

Gapenski's

**THIRD
EDITION**

FUNDAMENTALS
OF HEALTHCARE
FINANCE



KRISTIN L. REITER | PAULA H. SONG

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OF HEALTHCARE

FINANCE

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TO HEALTHCARE MANAGEMENT



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*We dedicate this book to the memory of our dear friend and colleague,
Louis C. Gapenski, whose textbooks have touched countless students of
healthcare finance.*

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PREFACE

Almost 30 years ago, Louis C. Gapenski published his first healthcare finance textbook, *Understanding Healthcare Financial Management*. Over time, his experiences prompted him to write others, including this book, *Fundamentals of Healthcare Finance*. When he passed away on April 20, 2016, the field of healthcare finance lost a gifted scholar, writer, teacher, mentor, and friend.

By traditional academic metrics, Lou was a successful scholar: many peer-reviewed articles, other publications and book reviews, and presentations at academic and professional conferences. However, Lou was best known for his compendium of best-selling textbooks on corporate finance and healthcare financial management. His collaboration with Eugene Brigham served as a textbook factory: Lou was a coauthor of five editions of *Financial Management: Theory and Practice* (translated into Bulgarian, Chinese, French, Indonesian, Italian, Portuguese, and Spanish), six editions of *Intermediate Financial Management*, and five editions of *Cases in Financial Management* (all three from Dryden Press). In the early 1990s, Lou turned his attention to the nascent discipline of healthcare financial management and was among the first to argue that the theory and application of corporate finance was both relevant and necessary to the training of healthcare managers. Over the next 25 years, Lou authored seven editions of *Understanding Healthcare Financial Management*, five editions of *Cases in Healthcare Finance*, six editions of *Healthcare Finance: An Introduction to Accounting and Financial Management*, and two editions of *Fundamentals of Healthcare Finance* (all four from Health Administration Press). By any standard, this was an extraordinary level of textbook productivity and was a constant source of amazement and curiosity among his colleagues.

Lou's textbooks and casebook in healthcare finance were novel and innovative in that they offered the rigorous finance training commonly found in business schools but using language and context that would speak to those whose passion was healthcare. In all of Lou's work, his commitment to teaching and learning was evident. While planning for new textbooks or new editions of existing books, Lou would reach out to colleagues, students, and individuals working in the field, seeking input on how to improve his books and the associated ancillary learning materials. He was eager to receive feedback, and he worked tirelessly to implement the recommendations of those around him. His creativity was apparent in the new features offered in each edition and in the stories and examples he included to engage students and draw them into the subject matter. When Lou originally approached us about becoming coauthors, we had no idea how much we would learn from him about writing textbooks—assessment of learning needs, clear exposition of complex concepts and calculations, development of ancillary learning materials, and the business of publishing itself. Better than anyone we know, Lou understood how to write a good textbook.

In this edition, we have worked very hard to build on Lou's original vision for the book: to provide a learning resource for students interested in how healthcare finance is used by clinical and operational managers as opposed to financial managers. We have provided updates and edits throughout to ensure that it remains a relevant and valuable learning tool for students and instructors. We hope that the book will continue to provide financial acumen to those who strive daily to improve healthcare delivery.

Note: Adapted from K. L. Reiter and G. H. Pink, 2016, "Remembering Louis C. Gapenski," *Journal of Health Care Finance* 43 (2): 1–4.

CONCEPT OF THE BOOK

Our goal in the third edition of *Fundamentals* was to create a text that introduces readers to those basic principles and applications of healthcare finance that are most important to entry-level clinical and operational managers. Thus, principles that are used primarily by financial staff personnel are covered either lightly or not at all. For example, background information about financial markets and securities is not included in this book.

The end result is a book that contains three introductory chapters, six accounting chapters, and four financial management (corporate finance) chapters. The idea here is that entry-level managers, who typically will be working at the department level or perhaps in a medical practice setting, need to understand those finance principles that they will encounter and work with on a daily basis, while other concepts can be learned later as needed. Although this book does cover some "organizational" finance issues, its focus is on topics that are most relevant to managers of clinical operations.

