

Financial Management in Healthcare

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Learning Outcomes

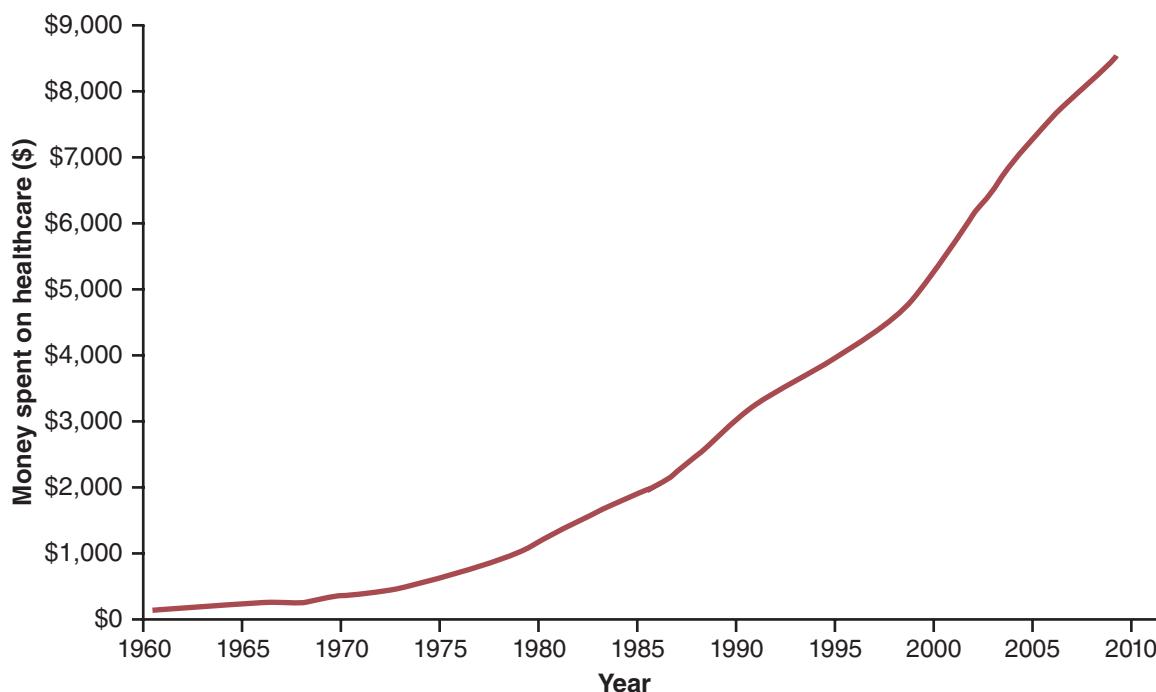
By the end of this chapter, you will be able to:

- Describe the major components of finance: financial accounting, managerial accounting, and corporate finance
- Describe the key features that make healthcare finance unique
- Discuss the importance of finance in the healthcare industry
- List the key financial challenges facing healthcare leaders

Introduction

Hendrickson Memorial Hospital is a typical general medical and surgical hospital. It has 285 inpatient beds with an adjoining 62-bed hospital-based nursing facility and three primary care health centers. The financial statements of Hendrickson Memorial list over \$250 million in assets at the end of 2012 and net patient services revenue of over \$320 million for the year. Government payers (Medicare, Medicaid, and others) paid half of its net patient services revenue. After all expenses associated with providing patient services and tallying other sources of revenues and expenses, net income for the year was nearly \$8 million in 2012, which was a good improvement over the \$4 million earned in 2011. Management feels prepared to enter 2013 and the new era marked by the Patient Protection and Affordable Care Act (PPACA) to begin in 2014. But is the hospital ready? With changes in government payments for services, new expectations of service delivery, requirements for improving electronic health records, and an intensive care unit in need of replacement, Hendrickson Memorial's management team recognizes that they must watch every dollar closely.

Sound financial management is a cornerstone to managing any organization. Development and adherence to processes for planning, tracking, reporting, and analyzing the flows of money are essential to managing an organization. Knowing where all the money is at all points in time and how it is being used is important to assure the appropriate use of resources. Healthcare organizations are no exception to this rule. In fact, given the public's interest in having accessible, high-quality, affordable healthcare services, it is all the more important to have sound financial management of healthcare organizations. Healthcare spending in the United States has increased from \$148 per person in 1960 to more than \$8,500 per person in 2011, as shown in Figure 1.1. With \$2.7 trillion dollars spent on healthcare every year (317 million people multiplied by \$8,500 per person), there is a large amount of money to be managed, and it must be managed well. Sound financial management is more than watching every dollar. Financial management, as a component of the overall management of an organization, must assure that dollars are being spent wisely.

Figure 1.1: Healthcare spending per person, United States 1960–2011

Source: Data from OECD Health Statistics 2013—Frequently Requested Data, retrieved from <http://www.oecd.org/els/health-systems/oecdhealthdata2013-frequentlyrequesteddata.htm>

Overall management of a healthcare organization starts with an understanding of the healthcare goals it wishes to accomplish, often expressed in a **mission statement**. For example, a rural hospital may define its healthcare goals as providing a broad range of healthcare services. Jersey Shore Hospital's mission statement (presented in Exhibit 1.1) includes providing quality health services through the usual components of a hospital: inpatient care (treatments that require overnight stays in the hospital), outpatient care (treatments that permit the patient to return home the same day), primary care (routine visits with physicians and nurse practitioners), and outreach services (health screenings, health fairs, conferences, workshops, and lectures). In contrast, a private physician practice in dermatology may focus its mission on a much more narrow set of services.

There are a variety of healthcare organizations in the healthcare industry (Shi & Singh, 2012). Different types of organizations will define their missions differently. And there may even be differences in the missions among the same types of organizations. As a component of the overall management of an organization, it is important for those involved with financial management to understand the mission and to determine if dollars are being spent on the most appropriate things.

Exhibit 1.1 Jersey Shore Hospital mission statement

Jersey Shore Hospital is a rural healthcare facility committed to providing quality health services with an efficient balance of outpatient care, acute and sub-acute inpatient care, primary care and outreach services. The Hospital maximizes the effectiveness of its program through integration with other healthcare providers to assure the community access to a broad array of healthcare services.

Source: Jersey Shore Hospital, Jersey Shore, PA, <http://www.JSH.org> (June 4, 2013)

Developing an **operational plan** is one way of communicating and assigning resources regarding how the mission is to be accomplished. Based upon the mission statement, the operational plan includes listing the specific goals, objectives, and activities that will be undertaken by the organization. For a healthcare organization, a good operational plan requires a keen understanding of patients' healthcare needs and the healthcare delivery process that addresses those needs. For many hospitals, achieving part of their mission requires provision of inpatient hospital services and outpatient services. The starting point for the operational plan is a forecast of the number of patients to be treated. An example of a patient forecast is provided in Exhibit 1.2. In this example, elective hospital admissions and outpatient visits have been quite stable over time. The number of older people presenting for emergency care has followed demographic trends. The proportion of outpatient surgeries (admission and discharge on the same day) is forecasted to increase from 70% in 2011 to 80% in 2013.

