



FIFTH EDITION

HEALTH CARE

FINANCE

Basic Tools For Nonfinancial Managers

JUDITH J. BAKER
R.W. BAKER
NEIL R. DWORKIN



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New to This Edition

The *Fifth Edition* continues to provide practical information, with examples taken from real life in the healthcare finance world. For example, we have added the following:

NEW MATERIAL IN THE 5TH EDITION:

- Chapter 3 “The Digital Age: Changing the Landscape of Healthcare Finance”—This new chapter is about understanding the impact of data analytics and big data, along with other important trends in the changing landscape of healthcare finance. It is important to recognize that digital advancements in health care are the drivers that enable innovation.
- Chapter 26 “Understanding Strategic Relationships: Health Delivery Systems, Finance and Reimbursement”—This new chapter focuses upon describing the strategic relationships between and among health delivery systems, finance, and reimbursement. This chapter assists a manager in recognizing both differences and interrelationships and in applying this recognition to their own organization’s structure.
- Chapter 27 “Understanding Value-Based Health Care and Its Financial and Digital Outcomes”—Value-based performance, the subject of this new chapter, is particularly important because it is the key to both improving patient care and reforming payment systems. Healthcare organizations should define what value means and make sure that definition is shared across the entire entity.
- Chapter 28 “New Payment Methods and Measures: MIPS and APMs for Eligible Professionals”—This new chapter highlights significant legislation and regulations that change payment methods and performance measures for physicians and other eligible professionals. The new payment method for physicians hinges upon proper reporting of new performance measures. The new system is a true reform, as it replaces a physician payment system that has been in effect for decades.
- Appendix 28-A “Meaningful Use: Modified and Streamlined with a New Name”—This new appendix describes the evolution of meaningful use before and after its transition into the new physician performance measures that are described in Chapter 28.
- Chapter 29 “Standardizing Measures and Payment in Post-Acute Care: New Requirements”—This new chapter is about important legislation and regulations that standardize measures and require studies about payment reform for post-acute care. This means performance measures for skilled nursing facilities, home health agencies, inpatient rehabilitation facilities, and long-term care hospitals are being standardized. Models for a patient-centered payment system that cuts across all four care settings are also being created.
- Chapter 30 “ICD-10 Implementation Continues: Finance and Strategic Challenges for the Manager”—This updated chapter focuses upon challenges for the manager within ICD-10 implementation. An all-new section introduces useful Key Performance Indicators that are used to assess an organization’s ICD-10 implementation progress.

Other new material in this edition includes the following:

- Chapter 9 “Understanding Inventory and Depreciation Concepts”—A new section about drug distribution systems in use in hospitals has been added to this chapter.
- Chapter 10 “Staffing: Methods, Operations, and Regulation”—A new section has been added describing legislation that requires reporting “verifiable and auditable” payroll information for the “Nursing Compare” website, along with information about existing Certificate of Need regulations.

- Appendix 16-A “Creating A DRG Budget for Respiratory Care: The Resource Consumption Approach”—This new appendix sets out a step-by-step DRG budget methodology.
- Appendix 16-B “Reviewing a Comparative Operating Budget Report”—This new appendix describes the review of a section from an actual operating budget report.
- Chapter 21 “Understanding Investment and Statistical Terms Used in Finance”—This chapter was originally only about investment terms; it now has a new section about understanding statistical terms.
- Chapter 31 “Case Study: The Doctor’s Dilemma”—This new case study is about a physician deciding whether or not to sell his practice to a health delivery system.

MATERIAL OMITTED FROM THIS EDITION

- Two *Fourth Edition* chapters and a *Fourth Edition* appendix have been omitted because they are becoming outdated. This includes the following: Chapter 24 “Information Technology and EHR: Adoption Requirements, Initiatives, and Management Decisions” has been replaced with the new value-based chapter.
- Appendix 24-A Accordingly, the e-Prescribing (eRx) appendix has also been omitted because the incentive program is ending.
- Chapter 25 “Electronic Health Records Framework: Incentives, Standards, Measures, and Meaningful Use” has been omitted because the incentives are ending.
- Relevant additions and deletions have been made to the “Examples and Exercises” section.

