



## Aged Care Update

15 June 2015

### What accounts for the variable financial performance of residential aged care providers?

It has been about a decade since residential aged care providers have been required to prepare and submit annual General Purpose Financial Reports (GPFRs) as a condition for operating under the Aged Care Act 1997. Since then, Ministers and government officials have from time to time used quartile financial performance analysis of the GPFR data to contrast the better financial results of providers in the higher performing quartiles with those of providers in the lower performing quartiles.

The narrative often used was that the composition of the top quartile of performers was broadly representative of the sector, including in relation to characteristics such as ownership, location and size of operator, which suggested that these characteristics were not determinants of financial performance. Instead, it was implied that management capacity mainly accounted for the difference.

It was also sometimes noted that there was no correlation between the better performers and indicators of poorer care quality, such as incidence of non-compliance and sanctions, complaints and accreditation outcomes. The conclusion drawn was that better financial performance was not being achieved at the expense of quality of care.

Many thought that the focus on management capacity was too simplistic an assessment, which led to the Aged Care Financing Authority being requested to delve deeper into this matter.

This Update canvasses ACFA's findings contained in its **recently released report** to Minister Fifield.

#### A couple of points about methodology

There are a number of points about the approach taken in the ACFA report that warrant noting.

First, unlike previous analyses, providers were allocated to four performance groups based on their operating performance, rather than being grouped by quartile which allocated an equal number of providers to each quartile. ACFA's approach of grouping providers with similar performance results provides a better basis for comparative analysis, and means that the numbers in each group varies, eg. 201 providers are in the top performing group, 193 in the second group, 290 in the third group and 340 in the bottom group. Operating earnings before interest, tax, depreciation and amortisation

range from an average \$25,731 per resident per annum (prpa) for the top group to an average of - \$2,072 for the bottom group.

Second, a methodology was employed that allowed the various types of accommodation revenue (accommodation bonds, periodic payments, accommodation charges and accommodation supplements) to be standardised to facilitate comparisons. This is particularly important as accommodation revenue is the only revenue stream in which providers have some discretion in setting prices, ie. the size of accommodation bonds.

Third, the analysis uses GPFRs for 2012-13, before the major changes to financial arrangements under the reforms took effect. The key change from a financial point of view with the capacity to impact differently in different regions is the increased discretion for providers to set market prices for accommodation for all non-supported residents.

Fourth, the GPFR data and data obtained from Departmental sources such as the payments system were supplemented by a survey of providers which focussed on qualitative factors that might be correlated with performance, such as business models, governance arrangements, asset management and financial management.

Fifth, because of the lack of comprehensive data, the ACFA report does not dwell on whether variations in the cost of supply across Australia are a factor. This aspect has relevance because the prices set by government for care and support, daily living expenses and accommodation for supported residents (just over 40% of the resident population) are the same in all regions of Australia. That is, of themselves, these prices are not sensitive to regional variations in the cost of supply, a point that key recommendations in the Productivity Commission's report, *Caring for Older Australians*, took into account.

Sixth, the study was not required to address the adequacy of financial performance in terms of its capacity to attract future investment.

### **What the available evidence tells us**

Not surprisingly, the ACFA analysis confirms that the higher performing groups include providers with a varied range of characteristics across the sector, including location, size of provider, ownership and resident profile. This suggests that these characteristics are not necessarily constraints on good financial performance for all providers.

The evidence also tells us that there is a likelihood of better financial performance amongst providers with certain attributes, including having sound management and governance practices, being located in large cities and having a high average number of residents per facility. These attributes do not constitute constraints that would prevent many lower performing providers adopting strategies to improve their financial performance, though it is acknowledged that the ACAR process and the secondary market for places may have reduced flexibility to optimise facility size.

However, the ACFA found that attributes associated with location do come together in some regional locations, and more likely in more sparsely populated and remote regions, in a way that can act as a constraint on financial performance.

### **Management**

The impact of variations in management capability and governance were demonstrated in a number of ways, of which the following are worth highlighting:

- Better performing providers had higher ACFI care revenue across all resident profiles. This suggests that these providers were better placed to manage more effectively ACFI assessments

(noting that the care price received by the provider is the same for residents with the same assessed care needs).

- Better performing providers had lower operating expenses across all ownership types and resident profiles (high, mixed or low care).
- Providers in the poorer performing groups seem to be challenged by increasing complexity of care. Although operating expenses per resident per annum increase as resident profiles change from low care, through mixed care to high care, the gap in operating expenses between the poorer and better performing providers increases as the care complexity of the resident profile increases.
- Better financial performance was correlated with providers who maintained lower liquidity and used more debt. For-profit providers used a higher proportion of debt and held lower liquid asset balances than not-for-profit providers.
- Better performing providers had a strategic focus on residential care, including a target resident profile, rather than operate across business lines.
- Better performing providers reported that they are more likely to be more rigorous in monitoring progress against their strategic plan, had refurbished their facilities more regularly, were less likely to prepare budgets on an historical basis and were more likely to outsource functions.
- Better performing providers were more likely to include aged care specific expertise on their Boards, and a lower proportion of community representatives.

### *Scale of facility*

Perhaps surprisingly, the data suggests that financial performance does not necessarily improve with increasing portfolio size. Instead, what characterised the better performing providers was that they had on average a higher number of beds per facility. That is, it appears that the average size of facility has a bigger influence on financial performance than size of portfolio.

This may reflect the high level of fixed costs in operating a facility regardless of its size, and the challenges in assembling a portfolio of facilities of optimum size and location.