Exhibit 1.2 Hospital patient volume forecast

Volume Measures	Actual	Actual	Plan
	<u>2011</u>	<u>2012</u>	<u>2013</u>
Planned care (elective) admissions	2,000	1,980	2,010
Nonelective admissions	8,000	8,200	8,800
Outpatient surgery admissions	8,800	9,100	9,800
Outpatient visits	80,100	81,000	81,400

After projections of patient volume, the operational plan includes the use of personnel (medical, operational, and administrative) and physical resources (buildings, equipment, and supplies). An example of a personnel plan is provided in Exhibit 1.3. For this example, despite increases in admissions and outpatient visits, there were fewer full-time equivalent employees in 2012 than in 2011. A continuation of this trend toward providing more services with fewer personnel is planned for 2013. Not presented, but following along these same lines, are plans for the buildings, equipment, and supplies that will be used to treat patients.

Exhibit 1.3 Hospital personnel plan (full-time equivalent employees)

	Actual 2011	Actual 2012	Plan 2013
Hospital Personnel			
Physicians	60	60	60
Nursing and allied health	342	322	313
Other clinical staff	132	131	130
Scientific, therapeutic, & technical	146	145	144
Nonclinical staff	198	181	169
Total	878	839	816

The financial aspects involved with acquiring and using the personnel and physical resources are presented in a **business plan**. The essence of a business plan is tying the personnel and physical resources in the operational plan to financial (dollar) resources. Business plans and budgets will be described more fully in Chapter 7. Sound financial management follows operational management—assuring that the goals and objectives are met by efficiently undertaking planned activities—with an emphasis on the finances involved.

Because sound financial management follows operational management, many finance personnel develop expertise in the operations whose dollars they are planning, tracking, reporting, and analyzing. Some of the best finance personnel are those who learn which aspects of the organization need to be watched, improved, or generally managed to achieve the organization's health care goals (Miller, Brunssona, & Lapsley, 1998). Anyone aspiring to become a general or financial manager of a healthcare organization is well advised to be attentive to the clinical concerns and patient concerns of operations, as well as financial concerns.

1.1 Understanding Finance

Finance is a commonly used term that describes an array of fields of study and practice where money is concerned. In the popular press, finance often refers to banking and government systems. Banks and government agencies, like the Federal Reserve, have a substantial role in the economy. Banks are institutions licensed to receive deposits, make loans, and provide for an orderly movement of money in the economy. The Federal Reserve is an agency with responsibility for banking information and regulation, payment systems (working with banks to process checks), and monetary policy (setting money supply and interest rates). Clearly banks and government agencies serve important roles in finance for the economy.

For patients at healthcare organizations, finance refers to the management of billing, payments, and interactions with insurance companies. An office of Patient Financial Services is generally available to answer patients' questions about their bills and provide financial assistance, when appropriate. Financial services representatives may work with patients to determine all possible assistance options, including private insurance, Medicare, Medicaid, and other programs.

For healthcare organizations and managers, finance also refers to **accounting**, the process of preparing financial statements and additional analyses of interest to an organization's management. More specifically, finance is the management of assets, liabilities, revenues, and expenses, which will be discussed in greater detail in Chapter 2. Assets are the items controlled by the organization and include money (checking accounts), supplies, equipment, buildings, and a host of other items. Liabilities, or debts, are the amounts owed to other individuals or companies. Revenues are the monies earned for providing patient services, selling pharmaceuticals and medical supplies, and other activities. Expenses are the monies associated with paying personnel, purchasing pharmaceuticals and medical supplies, and using equipment and buildings. This last definition of finance, or planning, tracking, reporting, and analyzing the flows of money, is the focus of this book.

There are three components of finance for managers: **financial accounting**, **managerial accounting**, and **corporate finance**. Each of these components refers to an area of activity that managers must control for sound financial management of an organization.

Financial Accounting

Financial accounting is the practice of "keeping track" of resources. It involves recording and compiling business and financial transactions, assuring the accuracy of transactions, and preparing reports of the results. With this definition, financial accounting functions are present in almost every part of an organization. Given the complex activities that occur in healthcare organizations, keeping track of resources can be a challenging task.

Tracking Costs

Imagine that a child is brought to the emergency department after falling on the playground. Where does financial accounting occur in this case? Accounting for the emergency department begins long before the first patient arrives with the tracking of resources that were acquired to build the department. The building and equipment were purchased and financial accounting recognized both the purchase and how it is being paid for, perhaps by borrowing money. Accounting also recognizes how much of the purchase price is allocated to each year of its useful life. (This allocation is an expense called *depreciation* that will be considered in Chapter 3.) Next, accounting keeps track of how much it costs to *keep the lights on*, even if zero patients are present at any given time. In addition to the explicit electricity needed to keep the lights on, inventories of supplies and resources must be available, waiting for patients to arrive. Based upon forecasts of patient volume, personnel are hired, hours tallied, and paychecks issued. Human resources and accounting work hand in hand to assure that wages and salaries are reported and paid properly.

Similarly, documentation of diagnoses and treatments requires clinical departments to work with accounting. Tracking patient care is where the most substantial financial accounting activity (in terms of the number of entries in an information system) occurs in healthcare organizations. After a careful patient history and physical examination, the child is diagnosed as having a scraped elbow with treatment consisting of cleansing the wound and applying a bandage. For proper medical documentation, as well as payment and financial reporting purposes, at least three different coding structures are involved in this case. The use of proper codes is important because they are the basis upon which healthcare providers and insurance companies communicate. If providers want to be paid promptly and correctly, they must use the right codes.

First, the diagnosis is clarified with an International Classification of Diseases—9th Clinical Modification (ICD-9-CM) code of 913.0 “abrasion or friction burn of elbow, forearm, and wrist, without mention of infection.” On October 1, 2014, the ICD-9-CM codes used to report medical diagnoses will be replaced by the ICD-10-CM codes. ICD-10 is more detailed and is the system used through most of the world. The new ICD-10 code will be S50.0 “contusion of elbow” and W09.8 “external cause of injuries, fall, falling (accidental), playground equipment.” The movement from ICD-9 to ICD-10 will be complex, as it means moving from a system that healthcare organizations have used for a number of years, with approximately 4,500 codes, to a new system with approximately 70,000 codes.

Second, after the diagnosis, treatment by the medical provider is clarified with a Current Procedural Terminology®, Fourth Edition (CPT-4) code of 99282 “Emergency department visit with expanded problem focused history and examination with medical decision making of low complexity.” And third, the use of the hospital emergency department as the site of the diagnosis and treatment is clarified with an Ambulatory Payment Classification (APC) code of 613 “Level 2 type A emergency visit.” (More detail on the use of CPT-4 and APC codes will be provided in Chapter 5.) Beyond the coding systems presented in this example, several other coding systems may be employed, based upon the diagnoses, underlying causes of the need for medical treatments, treatments, and disposition.

