King Saud University
College of Business Administration
Department of Health Administration - Masters` Program

FNI 513 Financing Health Systems
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CHAPTER 1
Introduction to Healthcare Finance

- Learning Objectives
- Defining Healthcare Finance
- The Role of Finance in Health Services Organizations
- The Structure of the Finance Department
- Current Challenges

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Goal of the Course

The primary goal of this course is to *introduce* you to the field of healthcare finance, including:

- **Principles and concepts**
- **Applications across a variety of provider settings**
- **The impact of alternative reimbursement methods**
- **Develop basic skills in financial analysis and decision-making.**

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Learning Objectives

- Understand the purpose of healthcare organizations
- Relate the purpose of healthcare financial management to the purpose of the organization
- Understand the objectives of healthcare financial management
- Apply quality assessment to healthcare financial management
- Apply organizational ethics to healthcare financial management

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Introduction

Successful organizations have two things in common:

1. **a congruent and well-understood organizational purpose, and**
2. **a functional management team.**

The purpose of this introductory chapter is to describe financial management in healthcare organizations within the context of organizational purpose and a competent management team.

Organizational Purpose

- **Organizational purpose is often determined by the owner.**
- **A community-owned, not-for-profit healthcare organization's purpose is to provide healthcare services to the community,**
- **A corporate-owned (via stockholders) for-profit healthcare organization's purpose is to provide profit for the owner.**

Organizational Purpose

- **By necessity, most organizations have more than one organizational purpose.**
- **For instance, even though a not-for-profit healthcare organization's purpose is to provide health-care services to the community, the organization must survive economically—meaning that it must generate sufficient revenue to offset expenses and allow for growth.**

Organizational Purpose

- **A for-profit healthcare organization's purpose is to provide profit for the owner; however, the organization must meet its customers' needs—meaning it must keep the physicians, patients, employers, and insurance companies satisfied.**
- **Most healthcare organizations also have secondary purposes—for example, many government-owned healthcare organizations provide large-scale medical education programs.**

Organizational Purpose

- To maintain congruence, the management team must communicate the organizational purpose or purposes not only to the employees but also to owners, customers, and other important constituents.
- When multiple purposes are present, the management team must prioritize the purposes

Healthcare Management Team

- **In its broadest context, the objective of healthcare management is to accomplish the organizational purposes.**
- **Doing so is not as simple as it sounds, especially if the health-care organization's purposes are "to provide the community with the services it needs, at a clinically acceptable level of quality, at a publicly responsive level of amenity, at the least possible cost."**

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Healthcare Management Team

- **Healthcare managers must identify, prioritize, and often resolve these sometimes-contradictory purposes in a political environment that involves the organization's governing board and medical staff; in a regulatory environment that involves licensing and accrediting agencies; and in an economic environment that involves increasing competition, resulting in demands for lower prices and higher quality.**

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Healthcare Management Team

- **Competent healthcare managers attempt to accomplish the organizational purposes by planning, organizing, staffing, directing, and controlling (called the management functions). and through communicating, coordinating, and decision making (called the management connective processes).**

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Purpose of Healthcare Financial Management

- **The purpose of healthcare financial management is to provide accounting and finance information that helps healthcare managers accomplish the organization's purposes.**
- **No licensure requirements are needed to be a practicing healthcare financial manager.**

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Healthcare financial managers monitor many measurements. Among the most common are the following:

- **Admissions: The number of patients, excluding newborns, accepted for inpatient service.**
- **Average daily census: The average number of inpatients, excluding newborns, receiving care each day during the reporting period.**
- **Average length of stay (ALOS): Derived by dividing the number of inpatient days by the number of admissions.**
- **Occupancy rate: The ratio of average daily census to the average number of statistical (set up and staffed for use) beds**

Accounting

- **Accounting is generally divided into two major areas: *financial accounting* and *managerial accounting*.**
- **The primary purpose of *financial accounting* is to provide accounting information, generally historical in nature, to external users, including owners, lenders, suppliers, the government, and insurers.**

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Managerial Accounting

- The primary purpose of managerial accounting is to provide accounting information, generally current or prospective in nature, to internal users, including managers. Such accounting information supports the planning and control management functions.
- Managerial accounting, or accounting information prepared for internal use, requires no prescribed format and therefore varies greatly among organizations.
- Managerial accounting topics such as budgeting and inventory control require knowledge of economics, statistics, and operations research.

