

Financial Management in Health Care Organizations

HSCC 450
Week 1
Lecture 2
Chapter 1: Intro to Health Care & Finance



Objectives

- Explain the relationship between the financial management function and other functions of management.
- Explain the placement and structure of financial management in the organization chart of a typical health care organization.
- List and explain the four concerns shared by all financial managers.
- List and explain the five conceptual pillars of financial management practice.
- Explain how managed care contracts affect health care providers' financial incentives.



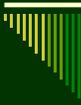
Key Terms

- Arbitrage profit
- Capital
- Cash
- Chief Financial Officer (CFO)
- Chief Information Officer (CIO)
- Comptroller
- Conservation
- Cost
- Generally Accepted Accounting Practices (GAAP)
- Internal Auditor
- Law of one price
- Managed care
- Maximizing behavior
- Opportunity cost
- Risk aversion
- Treasurer
- Time value of money



Financial Mgt Structure

- The following information uses Figure 1-1 in the text on page 13.
- The President or Chief Executive Officer is ultimately responsible for the financial management of the organization.
- Reporting to the CEO is the Senior V.P.
 - In some organizations this position is referred to as the Chief of Operations



Financial Mgt Structure

- The Chief Financial Officer, usually a V.P. position
 - This position oversees all financial operations of the organization.
 - The two main division responsible to the CFO are:
 - Comptroller (controller)
 - Treasurer



Financial Mgt Structure

- Comptroller
 - Responsible for:
 - Accounting and reporting functions
 - Generation of periodic financial reports
 - Cost analysis
 - Budget and budgetary functions

Financial Mgt Structure

- Treasurer
 - Responsible for:
 - Stewardship of organizational financial resources
 - Commercial banking relationships
 - Cash management
 - Lease-versus-purchase analysis
 - Management of pension and/or endowment funds
 - Management of obligations under long-term debt

Financial Mgt Structure

- Treasurer
 - Due to the unique position of the treasurer, this position is charge with managing accounts payable and accounts receivable
 - In the health care setting accounts receivable is synonymous with patient accounts

Financial Mgt Structure

- Many large organizations will have an internal auditor
 - This position reports to the CFO and ensures accounting and reporting functions are in accordance with generally accepted accounting practices (GAAP)
 - This position is separate from the comptroller to prevent conflicts of interest

Financial Mgt Structure

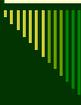
- Most organizations, especially the larger ones have instituted the position of Chief Information Officer (CIO)
 - Depending on the organizational structure, this position may report to the CFO
 - Responsibilities of this department include all equipment and the processes that move information within the organization

Financial Mgt Structure

- The CIO would supervise:
 - Medical records
 - Data processing
 - Telecommunications
 - Admitting
 - And, in some instances Quality Management Departments

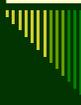
Universal Concerns

- There are four universal concerns associated with all financial managers, regardless of the type of organization.
- The four C's are:
 - Costs
 - Cash
 - Capital
 - Conservation



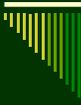
Universal Concerns - Costs

- The identification and control of costs is one of the most important aspects of financial management.



Universal Concerns - Costs

- Historically, before the introduction of the Prospective Payment System, financial managers identified the greatest possible cost to patients covered by the most generous payor.
 - The objective of cost finding was "revenue maximization"
 - The introduction of PPS by the Centers for Medicare and Medicaid have eliminated cost-based reimbursement
 - The goal now is to control cost



Universal Concerns - Cost

- Operational cost are not the only concern for financial managers.
 - The treasurer must attempt to obtain funds at the minimum cost possible
 - At this point for simplistic purposes borrowing money (cash) at 6% versus 7%



Universal Concerns - Cash

- Because accountants calculate profits in accordance with GAAP, naïve managers and the public assume these figures to be indicators of the organization's financial health.
 - However, profits change according to accountants' assumptions



Universal Concerns - Cash

- Cash, on hand, is unambiguous!
 - Cash is needed to pay obligations
 - Cash on hand is the only thing available to meet the payroll and pay creditors
 - Employees and creditors will only accept CASH!



Universal Concerns - Capital

- Some health care analysts suggest that access to capital is the principal determinant of organizational success and viability.
 - Lack of access to capital is often the reason cited for hospital closures.
 - New technologies can only be introduced by those organizations that possess the ability to acquire it.

Universal Concerns - Conservation

- In the financial management sector, conservation relates to the financial manager's ability to preserve the asset base of the organization
 - Organizations that liquidated themselves; through unwise investments, inappropriate capital investments, or the inability to control cost, then the organizations will not survive.