### *Resident profile (type of care)*

Providers with a predominance of high care residents (70% plus) were more likely to be associated with better financial performance than providers with predominantly low care residents and, to a lesser extent, mixed care.

The reasons for this outcome are more difficult to discern, but it is significant that high care providers are predominantly for-profit providers, are more likely to be focussed on residential care only, and for-profit providers received higher ACFI revenue and higher resident accommodation revenue.

It may also be relevant that not-for-profit providers dominate low and mixed care services, the latter probably reflecting 'ageing in place' in former low care facilities operated by the not-for-profit sector. As was noted earlier, poorer performing providers appear to encounter challenges in managing costs as the level of care complexity increases.

### *Location*

Better performing providers are more likely to have their services in city locations than regional locations, including rural or remote locations. Better performing providers also derive higher levels of income from accommodation payments by non-supported residents. The latter is linked to house values and correlates with city providers being over-represented in the better performing groups.

The importance of this link has the potential to increase following the extension, since 1 July 2014, of market-based accommodation pricing to all non-supported residents, and will depend on the

extent of the gap between the accommodation supplement for supported residents set by government and market-based prices received for non-supported residents.

Smaller average sized facilities, which are correlated with poorer financial performance, were more common in regional locations.

### *Regional providers*

Care is needed at this stage in drawing conclusions about the financial performance of regional providers.

This is because the Australian Bureau of Statistics definition of regional that was used for the ACFA analysis encompasses a wide variety of geographic locations, ranging from large regional cities through to rural and remote locations. As a consequence it was not possible, for example, to distinguish between the operating circumstances of providers in large regional cities and those of providers in rural and remote locations.

Nevertheless, even under this wider definition, regional providers are over-represented in the lower performing group. This reflects a combination of the following circumstances:

- Regional providers operate facilities with substantially lower number of beds per facility. Smaller facilities are correlated with poorer financial performance.
- Regional providers receive less operating revenue prpa than providers in all other locations. This includes lower resident accommodation revenue and lower levels of ACFI revenue across all resident care profiles. The former most likely reflects lower home values in many regional areas, while the later may reflect management capacity.
- Low care services, which are associated with poorer financial performance, are over-represented in regional areas.

Because of the constraints posed on the viability of many regional services, regional providers tend to be either state government providers or not-for-profit providers who operate services where they might not otherwise exist, reflecting mission objectives and community service obligations.

A noteworthy feature of not-for-profit services in regional areas is their dependence on non-operating revenue. Not-for profit providers in the lowest performing group, who are over-represented in regional areas, attracted non-operating income (such as donations) on average of \$4,122 prpa compared with \$274 for the better performing providers. This non-operating revenue is clearly critical for ongoing viability. But is it fair and appropriate that these communities have to rely on voluntary contributions to sustain their services?

The challenging operational environment for aged care services in regional areas has not gone unrecognised by the current funding system. Under current arrangements, viability supplements are available for small services in rural and remote locations and providers in these areas may be eligible for capital grants to build and renew services. Whether these are adequately compensating for the more challenging environment needs further examination.

It should also be noted that the 177 Multi-Purpose Services and Aboriginal and Torres Strait Islander flexible services, the overwhelming majority of which are in regional areas, have not been included in ACFA's analysis because of lack of data. The ACFA report was unable to draw any conclusion about the financial operations of these services.

### *Ownership*

Not-for-profit and government providers are more likely to be amongst the poorer performing providers because they are significantly over-represented in regional locations where services might not otherwise exist because of the implications of facility scale and remoteness on operating

revenue and expenses and viability. The evidence indicates that for-profit providers avoid operating in certain regional areas.

A distinguishing feature of government services is that they had significantly higher operating expenses, mainly due to higher wage and superannuation costs, mirrored by higher operating revenue received from state governments to meet these costs. Data inadequacies did not allow the relative contribution of wage rates, staffing numbers or staffing profile to these additional costs to be determined.

### **Drawing it all together**

What the evidence tells us is that providers wishing to be amongst the better financial performers should:

- favour locations (mainly cities) that maximise resident accommodation revenue,
- avoid facilities with smaller numbers of residents,
- maximise ACFI revenue through consistently accurate assessments,
- focus on residential high care,
- maintain lower liquidity and use more debt, and
- employ effective management and governance practices around matters such as expense management, monitoring progress against strategic plans, maintaining the currency of their facilities, managing to financial targets rather than historical outcomes, utilising outsourcing and attending to Board membership.

The evidence also confirms that the aged care system relies substantially on government and not-for-profit providers to ensure that services are provided in regional communities where they might not otherwise exist, and that these providers are over-represented in the lowest financial performance group. The dependence on government and not-for-profit providers in these areas is considerably amplified when Multi-purpose Services and Aboriginal and Torres Strait Islander flexible services are included.

It has to be acknowledged though that not-for-profit providers receive certain tax concessions in recognition of their mission objectives.

Responding to the apparent constraints on financial performance faced by providers in certain regional areas, the ACFA has recommended, and the Minister has accepted, that there should be a more detailed analysis undertaken that focuses on rural and remote providers.

Looking ahead, putting aside management capability and noting that prices for care and living expenses set by government are the same Australia-wide, the extent of the gap between the accommodation supplement set by government for supported residents and market-based accommodation prices for non-supported residents has the potential to impact on variability in financial performance across regions, reflecting differences in their socio-economic character. Compensating factors may be variations in building amenity and cross-subsidisation.

*Disclosure Statement: The author of this Update, Nick Mersiades, is a member of the Aged Care Financing Authority. The opinions in this Update should not be read as being an expression of the views of the Aged Care Financing Authority.*