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Managerial Accounting

- **In health services organizations, healthcare finance consists of both the accounting and financial management functions.**
- **Accounting, as its name implies, concerns the recording, in financial terms, of economic events that reflect the operations, assets, and financing of an organization.**
- **In general, the purpose of accounting is to create and provide to interested parties—both internal (managers) and external (investors)—useful information about an organization's financial status and operations.**

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Managerial Accounting

- **Whereas accounting provides a rational means by which to measure a business's financial performance and to assess operations, financial management (often called corporate finance) provides the theory, concepts, and tools necessary to help managers make better financial decisions.**
- **Of course, the boundary between accounting and financial management is blurred; certain aspects of accounting involve decision making, and much of the application of financial management concepts requires accounting data.**

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Definition of *Healthcare Finance*

- The definition depends on the *context*.
- Policy maker, manager, or educator
- Type of healthcare organization
- For purposes here, healthcare finance is the practice of finance within *health services organizations.*
- Healthcare finance includes both the *accounting* and *financial management* functions.

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Definition of *Healthcare Finance*

- **Historically, the purpose of finance has been to borrow and invest the funds necessary for the organization to accomplish its purpose.**
- **Today, the purpose of finance is to analyze the information provided by managerial accounting to evaluate past decisions and make sound assessments regarding the future of the organization.**

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Definition of *Healthcare Finance*

- **Finance uses techniques such as *ratio analysis* and *capital analysis* and requires knowledge of financial and managerial accounting, economics, statistics, and operations research.**
- **Many managerial accountants believe that cost accounting—the study of costs, including methods for classifying, allocating, and identifying costs—is either synonymous with or a subset of managerial accounting.**

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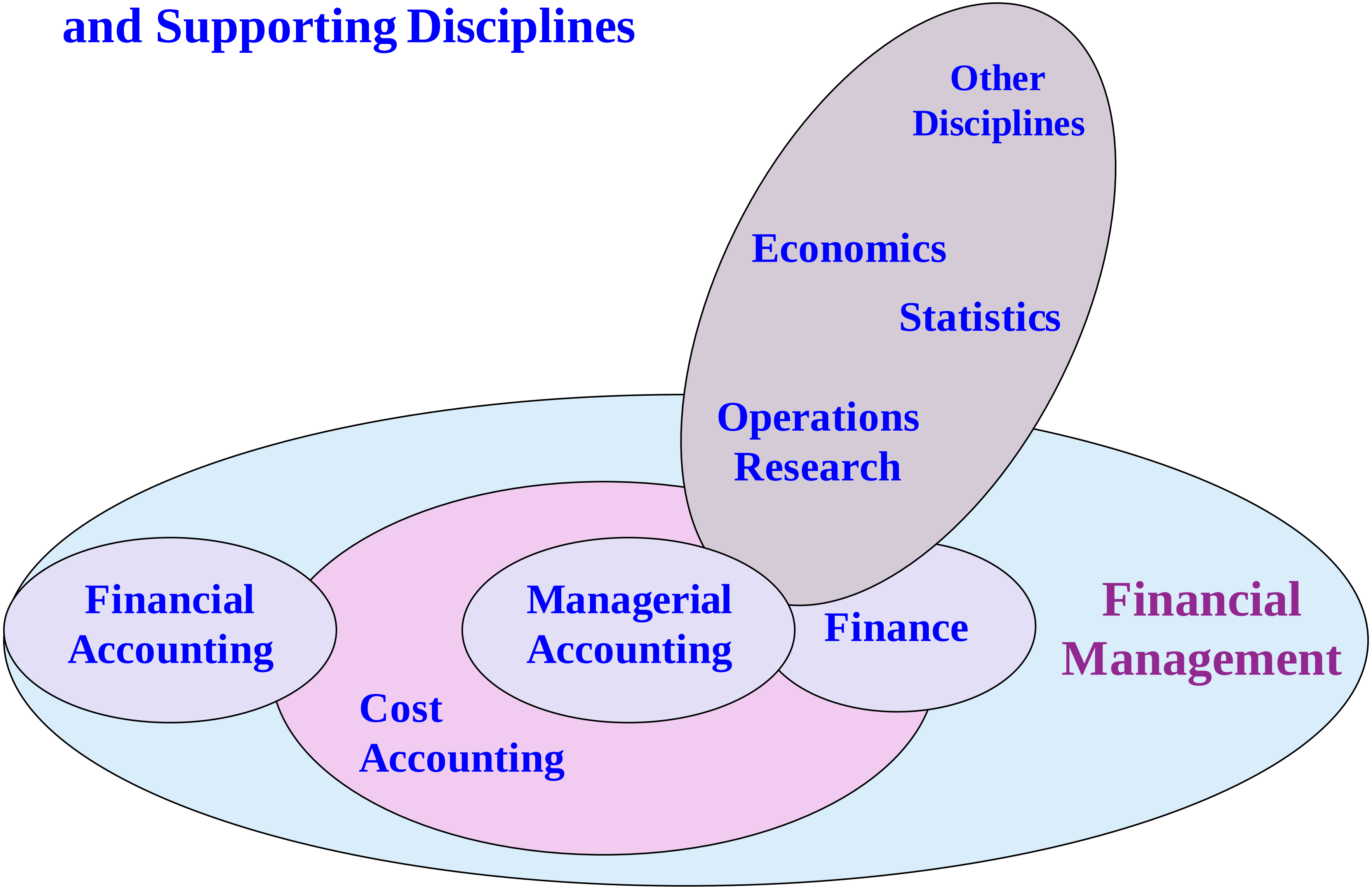
Definition of *Healthcare Finance*