How will the child or other responsible party pay for the visit to the emergency department? To start, a schedule of fees (called a **chargemaster** in hospitals) is prepared based upon historical or estimated costs; see Exhibit 1.4. All of the services provided to the patient are collected and placed on the patient bill and aligned with the schedule of fees. Some sets of services may be bundled into groups for payment purposes. In our hurt child example, the chargemaster for the emergency department might include a line item for each product provided to the child, including antibiotics, pain relievers, and bandages. By placing each product on the patient bill, the emergency department can determine the expenses associated with each patient’s care and track the use of supplies.

Exhibit 1.4 Ronald Reagan UCLA Medical Center charge description master file, June 1, 2012 (selected entries)

	<u>2012 CPT Code</u>	<u>Average Charge</u>
Evaluation and Management Services		
Emergency Room Visit, Level 2 (low to moderate severity)	99282	\$300
Emergency Room Visit, Level 3 (moderate severity)	99283	\$470
Emergency Room Visit, Level 4 (high severity)	99284	\$750
Outpatient Visit, established patient, 15 minutes	99213	\$183
Laboratory and Pathology Services		
Basic Metabolic Panel	80048	\$200
Blood Gas Analysis, including O ₂ saturation	82805	\$140
Complete Blood Count, automated	85027	\$30
Complete Blood Count, with differential WBC, automated	85025	\$40
Radiology Services		
CT Scan, Abdomen, with contrast	74160	\$2,070
Mammography, Screening, Bilateral	77057	\$336
MRI, Head or Brain, without contrast, followed by contrast	70553	\$6,270
X-Ray, Chest, two views	71020	\$230
Medicine Services		
Cardiac Catheterization, Left Heart, percutaneous	93452	\$17,847
Echocardiography, complete	93307	\$906
Electrocardiogram, routine, with interpretation and report	93000	\$289
Inhalation Treatment, pressurized or nonpressurized	94640	\$115
Surgery Services		
Arthroscopy, Knee, with meniscectomy (medial or lateral)	29881	\$9,018
Arthroscopy, Shoulder, with partial acromioplasty	29826	\$12,382
Carpal Tunnel Surgery	64721	\$5,481
Cataract Removal with Insertion of Intraocular Lens, 1 Stage	66984	\$6,730

Source: State of California, Office of Statewide Health Planning and Development, Annual Financial Data Hospital Chargemasters, <http://www.oshpd.ca.gov/Chargemaster/default.aspx>

After determining the charges on the patient bill, the payment status of the patient is evaluated. All hospitals, some clinics, and other healthcare settings have procedures to determine whether a patient will qualify for **charity care** (and thus no charge is made to the patient) or whether the patient directly or an insurance company will be presented with a bill. If an insurance company is responsible for payment, the hospital must determine the amount that will be paid, which is often specified in a contract between the hospital and the insurance company. The display from the chargemaster in Exhibit 1.4 provides only the services and the charge. Beyond these two elements, a complete chargemaster would include information on all insurance contracts and payment policies of payers. Chargemasters are under constant revision, as contract with insurance companies and payment policies change often.

Finally, a bill will be sent to the insurance company, and accounting will keep track of the bill's status, including the receipt of payment and the deposit of funds into the hospital's bank account. There are a great many ways in which insurance companies may pay providers, each of which may require unique information to be included on the bill to assure correct payment (Casto & Forrestal, 2013).

As this example demonstrates, even for the simplest patient visit, a substantial amount of information is collected and used in financial accounting, and nonaccountants collect much of it. Since the mission of healthcare organizations is the delivery of healthcare services, effective accountants learn to work closely with clinical and other administrative personnel to track resources.

With the visit example replicated hundreds or thousands of times, financial accounting systems capture data that permit the tracking of all funds, allowing for reporting and analysis. The most visible product of financial accounting is the set of financial statements that portray the financial status of an organization. These statements include the income statement, the balance sheet, and the statement of cash flows, which will be discussed in Chapter 2. A key to preparing these financial statements is to make them consistent in terms of processes and presentation to financial statements of all other companies in their industry. In fact, financial statements are prepared with the intended audience being persons outside of the organization.

Auditing

Financial accounting is also the field under which **auditing** falls. Auditing is the process of testing and reporting on the consistency of the accounting process. Larger organizations may have an **internal audit** function. Internal auditors are employees of the organization who report to the audit committee of the board of directors and work independently of hospital management. Internal auditors test and report on the consistency of the accounting process and often have a larger role in compliance with regulations, fraud investigation, and risk management. Internal auditors generally prepare an annual plan for reviews of areas of concern and look for any irregularities in processes. As employees, their work further entails investigating why irregularities happen and prepare recommendations for corrective actions. In essence, internal auditors serve as consultants to the board of directors and management to identify and propose solutions to any breakdowns in the accounting process.

The term *accountant* often brings to mind the **certified public accountant (CPA)** that is engaged by the organization to perform an **external audit**. This is an important aspect of the accounting process, though it is a small portion of accounting activity. The real work of accounting is the tracking of resources throughout the year, while the audit is the check at the end. The final results of an external audit are opinions by the CPA as to whether the organization has followed **generally accepted accounting principles (GAAP)**, or the guidelines and rules necessary in recording transactions and preparing financial statements, and whether financial statements appear to accurately portray the financial status of an organization.

The role of the external audit became much more visible over a decade ago with the high-profile scandals at companies such as Enron. The Sarbanes–Oxley Act of 2002 set new standards and expectations for both organizations and their external auditors. The act requires more focus on the effectiveness of internal controls over financial reporting by management, requires that senior management (the chief executive officer (CEO) and **chief financial officer (CFO)**) certify financial reports, and provides protections for employees who identify financial reporting issues (so-called whistleblowers). Not-for-profit healthcare organizations are not required to follow all of the provisions of Sarbanes–Oxley, as those were written for investor-owned corporations that issue stock, though many have voluntarily agreed to provisions that improve internal controls.

In addition to public accountants who serve as external auditors to healthcare organizations, Medicare, the U.S. government program that provides health insurance to the elderly and disabled, also has two auditing functions. The first auditing function concerns the **Medicare Cost Report**, which provides detailed financial information following Medicare's own special accounting rules. The second audit is the Recover Audit (RAC) program that seeks to identify overpayments and underpayments. Three quarters of costs recovered by Medicare through the RAC have been associated with the provision of medically unnecessary services, with insufficient documentation and incorrect coding equally sharing the remaining quarter (Centers for Medicare and Medicaid Services, 2012b). Good internal controls may not easily address provision of medically unnecessary services, though it can address documentation and coding.

