimbursements	6,391	(803)	5,588	5,300	-5.2%
Other	2,000		2,000	2,000	0.0%
	<b>764,974</b>	<b>(48,398)</b>	<b>716,576</b>	<b>472,000</b>	<b>-34.1%</b>



# Projected Revenues – Through 2014 (in millions)

Third party pay could represent a major source of income in future years.



	2009	2010	2011	2012	2013	2014
Other income	42	37	37	37	37	37
Third party pay (net)	0	-3	-5	-15	20	75
Yield on investments	165	195	205	221	238	262
Donations	40	40	45	48	51	55
Bequests	200	200	225	230	235	245



# The Expense Budget – Option 1

The first option for the operating expense budget for 2010 extends the reductions made in the course of fiscal year 2009 by an additional 3% for the Hospitals and 5% for Headquarters. It assumes that the cessation of operation of the Galveston Hospital is upheld. The budget for Research is reduced to \$33 million for 2010, with a projected budget of \$27 million in 2011.

Various reductions are made to Employee Benefits. The most significant are:

1. Suspension of the employer match for the 403(b) defined contribution plan.
2. The defined benefit pension plan is frozen to only existing participants. The benefit will not be available to new hires.
3. Numerous health maintenance organizations (HMOs) are offered across the system. These will be consolidated into a single, system-wide HMO.

In total, the expense budget for 2010 under Option 1 is about \$97.6 million or 12.8% less than the budget approved in St. Louis for 2009. The Boards felt that a reduction of greater magnitude would necessitate changes in the delivery model or in the configuration of the system that would require action by the voting Representatives. Note that this option, which is presented on page 16, results in total expense exceeding total revenue by \$195.4 million.



# The Expense Budget – Option 1

	2009 BUDGET (St. Louis)	Adjustments	2009 REDUCED BUDGET	2010 PROPOSED BUDGET	% Chg over 2009
<b>Corporate:</b>					
Board Expense	1,094	(142)	952	904	-5.0%
Executive Vice President's Office	1,182	(654)	528	502	-4.9%
Planning	0	588	588	559	-4.9%
Headquarters Building Operations	1,545	(613)	932	885	-5.0%
Medical Related	4,327	(495)	3,832	3,640	-5.0%
Hospital Related	1,830	(1,573)	257	244	-5.1%
Human Resources	3,139	(534)	2,605	2,475	-5.0%
Public Relations	12,169	(1,896)	10,273	9,759	-5.0%
Legal	3,069	(591)	2,478	2,354	-5.0%
Finance & Accounting	1,891	178	2,069	1,966	-5.0%
Information Services	15,016	72	15,088	14,334	-5.0%
General and Administrative	5,754	(5,225)	529	503	-4.9%
<b>Total corporate</b>	<b>51,016</b>	<b>(10,885)</b>	<b>40,131</b>	<b>38,125</b>	<b>-5.0%</b>
<b>Hospitals</b>	<b>521,803</b>	<b>(67,367)</b>	<b>454,436</b>	<b>431,010</b>	<b>-5.2%</b>
Explore implementation of Third Party Pay	-		-	3,000	
Basic and Clinical Research	46,000	(6,022)	39,978	33,000	-17.5%
Fundraising and Special Events	23,705	(1,360)	22,345	22,345	0.0%
<b>Insurance and Employee Benefits</b>					
Hospitals	64,600	27,637	92,237	71,808	-22.1%
Corporate	4,400	1,404	5,804	5,043	-13.1%
Depreciation	47,450	1,195	48,645	48,118	-1.1%
Contingency	6,000	7,000	13,000	15,000	15.4%
	<b>764,974</b>	<b>(48,398)</b>	<b>716,576</b>	<b>667,449</b>	<b>-6.9%</b>



## The Expense Budget – Option 2

The second option maintains the reductions identified under Option 1, while going much further with respect to changes that would require the affirmative vote of the owners. In addition to the Galveston Hospital, Option 2 calls for the cessation of operation of five more Hospitals:

- Erie Hospital
- Greenville Hospital
- Shreveport Hospital
- Spokane Hospital
- Springfield Hospital

In total, the expense budget for 2010 under Option 2 is about \$165.4 million or 21.6% less than the budget approved in St. Louis for 2009. This option, which is presented on page 18, results in total expense exceeding total revenue by \$127.6 million. However, if revenue projections are realized, a balanced budget would be achieved by the year 2014 as reflected in the graph on page 19. The large Contingency balance is to assist in transitioning patients between facilities.