- Others argue that cost accounting includes all managerial accounting and also requires some financial accounting.
- Cost accounting and managerial accounting also include topics that could be considered finance.

Exhibit 1.1 Shows Financial Management Relationships and Supporting Disciplines



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Major Objectives of Healthcare Financial Management

1. to generate income,
2. to respond to regulations,
3. to facilitate relationships with third-party payers,
4. to influence the method and amount of payment,
5. to monitor physicians, and
6. to protect tax status

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Generate Income

- **All organizations have at least one objective in common: to survive and grow. Organizations in other industries might refer to this objective as maximizing owners' wealth; healthcare organizations typically refer to it as maintaining community services.**
- **In either event, the organization will be of little use if it cannot afford to continue to operate. Therefore, the most important objective of healthcare financial management is to generate a reasonable net income.**

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Respond to Regulations

- **The government regulates healthcare to a significant degree because healthcare organizations are in a position to take advantage of the sick and the elderly; regulation protects individuals who cannot protect themselves.**
- **Healthcare organizations must also be accredited or certified to qualify for reimbursement from many third-party payers and to qualify for loans from certain lenders. Therefore, the second objective of healthcare financial management is to respond to the myriad of regulations in a timely and cost-effective manner.**

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Facilitate Relationships with Third-Party Payers

- **The third objective of healthcare financial management is to facilitate the organization's relationship with each third-party payer, such as an insurance company, that will pay all or a portion of the bill.**
- **Financial management must be responsive to third-party payers and in many ways must treat third-party payers as customers because the third party pays the bill.**
- **At the same time, financial management must be attentive to the patient because the patient has influence over the third-party payer and in some cases may be partially responsible for the bill.**

Influence Method and Amount of Payment

- **The fourth objective of healthcare financial management is to influence the method and amount of payment chosen by third-party payers.**
- **Third-party payers are becoming increasingly aggressive in asking healthcare organizations for discounts if they provide large numbers of patients.**

Influence Method and Amount of Payment

- **Healthcare organizations lose money if they provide care that costs more than the prospective payment.**
- **Some third-party payers are asking healthcare organizations to assume risk by agreeing to a capitated price (i.e., a price per head or subscriber) before the subscriber actually needs care.**
- **Capitated prices put healthcare organizations at risk for the cost of care, if needed.**