Another consideration in writing this book is that most readers will be seeing the material for the first time. Thus, the concepts here are explained as clearly and succinctly as possible. We have tried hard to create a book that readers will find user-friendly, enjoyable,

and self-instructive. If students don't find a book interesting, understandable, and useful, they won't read it.

INTENDED MARKET AND USE

The book is not designed for any specific type of educational program. Rather, it can be used in a wide variety of settings: undergraduate and graduate, traditional and executive, on-campus and distance learning, and even independently for professional development. However, the book is ideal for undergraduate health administration programs, undergraduate and graduate public health and health science programs, and nursing administration programs and courses.

The key to the book's usefulness is not the educational program but the focus of the course. If the course covers the fundamentals of healthcare finance, with a concentration on operational management, this book will be a good fit.

Practicing healthcare professionals who need to gain a better understanding of healthcare finance may greatly benefit from this book as well. Such professionals include clinicians who have management responsibilities and clinical managers who require additional finance skills.

CHANGES IN THE THIRD EDITION

Since the publication of the previous edition of this book, we have received comments from students and users at other universities. The reaction of students, other professors, and the marketplace in general has been overwhelmingly positive—every comment received indicates that the basic concept of the book is sound. Even so, nothing is perfect, and the healthcare environment is evolving at a dizzying pace. Thus, we have made many changes to the book, the most important of which are listed here:

- ◆ The book was updated and clarified throughout. Particular care was taken to include the most recent information on the Affordable Care Act and to update the real-world examples. In addition, there is no doubt that text material improves as it is repeatedly edited. Like all books, the first two editions had some rough spots, and considerable effort was expended to improve these discussions and to clarify end-of-chapter problems.
- ◆ The section on service line costing in chapter 4 was expanded to include discussions of two additional methods used to cost individual services: the cost-to-charge ratio and relative value units.
- ◆ Financial accounting coverage was updated to conform to the latest American Institute of Certified Public Accountants formats. For example, in chapter 12, we added a discussion of upcoming changes to the presentation of net assets by not-for-profit entities.

- ◆ We added more examples to the financial accounting chapters so readers can compare and contrast the financial statements of different types of healthcare organizations, including not-for-profit hospitals and home health care providers.
- ◆ Chapter 14 was added to several already-available online chapters to provide further discussion of time value of money concepts.
- ◆ The lecture presentation material was updated and improved based on continual use and suggestions from adopters and students alike.

All in all, these changes improve the quality and value of the book without affecting its basic concept and approach to learning.

INSTRUCTOR RESOURCES

This book's instructor resources, which are fully described below, include PowerPoint slides, a test bank, cases, and solutions to the end-of-chapter questions and problems and the five online cases.

For the most up-to-date information about this book and its instructor resources, go to ache.org/HAP and browse for the book by its title or author names.

This book's instructor resources are available to instructors who adopt this book for use in their course. For access information, please e-mail hapbooks@ache.org.

ANCILLARY MATERIALS FOR INSTRUCTORS

- ◆ *PowerPoint slides.* The essential material in each chapter—concepts, graphs, tables, lists, and calculations—is presented in roughly 25 to 35 slides. Hard-copy versions (or the files themselves) can be provided to students as lecture notes. Instructors may use these slides as is or customize them to meet their own unique needs.
- ◆ *Test bank.* An online test bank is available to adopters. It consists of roughly 15–20 multiple-choice questions per chapter.
- ◆ *Selected cases.* Five cases are available to instructors who want to incorporate cases into their courses. These cases are not as complex as those in *Cases in Healthcare Finance*, and they come with questions intended to both guide students and keep them on track. (See the next section for details.)

- ◆ *Solutions.* Instructors also have access to solutions to the end-of-chapter questions and problems, and solutions to the five online cases.
- ◆ *Additional online chapters.* Instructors who want to go over concepts beyond the fundamentals covered in the text may access four chapters that are posted online. (See the next section for details.)
- ◆ *Sample course syllabus.*

ANCILLARY MATERIALS FOR STUDENTS

Students (and instructors) can find the following learning tools on the Health Administration Press website at ache.org/books/FinanceFundamentals3.