Auditors provide opinions on the work of an organization. However, the financial and general managers of an organization are ultimately responsible for the financial results and their reporting.

Analyze This

If a hospital has a good internal auditor, does it still need an external auditor? Please explain your reasoning.

Managerial Accounting

In many ways, managerial accounting has the opposite focus and process as financial accounting. Financial accounting produces financial statements that strictly follow externally imposed rules to provide interested persons outside the organization a clear overview of its current status and most recent past. Managerial accounting provides reports that follow internal conventions for managers to provide information for decision making on the future of the organization. As such, this type of accounting does not need to follow a prescribed set of rules. Rather, its policies and procedures can be tailored to the specific needs of the organization.

The annual budget is the clearest example of a report developed by managerial accounting. The budget is used to establish guidelines for staffing and expenses at the beginning of the year and for evaluation of performance at the end of the year. More detailed managerial accounting reports can include analyses of the costs and profitability of specific services and analyses of whether organizations should provide services directly or purchase them from outside vendors. In smaller organizations, one accountant or multiple accountants may handle all accounting duties. In larger organizations, managerial accountants may work alongside financial accountants. While the financial accountants focus on record keeping and compiling business and financial transactions, managerial accountants administer the budget process and conduct analyses of costs and operational performance.

The key functions of managerial accounting will be covered in later chapters.

Corporate Finance

Corporate finance, as a distinct field of study and practice from accounting, is concerned with planning, analysis, acquisition, and management of resources. What's the difference between accounting and finance, since the terms used to describe them look so similar? The focus of accounting tends to be on the details of operations and reporting in real time (financial accounting) and for the near term (managerial accounting). The focus of finance tends to be on the planning and acquisition of funds for the long term, well in advance of operational activities. Finance will be involved with borrowing by the organization. In the short term, borrowing may be as simple as obtaining a loan from a bank. In the long term, borrowing can be as complex as issuing debt with varying rates of interest that is convertible into common stock. Corporate finance is also concerned with analyzing investments, assessing the risk of the organization, and evaluating the level of debt taken on by an organization.

In smaller organizations, one person may handle all accounting duties as well as all finance duties. In larger organizations, persons involved with corporate finance may work alongside accountants. While accountants focus on current operations, finance focuses on the long-run position of the organization. The key functions of corporate finance will be covered in later chapters.

For Review:

1. What are the three major components of finance?
The major components of finance are financial accounting, managerial accounting, and corporate finance. In smaller organizations, one person might do it all. In larger organizations, the functions will be separate.
2. How does financial accounting differ from managerial accounting?
Financial accounting records, tracks, and prepares statements on transactions for outside parties, following well-defined rules. Managerial accounting conducts specialized analyses of costs and operations, and budgets, for internal managers following organization-specific guidelines.
3. How does finance differ from accounting?
Finance is more concerned with the long-term planning and acquisition of assets and payment for assets, including borrowing money. Accounting is more concerned with short-term operational issues.

1.2 Unique Aspects of Healthcare Finance

Managing the finances of healthcare organizations has been a part of administration for as long as there have been formal organizations. Relatively new are the complex and differential points of interest and requirements of attention for corporations, particularly for healthcare organizations. Some aspects of finance are not particularly different in healthcare organizations as compared to other businesses of similar size. Methods to track the flow of funds

and financial activity are common to all businesses. For many of the expense-side financial management activities, healthcare organizations are no different from most other companies. Most all organizations require physical plant, equipment, supplies, and personnel. The payroll process can be very complex for a healthcare organization, as many are open 24 hours a day, 7 days a week, with a varied mix of medical, administrative, and support personnel employed. Part of what makes healthcare finance special is the relative complexity of the work hours and skills of the personnel, and the complexity of the physical plant, equipment, and supplies. Healthcare is the only industry where one can find a book that describes depreciation for major assets, in part due to Medicare reporting requirements (American Hospital Association, 2013a).

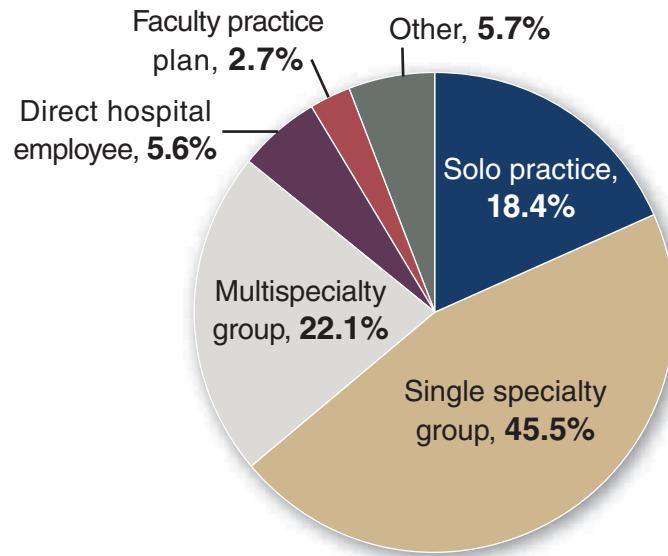
Not-for-Profit Structure

One unique aspect of many healthcare organizations is the not-for-profit ownership structure. Starting with Pennsylvania Hospital in 1751, most hospitals were affiliated with either governments (city or state) or religious institutions and were not without concerns about their proper financial accounting practices (Banfield, 1902). As the complexity of medicine rose and the healthcare system grew, the nongovernmental, not-for-profit ownership structure dominated. The Hill Burton Act in 1947 was a stimulus for much of the construction of not-for-profit hospitals in the 1940s to 1960s. Even today, of the 4,973 general care hospitals, 2,903 are nongovernment, not-for-profit hospitals, 1,045 are state and local government hospitals, and 1,025 are investor-owned (for-profit) hospitals (American Hospital Association, 2013b). Not-for-profit, government, and investor-owned hospitals each have differing financial reporting requirements and require specialized finance expertise.