Influence Method and Amount of Payment

Prospective Payment

- **A payment system in which a healthcare organization accepts a fixed, predetermined amount to treat a patient, regardless of the true ultimate cost of that treatment.**
- **Diagnosis-related groups (DRGs) are one type of prospective payment.**

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Influence Method and Amount of Payment

Capitated Price

- **A healthcare payment system in which an organization accepts a monthly payment from a third-party payer for each individual covered by that payer's plan, regardless of whether a given individual is treated in a given month.**
- **Also known as capitation, it provides a financial incentive to a healthcare organization to keep its population from using more healthcare services than necessary because the organization profits only if the total cost of treating the specified population falls below the total capitated price provided by the third-party payer**

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Monitor Physicians

- The fifth objective of healthcare financial management is to monitor physicians and their potential financial liability to the organization.
- In 2015 professional services including physicians, dentists, and other professionals accounted for 30.9 percent of all personal healthcare expenditures (Martin et al. 2017).

Monitor Physicians

- However, physicians influence much of the healthcare spending that is not directly attributed to them.
- For example, physicians order the patient admission, the diagnostic testing and treatment for the patient, and the patient discharge.
- Healthcare financial management must ensure through the utilization review process that physician ordering patterns are consistent with what the patient needs.

Monitor Physicians

- In addition, healthcare financial management must ensure through the credentialing process and the risk management process that the healthcare organization using more healthcare has minimized its exposure to legal liability for a physician's possible negligent actions.

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Protect Tax Status

- The sixth major objective of healthcare financial management is to protect the organization's tax status.
- For-profit healthcare organizations seek ways to reduce their tax liability, and not-for-profit healthcare organizations try to protect their tax-exempt status.
- Protecting tax-exempt status has become more difficult as state and local governments seek new revenue sources, and tax-exempt status has come under judicial and public scrutiny.

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Mini Case Study

Suppose you were recently hired to manage a new primary care physician's office. The physician's office will be located down-town in a major metropolitan area with significant competition. You need to establish the organization's purpose and financial objectives.

- **What items should you consider in establishing the organization's purpose?**
- **What organizational purpose should you suggest to the physician owners?**
- **What should the financial objectives of the organization be?**

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Quality Assessment and Healthcare financial management

- **Since the 1970s, healthcare organizations have responded to serious pressure to define quality.**
- **In the early 1970s, accrediting agencies and third-party payers applied this pressure.**
- **In the late 1970s and early 1980s, the consumer movement added pressure.**
- **In the late 1980s through the present, competition has added pressure.**

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Quality Assessment and Healthcare financial management

- **Economists predict that the pressure will continue as competition drives prices to their lowest—and relatively equal—point, and the market will force healthcare organizations that survive to compete on quality in addition to price.**
- **Healthcare organizations have responded to this pressure with two contrasting strategies: either a proactive strategy that attempts to adopt a comprehensive view of quality or a reactive strategy that attempts to limit views of quality to views developed by others.**

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Quality Assessment and Healthcare financial management - Proactive Strategy

- **Healthcare organizations that have adopted a proactive strategy have developed multiple measures of quality, including direct and indirect measures that go beyond the minimum measures required by accrediting organizations.**
- **Direct measures of quality assume that the organization can define and measure quality itself.**

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Quality Assessment and Healthcare financial management - Proactive Strategy

Direct measures include the following:

1. **Goal-based measures assess quality by the progress made toward the goals of the strategic and operating plans. The key advantage of goal-based measures is that they focus attention on success or failure.**
2. **Responsive measures assess quality by customer opinion. The key advantage of responsive measures is that they understand quality from the customer's point of view.**

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Quality Assessment and Healthcare financial management - Proactive Strategy

Direct measures include the following:

3. **Decision-making measures assess quality by evaluating decisions. The key advantage of decision-making measures is that they direct accountability to the decision maker.**
4. **Connoisseurship measures allow quality to be assessed by expert opinion, such as accreditation. The key advantage of connoisseurship measures is that they inspire high credibility.**

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Quality Assessment and Healthcare financial management - Proactive Strategy

Indirect measures of quality assume that the organization cannot define and measure quality itself but can define and measure the results of quality. These measures include the following:

1. **Resource measures** assume that price reflects quality. The key advantage of resource measures is that they provide quantitative data that are readily available.
2. **Outcome measures** assume that results reflect quality. The key advantage of outcome measures is the emphasis on results.