To summarize: A fundamental theme in the *Fifth Edition* is that healthcare financing is embracing the digital age. This is manifested by its coverage of electronic health records (EHRs), data analytics, value-based health care, and social media, among other topics. In this era of population health and the resulting need for clinical integration, data-driven collaboration has the potential to improve outcomes and lower costs, as well as more effectively engage the patient. The upshot: Everything is connected.

Preface

Our world of work is divided into three parts: the healthcare consultant, the instructor, and the writer. Over the years, we have taught managers in seminars, academic settings, and corporate conference rooms. Most of the managers were mid-career adults, working in all types of healthcare disciplines. We taught them and they taught us. One of the things they taught us was this: A nonfinancial manager pushed into dealing with the world of finance often feels a dislocation and a change of perspective, and that experience can be both difficult and exciting. We have listened to their questions and concerns as these managers grapple with this new world. This book is the result of their experiences, and ours.

The book is designed for use by a manager (or future manager) who does not have an educational background in financial management. It has long been our philosophy that if you can truly understand how a thing works—whatever it is—then you own it. This book is created around that philosophy. In other words, we intend to make financial management transparent by showing how it works and how a manager can use it.

USING THE BOOK

All our examples are drawn from the healthcare industry. Thus users will find examples and exercises covering many types of healthcare settings and providers, including hospitals, clinics, physician practices, long-term care facilities, and home health agencies.

Standard Elements

Each chapter within these parts contains the following four elements:

- “Progress Notes” set out learning objectives at the beginning of each chapter.
- An “Information Checkpoint” segment at the end of each chapter tells the user three things: information needed, where this information can be obtained, and how this information can be used.
- A “Key Terms” section follows the “Information Checkpoint.” Every Key Term is defined in the Glossary; it is also bold faced the first time it appears in the text.
- The “Discussion Questions” segment inquires about practical uses of chapter material and encourages responses based upon experience.

Structure and Topics

The book is structured in 12 parts, as follows.

Part I: Healthcare Finance Overview [Three chapters; one is new]

Part II: Record Financial Operations [Four chapters]

Part III: Tools To Analyze and Understand Financial Operations [Three chapters plus appendix; new text added to two chapters]

Part IV: Report and Measure Financial Results [Three chapters plus three appendices]

Part V: Tools to Review and Manage Comparative Data [Two chapters]

Part VI: Construct and Evaluate Budgets [Two chapters plus two new appendices]

Part VII: Tools to Plan, Monitor, and Control Financial Status [Three chapters; one is new]

Part VIII: Financial Terms, Costs, and Choices [Three chapters; one entire new section]

Part IX: Strategic Planning: A Powerful Tool [Three chapters plus one appendix; one chapter is new]

Part X: Information Technology As A Financial and Strategic Tool [Four chapters plus two appendices; three chapters and one appendix are all new and the fourth chapter has been substantially revised. In addition, two previous chapters and a previous appendix that have become outdated have been omitted and replaced in the *Fifth Edition*.]

Part XI: Case Studies [One new case study about the doctor's dilemma, one case study about strategic financial planning in long-term care, and a group of four interrelated case studies about the Metropolis Health System]

Part XII: Mini-Case Studies [Two mini-case studies; one concerns resource misallocation in a public health clinic and the other is about automating admissions processes]

More About the Metropolis Health System Case Studies

A group of four case studies about the Metropolis Health System (MHS) represents a comprehensive suite of information. This section includes the major case study about the system, followed by an appendix containing an MHS financial statement and excerpts from notes. A second case study appendix shows how one MHS hospital was turned around using comparative analysis of benchmarks and statistical data. A third case study appendix describes a detailed proposal to add a retail pharmacy to another of the MHS hospitals. The Metropolis grouping thus provides an interactive suite of case study material.