- ◆ *Additional online chapters.* These four chapters aim to expand the scope of study.
 - Chapter 14—Time Value Analysis
 - Chapter 15—Lease Financing and Business Valuation
 - Chapter 16—Distributions to Owners: Bonuses, Dividends, and Repurchases
 - Chapter 17—Capitation, Rate Setting, and Risk Sharing
- ◆ *Online appendixes.* These two appendixes (operational analysis ratios and financial analysis ratios) provide a more extensive list of ratios and their definitions than what is provided in this book.
- ◆ *Selected cases.* These cases are not overly complex, and they give students the opportunity to apply many of the concepts discussed in the book and in class. The cases contain a set of questions that guide students along a solution path as they work each case.
 - Case 1—The Dialysis Center: Cost Allocation Concepts
 - Case 2—University Hospital: Marginal Cost Pricing
 - Case 3—Panhandle Medical Practice: Activity-Based Costing
 - Case 4—Better Care Clinic: Breakeven Analysis
 - Case 5—Twin Falls Community Hospital: Capital Investment Analysis

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ERRORS IN THE BOOK

In spite of the significant effort that has been expended by many individuals on this book, it is safe to say that some errors exist. In an attempt to create the most error-free and useful book possible, we strongly encourage both instructors and students to e-mail us with comments and suggestions for improving the book. We certainly welcome your input.

CONCLUSION

In the environment faced by healthcare providers today, good finance is more important than ever to the economic well-being of the enterprise. As such, clinical managers must be thoroughly grounded in finance principles and applications. However, this is more easily said than done.

We hope that *Fundamentals of Healthcare Finance* will help you understand the finance issues currently faced by healthcare providers and, more important, that it will provide guidance on how best to deal with them.

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PURPOSE OF THE BOOK

This book is designed to introduce the fundamentals of healthcare finance as practiced in health services organizations. This purpose has several important implications.

First, because the book assumes the reader has no prior knowledge of the subject matter, it is totally self-contained, with each topic explained in basic terms. Furthermore, because clarity is so important when first explaining concepts, the chapters have been written in an easy-to-read fashion. None of the topics is inherently difficult, but new concepts often take some effort to understand. This process is made easier by the writing style used and the learning aids contained in the text.

Second, because this book focuses on fundamentals, it presents a broad overview of healthcare finance rather than an in-depth treatment that might be found in accounting or financial management books.

Third, and most important, the book discusses tasks that are essential to the operational management of clinical services, as opposed to tasks that are exclusively financial in nature and hence the sole province of the financial staff. The balance of the content is overweighted on accounting material, especially those aspects that are most relevant to entry-level managers. Of course, even managers whose primary responsibility is nonfinancial, such as those in operations, marketing, or human resources, need to know something about the finance department. Thus, the book is sprinkled with information related to topics that typically fall under the purview of the financial staff, but only in light doses.

When you finish the book, you will not be expected to fully understand every nuance of every finance principle or practice that pertains to every type of healthcare organization. Nevertheless, you will have sufficient knowledge of healthcare finance to function better as an operational manager and to judge the quality of financial analyses performed by others.

PART I

FOUNDATION CONCEPTS

Three factors make the provision of healthcare services different from any other services. First, many healthcare organizations, especially hospitals, are organized as not-for-profit corporations as opposed to for-profit, investor-owned businesses. For example, in Gainesville, Florida, Shands Healthcare at the University of Florida is a not-for-profit hospital, while North Florida Regional Medical Center is a for-profit hospital owned by investors. Second, payment for services rendered by healthcare providers typically is made by third-party payers, such as Medicare and Blue Cross and Blue Shield, rather than by the patients who receive the services. Finally, because the health status of the nation's population is a national concern, there is significant government involvement in the provision of health services. By focusing on these differences, part I presents the unique framework for the practice of healthcare finance.

Chapter 1 discusses the institutional setting for the delivery of healthcare services, including the organization and role of the finance staff and the types of healthcare organizations.