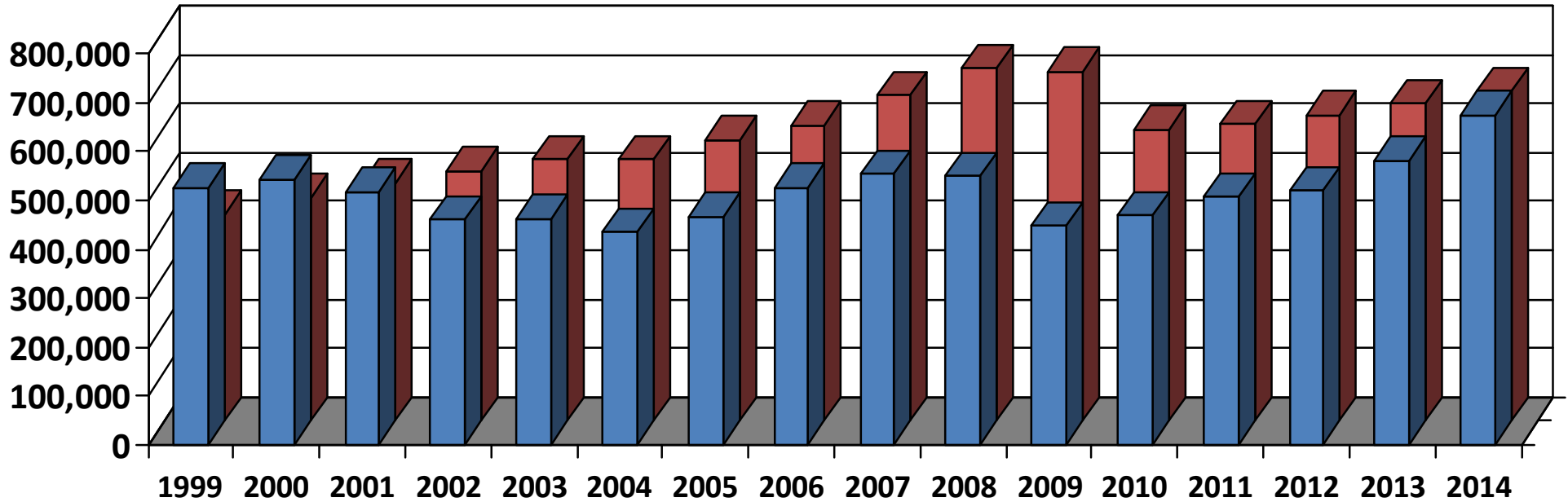
# The Expense Budget – Option 2

	2009 BUDGET (St. Louis)	Adjustments	2009 REDUCED BUDGET	2010 PROPOSED BUDGET	% Chg over 2009
<b>Corporate:</b>					
Board Expense	1,094	(142)	952	904	-5.0%
Executive Vice President's Office	1,182	(654)	528	502	-4.9%
Planning	0	588	588	559	-4.9%
Headquarters Building Operations	1,545	(613)	932	885	-5.0%
Medical Related	4,327	(495)	3,832	3,640	-5.0%
Hospital Related	1,830	(1,573)	257	244	-5.1%
Human Resources	3,139	(534)	2,605	2,475	-5.0%
Public Relations	12,169	(1,896)	10,273	9,759	-5.0%
Legal	3,069	(591)	2,478	2,354	-5.0%
Finance & Accounting	1,891	178	2,069	1,966	-5.0%
Information Services	15,016	72	15,088	14,334	-5.0%
General and Administrative	5,754	(5,225)	529	503	-4.9%
<b>Total corporate</b>	<b>51,016</b>	<b>(10,885)</b>	<b>40,131</b>	<b>38,125</b>	<b>-5.0%</b>
<b>Hospitals</b>	<b>521,803</b>	<b>(67,367)</b>	<b>454,436</b>	<b>365,004</b>	<b>-19.7%</b>
Explore implementation of Third Party Pay	-		-	3,000	
Basic and Clinical Research	46,000	(6,022)	39,978	33,000	-17.5%
Fundraising and Special Events	23,705	(1,360)	22,345	22,345	0.0%
<b>Insurance and Employee Benefits</b>					
Hospitals	64,600	27,637	92,237	65,635	-28.8%
Corporate	4,400	1,404	5,804	5,043	-13.1%
Depreciation	47,450	1,195	48,645	42,444	-12.7%
Contingency	6,000	7,000	13,000	25,000	92.3%
	<b>764,974</b>	<b>(48,398)</b>	<b>716,576</b>	<b>599,596</b>	<b>-16.3%</b>