Supplemental Resources

At the back of the book you will find additional resources as follows, all of which have been updated for the *Fifth Edition*:

- An Appendix containing Checklists
- A Glossary
- Examples and Exercises, with Solutions
- Other Supplemental Materials

Acknowledgments

With this edition we welcome Dr. Neil R. Dworkin as our coauthor. Neil brings a formidable combination of both educational and practical on-the-ground experience in health care. He also brings fresh viewpoints that are as valuable as his career achievements.

The *Fifth Edition* has evolved with the help of numerous instructors and students who give us feedback; we listen. We owe a great debt of thanks to Mike Brown, our long-suffering and understanding publisher. And we thank our *Fifth Edition* first readers, including Teresa Schroder, AuD, CCC-A, along with others who prefer to be anonymous; you know who you are. The continuing support and suggestions of Janet Feldman, PhD, RN, Vice President, Qualitas Associates, along with certain continuing technical support provided by Colleen McMurry, CPA, of McMurry and Associates, are also appreciated.

The input from finance sessions we taught as Adjunct Faculty at Texas Woman's University in Dallas also contributed to shaping the content of the *Fifth Edition*. Our continued gratitude goes to Craig Sheagren, Senior Vice President/CFO, McDonough District Hospital, Macomb, Illinois; and Nancy M. Borkowski, PhD, Professor, Department of Professional Management/Health Management, St. Thomas University, Miami, Florida, for their encouragement, information, suggestions, and assistance with the original concept of the book. We also thank John Brocketti, Chief Financial Officer, SUMA Health System, Akron, Ohio; Christine Pierce, Partner, The Resource Group, Cleveland, Ohio; and Dr. Frank Welsh, Cincinnati, Ohio, for their ongoing information and suggestions.

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Judith J. Baker, PhD, CPA, has worked with healthcare systems, costing, finance, and reimbursement throughout her career. With over 40 years' experience in health care, she is a co-founder of Resource Group, Ltd., a healthcare consulting firm. As a CMS contractor, she has assisted in validation of costs for new programs and for rate setting and has also consulted on cost report design. More recently, she has provided activity-based costing, rate setting, and organizational systems expertise to national clients within the healthcare industry.

Judith's doctorate is in human and organizational systems, with a concentration in healthcare costing systems. She has served as adjunct faculty at the University of Texas at Houston and the Texas Woman's University in Dallas, as well as the University of Rochester School of Nursing and the Case Western Reserve University Francis Payne Bolton School of Nursing.

Judith has written numerous peer-reviewed articles and has served as Consulting Editor for Aspen Publishers, Inc. Her books include *Activity-Based Costing and Activity-Based Management for Health Care*, *Prospective Payment for Long-Term Care*, *Prospective Payment for Home Health Agencies*, *Management Accounting for Health Care Organizations* (with Robert Hankins) and *Essentials of Cost Accounting for Health Care Organizations* (with Steven Finkler and David Ward). She is Editor Emeritus of the quarterly *Journal of Healthcare Finance*.

R. W. Baker, JD, is also a co-founder of Resource Group, Ltd., a healthcare consulting firm. He has more than 40 years of experience in health care and has designed, directed, and administered numerous financial impact studies for healthcare providers. His early studies centered around facility-specific MDS data collection and analysis. He and his firm subcontracted to the HCFA/CMS Nursing Home Case Mix and Quality Demonstration for over nine years. More recently he has designed, implemented, and managed a series of national time studies for pharmaceutical and medical device clients.

R. W. is the editor of continuing professional education seminar manuals and training manuals for facility personnel and for research staff members. He served as a Consulting Editor with Aspen Publishers, Inc. and is co-author of *A Step-by-Step Guide to the Minimum Data Set* (with Dr. Janet Feldman).