Chapter 2 focuses on alternative forms of business organization and ownership and how taxes influence finance decisions. Here, the specific differences between not-for-profit and investor-owned businesses are explored. In addition, the chapter briefly describes the nature of a business and the types of finance decisions that it must make.

Chapter 3 covers the third-party payer system and alternative reimbursement methods. Healthcare managers at all levels must know who the payers are and what payment methods are used. These external factors have a profound influence on the operations of all healthcare organizations. In addition, chapter 3 discusses the impact of healthcare reform on health services organizations.

Some of you may already be familiar with much of the information presented in part I, either because you have taken other courses that introduced this material or you have worked in the field. If

this is your situation, a quick review cannot hurt; after all, repetition is the key to learning. For the rest of you, part I plays an important role in your understanding of the healthcare finance concepts presented in the remainder of the book.

CHAPTER 1

INTRODUCTION TO HEALTHCARE FINANCE

THEME SET-UP: CAREERS IN HEALTHCARE MANAGEMENT

If you are using this book, you either are working in healthcare or are interested in a career in healthcare. Of course, numerous career opportunities are available in clinical fields, including medicine, dentistry, nursing, and occupational and physical therapy, which some of you are already practicing or will enter on graduation. However, most of you are considering careers in healthcare management. In addition, many clinicians find themselves balancing both clinical and administrative roles, and so healthcare management knowledge is important.

According to the Association of University Programs in Health Administration, an education in healthcare management will prepare you to enter the exciting and challenging healthcare field, the largest in the United States, representing more than 11 million jobs. Healthcare executives have the opportunity to make a significant contribution to improving the health of the population and to work in one of tens of thousands of healthcare organizations throughout the United States and the world.

An education in healthcare management can take you in many different directions. Career options for healthcare managers have never been more diverse or exciting. The kinds of entry-level jobs offered to a college graduate vary in terms of the individual's interests, skills, and experience. Today,

an estimated 300,000 people serve in healthcare management positions (from entry level to middle management to leadership) and in organizations of all sizes (from a practice with several people to a major corporation that employs thousands). After gaining the requisite experience, many healthcare management graduates are in a position to shape the future of healthcare in the United States and across the globe.

All that probably sounds good, but what types of organizations might be interested in hiring a healthcare management graduate? By the end of the chapter, you will have an idea of the settings available. See if any of them appeal to you.

LEARNING OBJECTIVES

After studying this chapter, you will be able to do the following:

- Define the term *healthcare finance* as it is used in this book.
- Discuss the structure of the finance department, the role of finance in healthcare organizations, and how this role has changed over time.
- Describe the major players in the healthcare sector.
- List the key issues currently facing healthcare managers.

1.1 INTRODUCTION

In today's healthcare environment, where financial realities play an important role in many, if not most, decisions, healthcare managers at all levels must understand the fundamentals of finance and how that knowledge is used to enhance the financial well-being of the institution. In this chapter, we introduce you to the rationale that underlies this book. Furthermore, we present background information about healthcare finance and the different types of healthcare organizations. We sincerely hope that this book provides significant help in your quest to increase your professional competency in the critical area of healthcare finance.

1.2 DEFINING HEALTHCARE FINANCE

What is healthcare finance? It can be surprising to find that there is no single response because the definition of the term depends, for the most part, on the context in which it is used. Thus, your understanding should begin with learning the scope and meaning of the term *healthcare finance* as it is used in this book.

To start, recognize that healthcare finance is not about financing the healthcare system. **Healthcare financing** is a separate topic that involves how society pays for the healthcare services it consumes. This issue is complex and politically charged, and we do not tackle it directly in this book. Of course, the manner of financing healthcare affects how hospitals and physicians are reimbursed for services and hence has a significant influence on healthcare finance.

Most users of this book will become (or already are) managers at healthcare organizations, such as medical group practices, hospitals, home health agencies, or long-term care facilities. Thus, to create a book that provides the most value to its primary users, we focused on finance as it applies in **health services organizations**. Of course, the principles and practices of finance cannot be studied in a vacuum but must be based on the realities of the current healthcare environment, including how healthcare services are financed.