Physicians

Another unique aspect of hospitals is the role of the key operational personnel—physicians. In no other organization is an important decision maker on both revenues and expenses not an employee, but one who is self-employed and bills for services through a separate organization outside of the view of the organization. As displayed in Figure 1.2, according to an American Medical Association survey, most physicians are not hospital or health system employees. In fact, only 5.6% of physicians are direct hospital employees (Kane & Emmons, 2013). Most physicians are in groups with other physicians in the same, single specialty (e.g., cardiology, dermatology, or internal medicine), in groups with physicians in more than one specialty, or in groups

Figure 1.2: Physician employment by type of organization



Source: Based on Kane, C. K., & Emmons, D. W. (2013). New data on physician practice arrangements: Private practice remains strong despite shifts toward hospital employment. Policy Research Perspectives. Chicago, IL: American Medical Association. Retrieved from <http://www.ama-assn.org/resources/doc/health-policy/prp-physician-practice-arrangements.pdf>

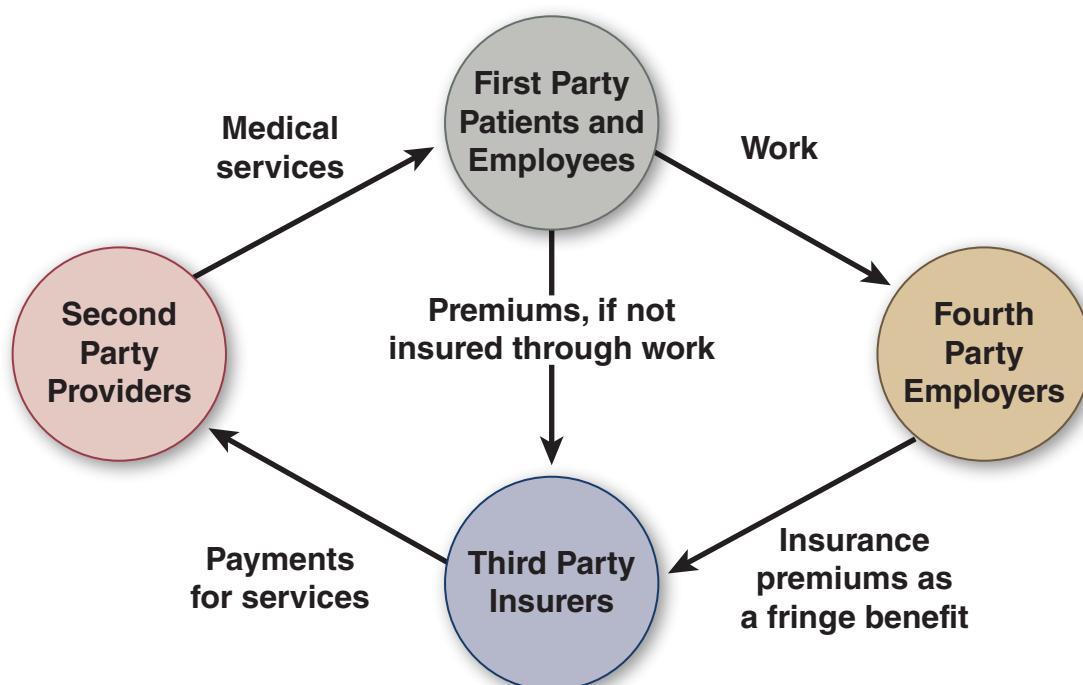
with physicians involved with medical education (faculty group). Hospitals largely use voluntary medical staff members who are not employees (Kitchener, Caronna, & Shortell, 2009).

Insurance

Certainly the most unique aspect of healthcare organizations is the insurance system that provides payment for most patients. For much of the early history of healthcare organizations in the United States (pre-1945), insurance coverage was not widespread and therefore patients were expected to pay for services, to the extent that organizations were not designed purely as charities. Healthcare finance became complex with the expansion of insurance coverage in the private sector after World War II and particularly with the introduction of insurance coverage in the public sector in the form of Medicare (for the elderly and disabled) and Medicaid (for the poor) in 1965.

Insurance coverage introduced a private third party in the healthcare transaction for many starting in the 1930s and a government third party for the elderly, disabled, and poor in the 1960s (hence the term, **third-party payer**). As depicted in Figure 1.3, patients are the first party in healthcare. In the flow of funds in healthcare, at various points in time, individuals may be patients, insurance purchasers, and workers. As patients, individuals interact with the second party, healthcare providers. Individuals may purchase health insurance from companies directly (the third party), or work for employers who engage in purchasing insurance or funding payment for healthcare services directly (the fourth party).

Figure 1.3: The four parties in healthcare



Analyze This

Which of the four parties is to blame for rising healthcare costs? Why?

The presence of insurance coverage alone did not initially make healthcare finance more complex. For much of the 1950s to the 1980s, much of insurance paid on what is called a *reimbursement* system. In fact, we still commonly use this term today. Reimbursement implies that a healthcare organization incurs expenses that will be later paid back by the insurance company. At that time, hospitals completed cost reports with insurance companies that followed company-specific rules or governmental rules (so-called statutory accounting since the rules are based on law, called statutes) that differ from GAAP. Hospitals received periodic interim payments during a year and then with the audited cost report, agreed to a settlement amount with the insurance company or government program. There was some complexity in terms of having financial accounting systems that could produce both traditional GAAP statements and cost reports; however, there was little risk to the organization as all costs were being reimbursed.

In 1983 Medicare introduced fixed payments for hospital inpatients based upon diagnosis-related groups (DRGs). Given the diagnosis and procedure coding that occurred, the patient was assigned to one of several hundred DRGs, each of which was associated with a specific payment amount. In 2000, a similar system was introduced for hospital outpatient services based on ambulatory patient classifications (APCs) and the connection between hospitals' expenses and the amount of payment received from the government was severed. Most private insurance companies have followed Medicare's lead, and there are few institutions that safely receive reimbursement for all of their expenses. This change in risk has been associated with enhanced efforts on the part of healthcare organizations to understand and manage their costs (managerial accounting) and to use more sophisticated tools to plan for the future and acquire funds (corporate finance).

As a result of the large number of private insurance companies (not-for-profit and investor-owned), governmental programs, and employer programs, almost every hospital today faces dozens, if not a hundred different contracts that specify billing procedures and payment amounts. In California, it was estimated that administrative costs in healthcare accounted for one quarter of all spending and that billing and insurance related activities accounted for half of that (Kahn, Kronick, Kreger, & Gans, 2005). Even though the "usual" finance role in hospitals (financial accounting, managerial accounting, and corporate finance) is not large as a percentage of expenses, the unusual number of employees required to document and track billing and insurance related activities makes this a very expensive aspect of hospital administration.

For Review:

1. What are some of the key features that make healthcare finance unique?

Healthcare finance is different from finance in many other industries due to the not-for-profit structure of many healthcare organizations, the role of physicians as unpaid workers in many organizations like hospitals, and the insurance coverage of services that involves both insurance companies and employers in the payment process.

1.3 Role of Finance in Healthcare Organizations

Given the preceding introduction to healthcare finance, stating its importance is perhaps unnecessary. In all organizations there is an important role for finance in planning, tracking, reporting, and analyzing the flows of funds. In healthcare organizations a differentiating factor may be the consequences of not fulfilling the finance role. When Refco, a financial services company, closed due to financial mismanagement in 2005, there was one less broker of commodities and futures contracts. Although this closure impacted some investors and Refco's employees, there was no larger societal concern. When emergency departments close, many patients or potential patients may face challenges in receiving timely medical care services, which becomes a societal concern. Emergency department closures are associated with financial problems, but not necessarily financial management problems (Hsia, Kellermann, & Shen, 2011). It may be that finance personnel at organizations that closed their emergency departments were doing a good job, recognized gaps between revenues and expenses, and proposed planning for cost reduction or redirecting patient care. It is also possible that there was inadequate planning and management of financial resources. Irrespective of the role of finance, no amount of planning and analysis can overcome poor financial results that arise from an organization that is not effective and efficient or from a general economic environment that is unfavorable.