Neil R. Dworkin, PhD, is Emeritus Associate Professor of Management at Western Connecticut State University, where he was Coordinator of the Masters in Health Administration Program and where he taught Strategic Management, Finance, Marketing, Health Policy, and Health Delivery Systems. He is presently an adjunct faculty member at Charter Oak State College, which is part of the Connecticut State University System and where he teaches Continuous Quality Improvement in Health Care and Health Care Systems and Administration.

Neil has hospital administration experience, and has been a nursing home administrator in New York and Connecticut. He has over 40 years' experience in the healthcare field. He was the lead author in a three-article series on "Managerial Socialization in Short-Term Hospitals" that was published in *Hospital Topics* and *Problems and Perspectives in Management*. Neil has also served as an editor of *The Journal of Health Administration Education*.

PART

I

*Healthcare
Finance
Overview*

Introduction to Healthcare Finance

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THE HISTORY

Financial management has a long and distinguished history. Consider, for example, that Socrates wrote about the universal function of management in human endeavors in 400 B.C. and that Plato developed the concept of specialization for efficiency in 350 B.C. Evidence of sophisticated financial management exists from much earlier times: the Chinese produced a planning and control system in 1100 B.C., a minimum-wage system was developed by Hammurabi in 1800 B.C., and the Egyptians and Sumerians developed planning and record-keeping systems in 4000 B.C.¹

Many managers in early history discovered and rediscovered managerial principles while attempting to reach their goals. Because the idea of management thought as a discipline had not yet evolved, they formulated principles of management because certain goals had to be accomplished. As management thought became codified over time, however, the building of techniques for management became more organized. Management as a discipline for educational purposes began in the United States in 1881. In that year, Joseph Wharton created the Wharton School, offering college courses in business management at the University of Pennsylvania. It was the only such school until 1898, when the Universities of Chicago and California established their business schools. Thirteen years later, in 1911, 30 such schools were in operation in the United States.²

Over the long span of history, managers have all sought how to make organizations work more effectively. Financial management is a vital part of organizational effectiveness. This text's goal is to provide the keys to unlock the secrets of financial management for nonfinancial managers.

Progress Notes

After completing this chapter, you should be able to

1. Discuss the three viewpoints of managers in organizations.
2. Identify the four elements of financial management.
3. Understand the differences between the two types of accounting.
4. Identify the types of organizations.
5. Understand the composition and purpose of an organization chart.

THE CONCEPT

A Method of Getting Money in and out of the Business

One of our colleagues, a nurse, talks about the area of healthcare finance as “a method of getting money in and out of the business.” It is not a bad description. As we shall see, revenues represent inflow and expenses represent outflow. Thus, “getting money in” represents the inflow (revenues), whereas “getting money out” (expenses) represents the outflow. The successful manager, through planning, organizing, controlling, and decision making, is able to adjust the inflow and outflow to achieve the most beneficial outcome for the organization.

HOW DOES FINANCE WORK IN THE HEALTHCARE BUSINESS?

The purpose of this text is to show how the various elements of finance fit together: in other words, how finance works in the healthcare business. The real key to understanding finance is understanding the various pieces and their relationship to each other. If you, the manager, truly see how the elements work, then they are yours. They become your tools to achieve management success.

The healthcare industry is a service industry. It is not in the business of manufacturing, say, widgets. Instead, its essential business is the delivery of healthcare services. It may have inventories of medical supplies and drugs, but those inventories are necessary to service delivery, not to manufacturing functions. Because the business of health care is service, the explanations and illustrations within this book focus on the practice of financial management in the service industries.

VIEWPOINTS

The managers within a healthcare organization will generally have one of three views: (1) financial, (2) process, or (3) clinical. The way they manage will be influenced by which view they hold.