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Quality Assessment and Healthcare financial management - Proactive Strategy

Indirect measures of quality

3. **Reputational measures** assume that public perception reflects quality. The key advantage of reputational measures is that they produce ratings for the public.
4. **Value-added measures** assume that process reflects quality. The key advantage of value-added measures is that, after adjusting for input and output, they focus on process, which the organization can control.

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Quality Assessment and Healthcare financial management - Reactive Strategy

1. **Ensuring quality by centralizing quality efforts in a quality assurance department, then decentralizing quality efforts to clinical departments, and then further decentralizing quality efforts to all departments;**
2. **Ensuring quality by studying clinical outcomes, then studying clinical processes, then studying all outcomes and all processes, and finally studying key outcomes and key processes;**

Quality Assessment and Healthcare financial management - Reactive Strategy

3. **Improving quality by continuous attention and total management; and**
4. **Assessing quality by identifying key processes and desired outcomes.**

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Quality Assessment and Healthcare financial management

The Joint Commission standards required accredited hospitals to:

1. **make their doctors tell patients when they receive substandard care or care that differs significantly from anticipated outcomes;**
2. **implement an organization-wide patient safety program with procedures for immediate response to medical errors;**
3. **report to the hospital's governing body at least once annually on the occurrence of medical errors; and**
4. **revise patient satisfaction surveys to ask patients how the organization can improve patient safety**

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National Patient Safety Goals A set of goals established by The Joint Commission to address safety areas of special concern for hospitals.

1. **Improve the accuracy** of patient identification.
2. **Improve the effectiveness** of communication among caregivers.
3. **Improve the safety** of using medications.
4. **Reduce the harm** associated with clinical alarm systems.
5. **Reduce the risk** of healthcare-associated infections.
6. **Identify safety risks** inherent in the hospital's patient population.

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Effects of Quality on Profitability

Deming introduced the following chain reaction analogy:

Improvements in quality (fewer errors) lead to improvements in productivity, which lead to lower costs, which lead to lower prices, which lead to improved market position, which leads to increased volumes, which lead to increased profit.

Significant evidence shows that improved quality has led to improved profitability in healthcare.

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Mini Case Study

Suppose that you are the administrator of a nursing home owned by a for-profit parent corporation that owns 30 nursing homes. You have been asked by the board of directors of the parent corporation to explain how your quality initiatives will improve profitability.

- **What is your presentation?**

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Organizational Ethics and Healthcare Financial Management

Joint Commission standards require health-care organizations to have mechanisms in place to address ethical issues related to such topics as patient rights and management responsibilities.

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Organizational Ethics and Healthcare Financial Management

- **Ethical issues concerning patient rights include informed consent, patient confidentiality, and the patient's right to participate in care decisions and end-of-life decisions.**
- **Ethical issues concerning management responsibilities include resource allocation, conflicts of interest, and patient billing practices.**

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Organizational Ethics and Healthcare Financial Management

- **Resource allocation decisions by managers often conflict with the decisions made by physicians and other clinicians.**
- **Managers typically represent a utilitarian view of ethics, best represented by the phrase "the greatest good for the greatest number."**
- **This view allows managers to sacrifice the use of resources for one patient to maintain resources for other patients, given the assumption that resources for the healthcare organization are limited.**

Organizational Ethics and Healthcare Financial Management

- **Clinicians typically represent a deontological view of ethics, which means that their decisions are governed by their duties to patients, which take precedence over the ends-based decision making of the manager.**
- **This continuous conflict seems to keep resource allocation decisions somewhat balanced.**
- **Conflicts of interest occur when an individual owes duties to two or more persons or organizations and when meeting a duty to one somehow harms the other.**

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Organizational Ethics and Healthcare Financial Management

- **Perhaps the worst examples of conflict of interest involve the conflict between a manager's duties to the organization and a manager's duties to self, such as when managers use their positions of authority for personal gain.**
- **Even the perception of impropriety may cause a loss of credibility**

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Organizational Ethics and Healthcare Financial Management