# Revenues (Blue) vs. Expenses (Red)

In this financial model, net income from third party pay is estimated at \$75 million in 2014.



\$ in thousands



## The Expense Budget – Option 3

The third option for the operating expense budget for 2010 restores a budget for the Galveston Hospital and calls for substantial reductions uniformly applied to all twenty two Hospitals. While the financial results of Option 3 would mirror that under Option 2, it would have very different results on the operations of the Hospitals. These reductions could result in:

- The *de facto* closure of some of the smaller Hospitals as sufficient resources would not be available to serve an inpatient population.
- The closure of a major service line (spinal cord injury and/or cleft lip & palate) at the larger Hospitals.
- Forcing Hospitals to selectively end programs such as provision of in-house Orthotics and Prosthetics, Motion Analysis, Child Life, etc.
- Significant impact on employee morale, with major layoffs and loss of some premier medical and other professionals.
- Loss of Shriners Hospitals' standing as a leader in pediatric subspecialty care and inability to fully achieve our mission and vision.

The expense budget under Option 3 appears on page 21.



# The Expense Budget – Option 3

	2009 BUDGET (St. Louis)	Adjustments	2009 REDUCED BUDGET	2010 PROPOSED BUDGET	% Chg over 2009
<b>Corporate:</b>					
Board Expense	1,094	(142)	952	838	-12.0%
Executive Vice President's Office	1,182	(654)	528	465	-11.9%
Planning	0	588	588	517	-12.1%
Headquarters Building Operations	1,545	(613)	932	820	-12.0%
Medical Related	4,327	(495)	3,832	3,372	-12.0%
Hospital Related	1,830	(1,573)	257	226	-12.1%
Human Resources	3,139	(534)	2,605	2,292	-12.0%
Public Relations	12,169	(1,896)	10,273	9,040	-12.0%
Legal	3,069	(591)	2,478	2,181	-12.0%
Finance & Accounting	1,891	178	2,069	1,821	-12.0%
Information Services	15,016	72	15,088	13,277	-12.0%
General and Administrative	5,754	(5,225)	529	466	-11.9%
<b>Total corporate</b>	<b>51,016</b>	<b>(10,885)</b>	<b>40,131</b>	<b>35,315</b>	<b>-12.0%</b>
<b>Hospitals</b>	<b>521,803</b>	<b>(67,367)</b>	<b>454,436</b>	<b>374,540</b>	<b>-17.6%</b>
Explore implementation of Third Party Pay	-		-	3,000	
Basic and Clinical Research	46,000	(6,022)	39,978	33,000	-17.5%
Fundraising and Special Events	23,705	(1,360)	22,345	22,345	0.0%
<b>Insurance and Employee Benefits</b>					
Hospitals	64,600	27,637	92,237	73,953	-19.8%
Corporate	4,400	1,404	5,804	5,043	-13.1%
Depreciation	47,450	1,195	48,645	48,400	-0.5%
Contingency	6,000	7,000	13,000	4,000	-69.2%
	<b>764,974</b>	<b>(48,398)</b>	<b>716,576</b>	<b>599,596</b>	<b>-16.3%</b>



# The Challenges Before Us

**The choices that will come to the floor for vote are extraordinarily difficult, and will affect the lives of many different stakeholders. However, one thing unites us – the desire to continue to take care of children well into the future. May we therefore choose wisely...**