Sound financial management often implies making trade-offs among organizational goals. It has become common for healthcare organizations to employ *balanced scorecards* for assessing organizational performance against goals. The elements of balanced scorecards vary by organization and commonly include mission fulfillment, patient satisfaction, employee engagement, organizational development, and financial results. An example of a balanced scorecard, reporting on five mission critical elements, is presented in Exhibit 1.5. Trade-offs may be required among elements of the scorecard, but certain minimum levels may be required. For financial results, there's an old saying of "no margin, no mission" (Meliones, Ballard, Liekweg, & Burton, 2001). Margin is a quick way of saying profit margin. It is a constant challenge for organizations to provide quality care, and to keep the patient and family satisfied and informed, while earning a sufficient profit margin to keep the organization open. Finance managers do not have the final say on the services offered and the trade-offs made by organizations, but their voices are important.

Exhibit 1.5 Example hospital balanced scorecard

Mission / Objective	<u>Goal</u>	<u>Actual</u>
Provide Quality Care		
Medication error rate	<10%	4%
Pneumonia outcomes: Antibiotic administration	100%	100%
Heart failure outcomes: Discharge instructions	100%	100%
Meaningful use of information technology—All measures	100%	100%
Satisfied Patients		
New patient satisfaction with clinics	>4.0	4.7
Annual patient satisfaction survey: Calls returned timely	>4.2	4.5
Annual patient satisfaction survey: Test results timely	>4.4	4.6
Patient Centered Care		
Hospital inpatient survey: Family information	>90%	98%
Hospital inpatient survey: Patient understanding	>90%	75%
Hospital inpatient survey: Medication knowledge	>90%	65%
Awareness of Available Services		
Increase usage of preventative screening colonoscopies	>1%	3%
Increase usage of preventative screening mammograms	>1%	5%
Number of educational opportunities available to public	>3	2
Website usage: Total “hits”—patient education	>25,000	25,524
Financial Status		
Accounts receivable days	<65 days	55
Operating margin	>1%	1.7%

Source: Author calculations

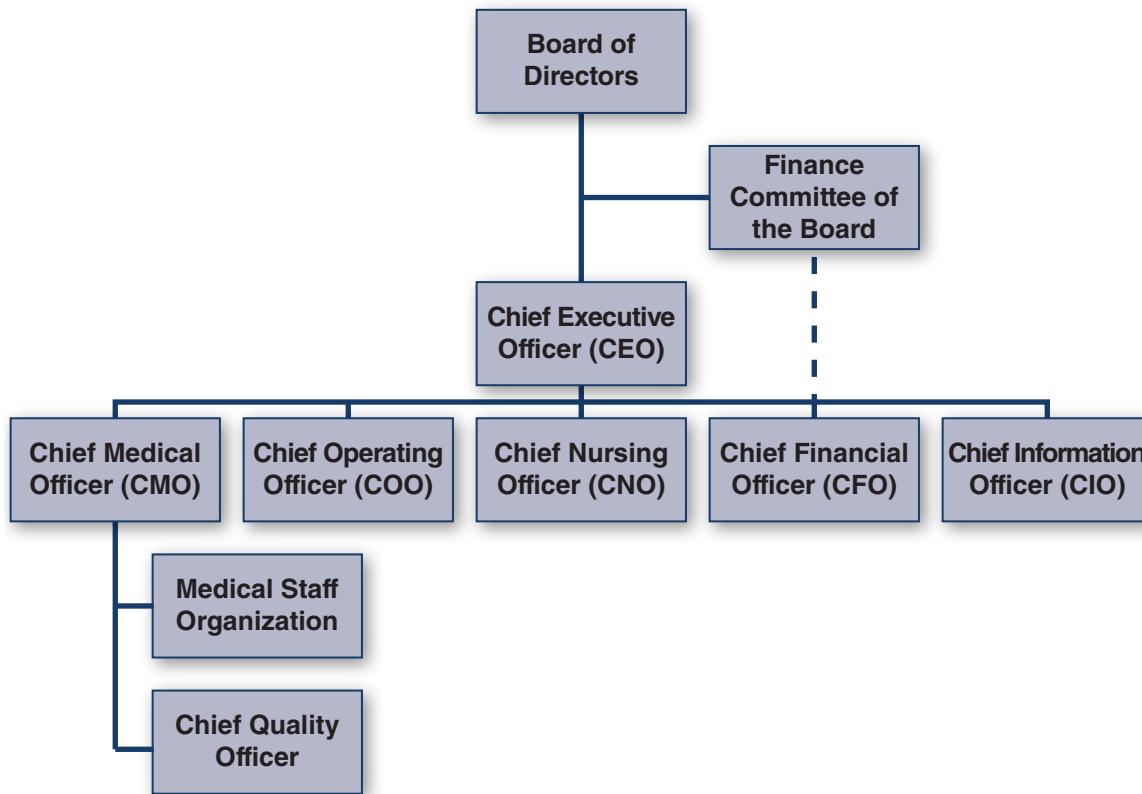
From the Front Lines

It is easy to lose sight of the true focus of this industry—patient care. I receive regular reports on utilization of services and financial statements and can become too focused on the volume of services and profitability. Using a balanced scorecard keeps us focused on what always matters most—our patients. It is a great reminder to continuously improve the quality of care and remain attentive to all patients' needs.