In health services organizations, *healthcare finance* consists of both the accounting and financial management functions (see “Critical Concept: Healthcare Finance”). **Accounting**, as its name implies, concerns the recording, in financial terms, of economic events that reflect the operations, assets, and financing of an organization.

Healthcare financing

The system that a society uses to pay for healthcare services.

Health services organizations

Organizations that provide patient care services. Examples include hospitals, medical practices, clinics, and nursing homes. Also called *providers*.

Accounting

The measurement and recording of events that reflect the operations, assets, and financing of an organization.



CRITICAL CONCEPT

Healthcare Finance

Healthcare finance can have many different definitions, depending on the setting. For our purposes, healthcare finance encompasses the accounting and financial management functions of healthcare organizations. Accounting involves the measurement, in financial terms, of a business's operations and financial status, while financial management (corporate finance) involves the application of theory and concepts developed to help managers make better decisions. In practice, the two functions blend, with accounting generating the data needed to make sound decisions and financial management providing the framework for those decisions.

Financial management

The use of theory, principles, and concepts developed to help managers make better financial decisions.

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.

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.

SELF-TEST QUESTIONS

1. What does the term *healthcare finance* mean?
2. What is the difference between accounting and financial management?

1.3 THE ROLE OF FINANCE IN HEALTH SERVICES ORGANIZATIONS

Chief financial officer (CFO)

The senior manager (or top finance dog) in a large organization's finance department. Also called *vice president of finance*.

The primary role of finance in health services organizations, as in all businesses, is to plan for, acquire, and use resources to maximize the efficiency (and value) of the enterprise (see “Critical Concept: Role of Finance”). As discussed in section 1.4 of this chapter, the two broad areas of finance—accounting and financial management—are separate functions at larger organizations, although the accounting function usually is carried out under the direction of the organization's **chief financial officer (CFO)** and hence falls under the overall category of finance.

CRITICAL CONCEPT Role of Finance

The primary role of finance in health services organizations is to plan for, acquire, and use resources to maximize the efficiency of the organization. This role is implemented through specific activities such as planning and budgeting.

FINANCE ACTIVITIES

Chapters 1 through 3 of this book provide foundational information that is helpful for understanding finance activities. The specific finance activities explored in the remaining chapters of this book include the following:

- ◆ *Costs and profitability, planning, and budgeting.* First and foremost, healthcare finance involves evaluating the financial

effectiveness of current operations and planning for the future. Chapters 4 through 6 cover these functions.

- ◆ *Financial operations.* Healthcare organizations spend a lot of time managing cash and supply inventories as well as collecting money owed for services rendered. Proper management of these functions is necessary to ensure operational effectiveness and to reduce costs. Typically, managers at all levels are involved, to a greater or lesser extent, in these processes, which are discussed in chapter 7.
- ◆ *Financing decisions.* All organizations must raise funds to buy the assets necessary to support operations. Such decisions involve many issues, such as the choice between long-term and short-term debt and the use of leases versus conventional financing. Senior managers and the financial staff typically make the financing decisions, but these decisions have ramifications for managers at all levels. Business financing is the subject of chapter 8.
- ◆ *Capital investment decisions.* One of the most critical decisions managers make is the selection of new facilities (including land, buildings, and equipment). Such decisions are the primary means by which businesses implement strategic plans; hence, they play a key role in a business's financial future. Chapters 9 and 10 describe these decisions, which affect everyone in the organization.
- ◆ *Financial reporting.* For a variety of reasons, businesses must record and report to outsiders the results of operations and current financial status. This task is typically accomplished with a set of financial statements, which are explained in chapters 11 and 12.
- ◆ *Financial and operational analysis.* To achieve and maintain a high level of organizational performance, businesses must constantly monitor both financial and operational conditions and take actions as needed to ensure that goals are met. Chapters 7 and 13 address these topics.

In addition to those finance activities that involve operational managers, the following activities are accomplished primarily by the finance staff:

- ◆ *Contract management.* In today's healthcare environment, health services organizations must negotiate, sign, and monitor contracts with managed care organizations and health insurers. The finance staff typically has primary responsibility for these tasks, though operational managers clearly are affected by external contracts and must be involved in their negotiation and management.