5 Pillars of Financial Practice

- The four C's are managed utilizing five basic tools:
 - Cash flows
 - Maximizing behavior
 - Risk aversion
 - Time-value-of-money
 - Control of opportunity cost

5 Pillars – Cash Flow

- According to Donald Trump, "Cash is king."
 - Never a truer statement!
 - Regardless of profits based on accrual accounting, it is the organization's ability to generate cash that determines the "financial health" of the organization

5 Pillars – Maximizing Behavior

- Maximizing behavior essentially comes down to "getting the most for you money".
 - Investors will seek the highest return at the levels of risk they are willing to assume
 - Employees will seek the greatest compensation they can achieve based on their level of education, training, and experience
 - The list of examples is endless

5 Pillars – Risk Aversion

- Essentially, one does not desire to invest if there is a chance (risk) of no return on investment.
- Or, if one chooses to "bet" and the payoff is the same as the investment – what is the point of the bet

5 Pillars – Time-Value-of-Money

- **I N T E R E S T !**
 - If you invest \$1000.00 at a rate of 10% per year, at the end of the year you would have \$1,100.
 - $\$1000 \times 10\% \times 1 \text{ yr} = \$1,100.00$
 - In this case, the time-value-of-money is \$100!
 - The time-value-of-money is a major driving force of financial markets
 - Just evaluate any loan you have

5 Pillars – Opportunity Cost

- Speaking of loans, the amount of interest you pay on any loan you have is the “opportunity cost”
 - Referring to our previous example, if you borrowed \$1000 for 1 year at 10% (simple interest), then the cost of borrowing that \$1000.00 is \$100
 - This is referred to “opportunity cost” and is actually a debit or financial loss to the organization

Law of One Price

- “The law of one price says that in a given market, without transportation cost, in which information is freely available, only one price can prevail for any good or service (assumed to be of uniform quality).”
 - HMMM?

Law of One Price

- No matter the goods or services, if all things are equal, then the price should be equal.
 - A Diet Pepsi at Joe’s Convenience Store should be the same at Food Lion.
 - To which, we know this is not the case

Arbitrage Profits

- When the law of one price is violated, then the opportunity for arbitrage profit occurs. (arbitrage opportunity)
 - The opportunity to buy an asset at a low price and then immediately sell it on a different market at a higher price.
 - If I purchase an asset for \$5 on one market, then immediately sell the asset on another market for \$20, the arbitrage profit is \$15

Arbitrage Profits

- Suppose Walmart is selling the DVD of *Shaft in Africa* for \$10. However, I know that on eBay the last 20 copies of *Shaft in Africa* on DVD have sold for between \$25 and \$30. Then I could go to Walmart, buy copies of the movie and turn around and sell them on eBay for a profit of \$15 to \$20 a DVD. It is unlikely that I will be able to make a profit in this manner for too long, as one of three things should happen:
 - Walmart runs out of copies of *Shaft in Africa* on DVD
 - Walmart raises the price on remaining copies as they’ve seen an increased demand for the movie
 - The supply of *Shaft in Africa* DVDs skyrockets on eBay, which causes the price to fall.

Law of One Price - Again

- The law of one price is as important, and limiting, for financial management in health care as in any other sector of the economy.
 - The cost of capital is determined in capital markets (absent charity), with one price prevailing for all borrowers in a given risk class.
 - Health care financial management is financial management in the health care sector, with the same economic and financial constraints faced by others in financial management



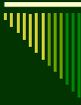
Managed Care

- Managed care refers to any of many arrangements in which a health plan assumes responsibility and the financial risk for the health of the members of a defined population.
 - The health plan is a type of third payor, and may be distinct from the providers who sign contracts with it and provide care



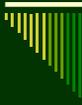
Managed Care

- Interesting words, but what does it all mean.
 - Well, historically, patients presented to providers with an illness.
 - Providers would provide curative care.
 - The patient and/or insurance received a bill for services rendered
 - Fee-For-Service
 - The bill (or a negotiated fee) would be paid.



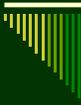
Managed Care

- Under managed care, the patients (covered lives) contract for care with health plans
 - The health plan “contracts” with providers to provide care.
 - Providers receive a negotiated fee for each service
 - Some providers assume part of the financial risk by accepting some form of “capitation” payment



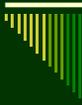
Managed Care

- Most often with managed care there is a gatekeeper for health care services
 - Covered lives that seek services “out of network” assume part or all of the financial risk for going “out of network”



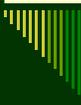
Managed Care

- Health Maintenance Organizations (HMO)
 - The covered life is only covered for referrals made by the Primary Care Physician (PCP) or the “gatekeeper
- Preferred Provider Organization (PPO)
 - The covered life has coverage for covered services, regardless of the provider, however has an incentive to use physicians within a particular panel.



Managed Care

- Particular arrangements for payment for care are specified in the covered lives’ contracts and vary widely.
- Incentives for providers are specified in the contractual agreements with the health plan and they vary widely as well.



Managed Care – The Issue

- Managed care places an additional layer (barrier) between the provider and the patient
 - Some services, even those medically necessary, may not be covered by the plan.
 - Patients are free to pay out of pocket for these services



Summary

- The four C's and the 5 pillars are common to all financial managers
- Financial management is financial management
 - However, the financial managers in health care must contend with third party payors, be they traditional insurance providers or some form of managed care
 - Managed care adds an additional layer, which providers must "wade" through to receive payment
 - Additionally, under managed care the providers assume some financial risk