Source: Hospital CEO

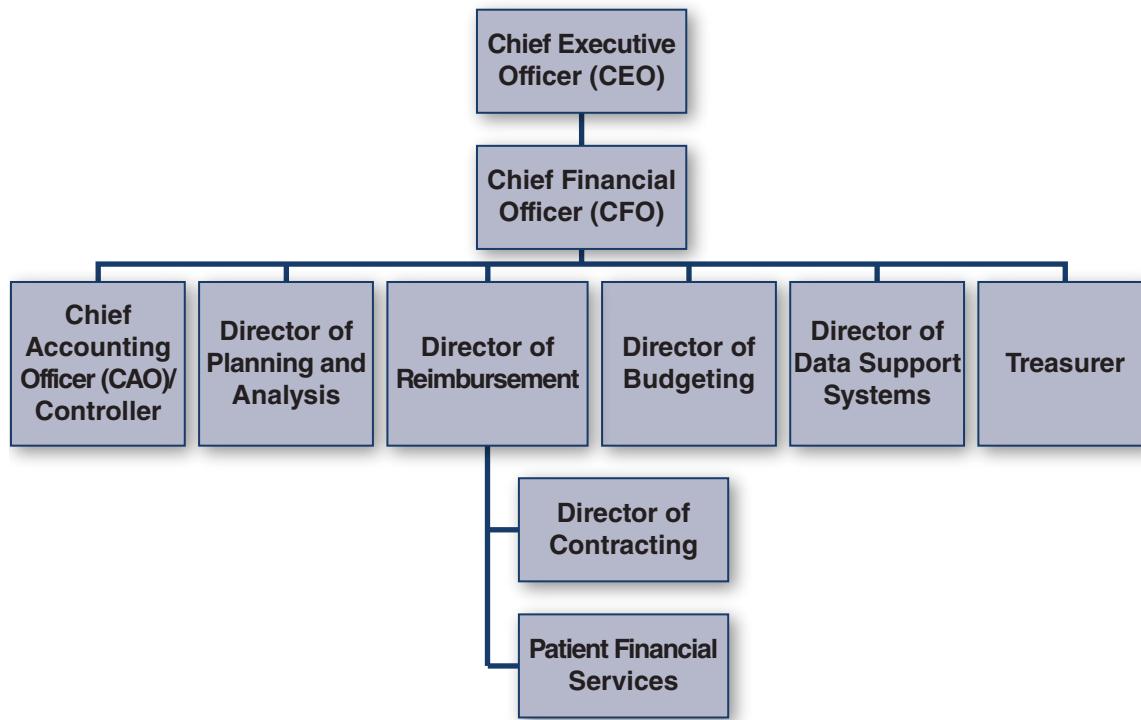
Structure of a Finance Department

The formal role and structure of finance can vary substantially between organizations, based on the size and complexity of the organization and the emphasis of finance in decision making and control. For a small medical office or clinic, all accounting and finance functions may be performed by a single person. A common organizational structure for a hospital will involve a board of directors and president/CEO, leading a team of individuals who lead important operational areas, including finance, such as that in Figure 1.4. Some organizations will have a number of other areas reporting to the CEO, such as human resources, development, and marketing.

Figure 1.4: Common hospital organizational structure

The board of directors will typically have a number of committees, including committees devoted to compensation, audit, and finance. The chief financial officer (CFO) reports directly to the president/CEO for assignments, direction, and evaluation purposes. At the same time, the CFO will be a key resource to the finance committee and perhaps other committees of the board of directors.

Under the direction of the CFO are a number of employees with responsibility for the major finance functions, as seen in Figure 1.5. One is the chief accounting officer (CAO), often called a controller. The CAO will typically be responsible for financial accounting and reporting. Working closely with the CAO is the director of planning and analysis. In some organizations, planning and analysis includes many major managerial accounting functions, whereas in others it includes long-term planning. Directors of reimbursement have varied roles that can include a focus on external affairs (contracting and government regulatory compliance) and internal affairs (patient financial services). Directors of budgeting typically focus on the budgeting of operations (departments and programs) and work closely with directors of human resources, as labor can account for 60% of a healthcare organization's budget. Directors of data support systems work closely with the chief information officer (CIO) and assure the operation and integrity of data systems containing financial data. Finally, the treasurer will have responsibility for management of financial resources (cash and investments).

Figure 1.5: Common hospital finance department structure

For each of the employees reporting directly to the CFO, there may be several more people reporting to each of them. For a 400-bed community hospital with 5,000 employees and a billion dollars in expenses per year, it would not be unusual to have five accountants reporting to the CAO, three or four financial analysts reporting to each of the directors of planning and budgeting, and another three or four data/business systems analysts reporting to the director of data support services. Contracting and contract management may involve two or three employees and patient financial services may involve a number of others. In some organizations, patient financial services are consolidated, whereas in others there are patient services personnel located in the clinical departments. Thus, there may be 30 employees or more in central healthcare finance. In addition, each hospital department will have a finance director and one or more analysts. The numbers really add up!

Financial Operations and Evidence-Based Financial Management

The previous description of the role of finance presumes that finance personnel know how to do their jobs and that their jobs contribute positively to the success of an organization. For internal operations, including routine accounting services, contracting and support of patient financial services, operational budgeting, and data support, it is reasonable to expect that qualified managers will have a good understanding of the data and the skills of finance personnel. It is possible to work with financial services consultants and network with colleagues

to benchmark the numbers and skills of finance personnel for an organization of a given size and scope of services. We cannot say with great certainty that many aspects of managing organizations are truly evidence-based, as they are rarely subjected to critical testing and evaluation. All the same, routine financial accounting functions are reasonably well understood by most accountants.

For externally focused finance functions, including planning and analysis, it is less clear that managers have a basis for determining the right number of persons to employ and even less clear that the analyses conducted by these persons will have sufficient evidence for decision making. Just as there has been a movement toward evidence-based medicine, there is a movement toward evidence-based management of organizations, including finance (Finkler, Henley, & Ward, 2003). As with internal finance operations, it is possible to work with financial services consultants and network with colleagues to develop projections for future programs and services. It is also possible to look to the management literature for analyses of similar programs and services that might have been published. However, unlike evidence-based medicine, there is not an eager set of scientists looking to publish results on financial management.

From the Front Lines

The use of evidence-based management practices is growing at our hospital, as we have begun to focus on a culture of increased data management to make decisions. Because of this focus, we have transformed our Emergency Department by making a 30-minute pledge from door to doctor. As a result, we have experienced a huge improvement in efficiency and significant increases in quality and satisfaction. We consider this one of our key successes with these evidence-based practices, and I am sure that there will be many more to come.

Source: Hospital CEO

Analyze This

Suppose that Hendrickson Memorial Hospital has employed three managerial accountants to manage the annual budget process. How would we know if three was the right number?

For Review:

1. What is a balanced scorecard?

A balanced scorecard is a selection of measures of organizational performance that go beyond financial matters. Scorecards may include measures of quality, patient satisfaction, employee satisfaction, and other issues of importance to the organization.

2. To whom in the organization is finance responsible?

At the highest level, finance reports to the chief executive officer of the organization, with an important connection to the board of directors through the finance committee.

3. What positions report to the chief financial officer?

A number of positions may report to the CFO. Key among these positions will be a chief accounting officer or a similar position for a person who is responsible for financial accounting. Other positions may include directors for planning and analysis, reimbursement, budgeting, data support, and treasury.

1.4 Current Challenges of the U.S. Healthcare System

Much of the complexity of healthcare finance comes from the complexity of the operations of healthcare organizations, the expense side, and also from the complexity of the myriad of payers and payment structures, the revenue side. Indeed, having four parties at the healthcare table makes for difficult dinnertime conversations. According to polls of healthcare executives, the top concerns year-in and year-out are finance related, with the top three specific finance concerns in 2012 being Medicaid reimbursement, government funding cuts, and Medicare reimbursement (American College of Healthcare Executives, 2013).

In 2014, the reform of the healthcare system is primarily insurance-based, with incentives and hopes for operational reforms to follow. The **Patient Protection and Affordable Care Act of 2010 (PPACA or ACA)** provides for mechanisms to offer and assure health insurance coverage for a much higher percentage of Americans than have been insured in the past. There are far too many elements of the ACA to consider in this chapter (or another complete book); however, selected elements affect finance in important ways that merit attention.

