



American Academy
of Value Based Care

Observation vs. Inpatient Admission Quick Reference Guide

2025

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1. FINANCIAL IMPACT OVERVIEW

Appropriate use of observation status is a key driver of hospital cost savings and compliance. Aligning admissions with the Two-Midnight Rule reduces unnecessary inpatient stays while maintaining high-quality care and ensuring regulatory accuracy.

Core Savings Opportunity

- Each appropriate inpatient-to-observation conversion can yield up to **\$10,000** in avoided inpatient costs¹
- **National Averages:**
- **Inpatient stay:** \approx \$11,000–\$14,000 per discharge (CDC)^{1,2}
- **Observation stay:** \approx \$2,000–\$5,000 (medicare)²
- **Average hospital expense:** \approx \$3,000 per inpatient day (2023), fluctuates significantly by state, with some states averaging over \$4,000 per day³

Performance Opportunity

- **Cost Efficiency:** Protocol-driven observation care reduces total cost by 15–30 % compared with short-stay inpatient admissions⁴
- An **8 percent increase** in observation utilization correlates to an estimated \$0.64 PMPM financial improvement
- **National Savings:** Potential national cost savings of \$950 million annually.⁴
- **Shorter Stays:** A 23%–38% shorter length-of-stay in the hospital⁴

Regulatory Framework — Two-Midnight Rule⁴

- **Inpatient admission** requires a physician's expectation that medically necessary hospital services will span **at least two midnights** (\geq 48 hours)
- **Observation status** applies when the expected hospital stay is **less than two midnights** or when clinical uncertainty requires short-term monitoring.

Cost Comparison¹⁻⁵

Category	Inpatient Admission	Observation Stay
Average Cost	\sim \$13,000	\approx \$3,000
Patient Responsibility (Medicare 2025)	\$1,792 Part A deductible	20% Part B coinsurance
SNF Eligibility	Counts toward 3-day SNF requirement	Does not count toward 3-day SNF requirement
Billing Basis	Medicare Part A (DRG-based)	Medicare Part B (CPT/OPPS)
Regulatory Basis	Two-Midnight Rule: Physician expects \geq 2 midnights of hospital-level care	Used when $<$ 2 midnights expected or for short-term monitoring

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