- ◆ *Financial risk management.* Many financial transactions that take place to support the operations of a business can, in themselves, increase a business's risk. Thus, an important finance staff activity is to manage financial risk.

THE FOUR CS

The finance activities at health services organizations may be summarized by the four Cs: costs, cash, capital, and control (see “Critical Concept: The Four Cs”).



CRITICAL CONCEPT

The Four Cs

The finance activities in healthcare organizations can be summarized by the four Cs: (1) *cost* measurement and minimization, (2) *cash* management, (3) *capital* acquisition, and (4) *control* of resources.

The measurement and minimization of costs are vital activities to the financial success of all healthcare organizations. Rampant costs, compared to revenues, usually spell doom for any business.

A business might be profitable but still face a crisis because of a shortage of cash. Cash is the lubricant that makes the wheels of a business run smoothly; without it, the business grinds to a halt. In essence, businesses must have sufficient cash on hand (or the ability to raise it quickly) to meet cash obligations as they occur. In healthcare, a critical part of managing cash is collecting money from

insurers for patient services provided. (This element is so important that some healthcare finance professors include *collections* as the fifth C.)

Capital represents the funds (money) used to acquire land, buildings, and equipment. Without capital, healthcare businesses would not have the physical resources needed to provide patient services. Thus, capital allows healthcare organizations to meet the healthcare needs of their communities.

Finally, a business must control its financial and physical resources to ensure that they are being wisely employed and protected for future use. In addition to meeting current mission requirements, healthcare organizations must plan to meet society's future healthcare needs.

IMPORTANCE OF FINANCE OVER TIME

In times of high profitability and abundant financial resources, the finance function tends to decline in significance. For example, when most health services organizations were reimbursed on the basis of the actual costs they incurred, the role of finance was minimal. At that time, the most critical finance function was cost accounting because it was more important to account for costs than it was to control them. In response to payer (primarily Medicare) requirements, health services organizations (primarily hospitals) churned out a multitude of reports to comply with regulations and to maximize revenues. The complexities of cost reimbursement meant that a large amount of time had to be spent on cumbersome

accounting, billing, and collection procedures. Thus, instead of focusing on value-adding activities, most finance work focused on bureaucratic functions.

In recent years, however, providers have redesigned their finance functions to recognize the changes that have occurred in the health services field. Billing and collections remain important, but to be of maximum value to the enterprise, the finance function must support cost-containment efforts, managed care and other payer contract negotiations, joint venture decisions, and integrated delivery system participation. In essence, finance must help lead organizations into the future rather than merely record what has happened in the past.

Although in this book our emphasis is on finance, we must stress that all organizational functions are important. In addition to finance, managers must understand some elements of many different functions, such as marketing, facilities management, and human resource management. All business decisions have financial implications, however, so all managers (whether in operations, marketing, personnel, or facilities) must know enough about finance to incorporate financial considerations properly into the plans and decisions in their specialized areas (see “For Your Consideration: Do Nonfinancial Managers Need to Know Finance?”).

SELF-TEST QUESTIONS

1. What is the role of finance in today’s healthcare organizations?
2. What are the four Cs?
3. How has the role of finance changed over time?



FOR YOUR CONSIDERATION

Do Nonfinancial Managers Need to Know Finance?

A much-debated topic at the water cooler is whether nonfinancial managers, including clinical managers, need to know much about finance. As outlined in the American College of Healthcare Executives (ACHE) 2018 Competencies Assessment Tool, healthcare managers should over time attain competencies in 24 areas of financial management. Among the areas listed are basic accounting principles, reimbursement principles, budgeting, revenue generation, performance monitoring, and applying financial planning to organizational objectives. Of course, financial management competencies represent only a small proportion of the complete list of management competencies assessed by the tool. Still, by including financial management in the assessment tool, ACHE considers it a key skill set for healthcare managers regardless of work setting or years of experience.

What do you think? Do nonfinancial general managers need financial management skills? What about clinical managers? Justify your answers.