The first element of the ACA of importance to finance is the *individual mandate*, which was supported by the Supreme Court of the United States' ruling in 2012. The individual mandate requires that all individuals either purchase insurance or pay additional federal income taxes. For healthcare organizations, this potentially means that there will be fewer people without insurance and limits the amount of effort required for patient financial services and obligations for provision of charity care. Although it is difficult to forecast the number of people who will purchase individual insurance, this is the challenge to finance in each healthcare organization.

Analyze This

Hendrickson Memorial Hospital provided charity care costing \$6.7 million in 2012, covering about 2.5% of patients. How much less should they budget for charity care in 2014 after the implementation of ACA?

The second element of the ACA, which is not supported by the Supreme Court, is the required expansion of Medicaid across the country to a higher percentage of the poverty level. Some states will elect to participate in Medicaid expansion, receiving 100% federal funding for the first five years and a lower percentage thereafter. Forecasting this impact on the insurance status of patients may be easier than forecasting the number of people buying individual health insurance, as there are already processes in place of enrolling individuals in Medicaid.

Some states will elect not to participate in Medicaid expansion, for political or other reasons, thereby affecting the number of people who will remain without insurance coverage. Those who would qualify for coverage under the Medicaid expansion have low incomes such that there will be no tax consequences associated with not fulfilling the individual mandate.

The third element of the ACA that concerns finance is how the ACA translates into Medicare payments. To pay for more individuals covered by insurance through government subsidies (both individual purchasers and Medicaid enrollees), Medicare payments are being reduced. Part of the Medicare payment reduction will come through reduced payments to Medicare-managed care plans called Medicare Advantage. Since Medicare Advantage is currently more expensive than traditional Medicare, this is seen by some as a sensible financial decision, though participants who have selected Medicare Advantage plans may not appreciate the change. Another part of the Medicare payment reduction will come through paying hospitals a lower amount over time.

Altogether, the changing actions of each of the four parties in healthcare and the changing role of the government with the ACA make this a challenging time for managing the finances of healthcare organizations. The net short-run financial impact of the ACA on healthcare organizations is that they may have a larger number of patients covered by individual insurance or Medicaid rather than being charity care cases, with payment rates for Medicare reduced. The net impact of having more persons covered by insurers, and insurers paying lower amounts for services, is the subject of much attention and analysis by each organization's chief financial officer.

For Review:

1. What are some key financial challenges facing healthcare leaders? Medicaid reimbursement, government funding cuts, and Medicare reimbursement are key challenges. Each of these challenges is tied to the ACA and its implementation.

Summary & Resources

Chapter Summary

This chapter has described the major components of finance: financial accounting, managerial accounting, and corporate finance. Financial accounting is the practice of recording and compiling business and financial transactions, assuring the accuracy of transactions, and preparing reports of the results. An important product of financial accounting is the financial statement of an organization. Given the importance of assuring that financial statements accurately reflect the financial status of an organization, auditors review the process against generally accepted accounting principles and provide an opinion on the statements. Managerial accounting provides reports for decision making on the future of the organization, including the annual budget. Corporate finance is concerned with the analysis of investments, the cost of capital, the long-term risk, and the level of debt taken on by an organization.

Healthcare finance is somewhat unique owing to the complex nature of the healthcare industry. Healthcare includes both traditional for-profit firms as well as not-for-profit firms, including most hospitals. Many healthcare providers, notably physicians, are important

decision makers, and yet they are not employees or owners in most healthcare organizations. Healthcare services are primarily paid for by insurance companies, rather than the people directly receiving the services (patients). These features make healthcare finance very complex.

Sound financial management is essential for the well-being of any organization, and perhaps even more important for organizations that contribute toward the well-being of most persons. Not all of the financial management practices employed by healthcare organizations have been proven to be ideal, and many will be tested in coming years. The high cost of healthcare services and health insurance reforms will combine to pressure healthcare organizations to be managed and financially managed more efficiently than ever before. Many people are required to make financial management work efficiently.

Discussion Questions

1. There are a number of goals for any healthcare organization. How can finance be assured that goals related to good functioning of the finance department are appropriately addressed?
2. For a small organization, how is it possible for one person to handle all of the functions of a full finance department?

Key Terms

accounting The process of preparing financial statements and additional analyses of interest to an organization's management.

audit The process of testing and reporting on the consistency of the accounting process.

business plan A description of the operational goals of an organization with a listing of the physical and financial resources necessary to achieve those goals.

certified public accountant (CPA) The designation achieved by accountants who have passed the Uniform Certified Public Accountant Examination and have met additional state education and experience requirements.

chargemaster The complete listing of prices charged by an organization for products and services, with detail on coding and other information required by insurance companies.

charity care Medical services provided with no expectation of payment by the patient.

chief financial officer (CFO) The corporate officer who is primarily responsible for the financial management of an organization, reporting only to the chief executive officer.

corporate finance The planning, analysis, acquisition, and management of assets, and how they are paid for either with cash or borrowed money.

external audit A testing and reporting on the consistency of the accounting process conducted by an independent accounting firm.

finance The planning, analysis, acquisition, and management of financial resources.

financial accounting Recording and compiling business and financial transactions, assuring the accuracy of transactions, and preparing reports of the results.

generally accepted accounting principles (GAAP) Guidelines and rules followed by financial accounting in recording transactions and preparing financial statements.

internal audit A testing and reporting on the consistency of the accounting process conducted by accountants employed by an organization who are independent of financial accounting.

managerial accounting The process of preparing reports for managers for decision making on the future of the organization.

Medicare Cost Report A report that provides detailed financial information on an organization providing services to Medicare patients that follows specific accounting rules.

mission statement A brief declaration of the reason that an organization exists.

operational plan A statement of the goals of an organization with a listing of the activities that will be undertaken during a specified time period.

Patient Protection and Affordable Care Act of 2010 (PPACA or ACA) A U.S. federal statute (Public Law 111-148) signed on March 23, 2010, that requires individuals to purchase insurance and makes numerous changes to the regulation of health insurance payment practices.

third-party payer An insurance company, government, or other entity that pays a healthcare provider for services given to a patient.

Suggested Websites

- The Centers for Medicare and Medicaid Services' reimbursement sections (<http://www.cms.gov>) provide up-to-date information on governmental reimbursement methods. CMS also provides information on the movement to ICD-10-CM coding (<http://www.cms.gov/Medicare/Coding/ICD10/index.html>).
- The Healthcare Financial Management Association (<http://www.HFMA.org>) offers free access to students and timely information on healthcare finance practice.
- The Federal Reserve (<http://www.federalreserve.gov/>) is an agency with responsibility for monetary policy, banking information and regulation, and financial payment systems.