- **This is especially true in financial management, where contracts for services and products are awarded to vendors who may attempt to buy influence with a lunch or a gift.**
- **For the most part, patient billing practices, especially for insured patients, are covered by law; however, even certain legal practices have ethical ramifications.**
- **For instance, how long should a healthcare organization hold a patient's deposit after the insurance company pays in full?**

Organizational Ethics and Healthcare Financial Management

- **Although a healthcare organization may be under no legal obligation to refund overpayments by insurance companies, is keeping someone else's money ethical?**
- **Many healthcare organizations use ethics committees to provide answers to these and other billing questions.**
- **Although healthcare organizations are not required to organize ethics committees, committees are a useful way to solicit community input on billing issues.**

Mini Case Study

Imagine that you manage a four-physician office practice in a competitive neighborhood. Vendors often bring lunches and gifts for your staff and samples of prescription medications that the physicians then give to patients.

- **Could any of these practices pose a problem?**
- **If so, why?**

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Value of Healthcare Financial Management

- **Healthcare financial management provides accounting information and financial techniques that allow managers to perform the management functions and the management connective processes and therefore accomplish the organizational objectives.**
- **In addition, healthcare financial management also has direct value to these functions, as explained in the following list of management functions.**

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Value of Healthcare Financial Management

- **Planning: After the governing body completes the strategic plan and senior management completes the operating plan, financial management is often responsible for completing the operating budget and capital budget.**
- **The operating budget often provides the incentives to plan properly.**

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Value of Healthcare Financial Management

- **Organizing: Financial management provides a chart of accounts based on the organizational chart that identifies revenue centers and cost centers.**
- **Together with the organizational chart, this chart of accounts provides the basis for responsibility accounting, which is the ability to hold department managers responsible for their revenues and expenses.**

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Value of Healthcare Financial Management

- **Staffing: Financial management often staffs a variety of departments and processes important to the healthcare organization.**
- **Departments such as medical records and information systems are currently being placed under the supervision of financial management, in addition to departments such as accounting, admitting, and materials management, which have been traditionally under financial management.**
- **The increasing importance of nontraditional departments in the billing process appears to justify this trend.**

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Value of Healthcare Financial Management

Directing: Financial management provides rewards and penalties to motivate others to accomplish the organization's purposes.

Controlling: Perhaps the responsibility closest to the overall function of financial management, the control of the budget, financial reports, financial policies and procedures, and financial audits allows financial management to monitor performance and take the appropriate corrective action when performance is unsatisfactory.

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Value of Healthcare Financial Management

- **These management functions mean little without the management connective processes to integrate the functions.**
- **Communicating and coordinating are important to financial management for both reporting and advising.**
- **Also important is coordinating the relationships between, for example, revenue and expenses, capital budgets and operating budgets, and volumes and prices and collected revenues.**

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Value of Healthcare Financial Management

- Decision making is important to financial management as a direct measure of quality.
- Governing boards, CEOs, and outside sources such as independent auditors often judge the quality of financial management on the basis of the decisions and recommendations made by financial management.
- The advantage of this view of quality is that it holds the decision maker accountable.

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Value of Healthcare Financial Management

- **The disadvantage is that it assumes rational decision making.**
- **Decisions made in healthcare financial management are often based on politics or other criteria that are unknown to the evaluator of the decision.**
- **Therefore, a decision may be evaluated as bad on the basis of the known facts, but it may be evaluated as good on the basis of another criteria unknown to the evaluator**

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Effect of Financial Management on the Changing Face of Healthcare

- **Many observers say that financial management is the most important predictor of whether healthcare organizations will survive in the current competitive climate and beyond.**
- **Health-care is one of several industries that society has allowed to grow beyond the industry's ability to produce efficiently**

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Effect of Financial Management on the Changing Face of Healthcare

- **Healthcare reforms are expected to profoundly affect the financial situation of healthcare organizations: the increase in the number of individuals with health insurance; the changing reimbursement structures; and the explicit linking of reimbursement with quality measures.**
- **Clearly, only the well-managed healthcare organizations will survive this changing situation; financial management will be instrumental in their survival.**

THANK YOU