1. The financial view. These managers generally work with finance on a daily basis. The reporting function is part of their responsibility. They usually perform much of the strategic planning for the organization.
2. The process view. These managers generally work with the system of the organization. They may be responsible for data accumulation. They are often affiliated with the information system hierarchy in the organization.
3. The clinical view. These managers generally are responsible for service delivery. They have direct interaction with the patients and are responsible for clinical outcomes of the organization.

Managers must, of necessity, interact with one another. Thus, managers holding different views will be required to work together. Their concerns will intersect to some degree, as illustrated by **Figure 1–1**. The nonfinancial manager who understands healthcare finance will be able to interpret and negotiate successfully such interactions between and among viewpoints.

In summary, financial management is a discipline with a long and respected history. Healthcare service delivery is a business, and the concept of financial management assists in balancing the inflows and outflows that are a part of the business.

WHY MANAGE?

Business does not run itself. It requires a variety of management activities in order to operate properly.

THE ELEMENTS OF FINANCIAL MANAGEMENT

There are four recognized elements of financial management: (1) planning, (2) controlling, (3) organizing and directing, and (4) decision making. The four divisions are based on the purpose of each task. Some authorities stress only three elements (planning, controlling, and decision making) and consider organizing and directing as a part of the controlling element. This text recognizes organizing and directing as a separate element of financial management, primarily because such a large proportion of a manager's time is taken up with performing these duties.

1. **Planning.** The financial manager identifies the steps that must be taken to accomplish the organization's objectives. Thus, the purpose is to identify objectives and then to identify the steps required for accomplishing these objectives.
2. **Controlling.** The financial manager makes sure that each area of the organization is following the plans that have been established. One way to do this is to study current reports and compare them with reports from earlier periods. This comparison often shows where the organization may need attention because that area is not effective. The reports that the manager uses for this purpose are often called feedback. The purpose of controlling is to ensure that plans are being followed.
3. **Organizing and directing.** When organizing, the financial manager decides how to use the resources of the organization to most effectively carry out the plans that have been established. When directing, the manager works on a day-to-day basis to keep the results of the organizing running efficiently. The purpose is to ensure effective resource use and provide daily supervision.
4. **Decision making.** The financial manager makes choices among available alternatives. Decision making actually occurs parallel to planning, organizing, and controlling. All types of decision making rely on information, and the primary tasks are analysis and evaluation. Thus, the purpose is to make informed choices.

THE ORGANIZATION'S STRUCTURE

The structure of an organization is an important factor in management.

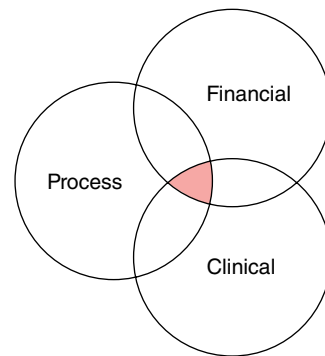


Figure 1-1 Three Views of Management Within an Organization.

Organization Types

Organizations fall into one of two basic types: profit oriented or nonprofit oriented. In the United States, these designations follow the taxable status of the organizations. The profit-oriented entities, also known as proprietary organizations, are responsible for paying income taxes. Proprietary subgroups include individuals, partnerships, and corporations. The nonprofit organizations do not pay income taxes.

There are two subgroups of nonprofit entities: voluntary and government. Voluntary nonprofits have sought tax-exempt status. In general, voluntary nonprofits are associated with churches, private schools, or foundations. Government nonprofits, on the other hand, do not pay taxes because they are government entities. Government nonprofits can be (1) federal, (2) state, (3) county, (4) city, (5) a combination of city and county, (6) a hospital taxing district (with the power to raise revenues through taxes), or (7) a state university (perhaps with a teaching hospital affiliated with the university). The organization's type may affect its structure. **Exhibit 1-1** summarizes the subgroups of both proprietary and nonprofit organizations.

Organization Charts

In a small organization, top management will be able to see what is happening. Extensive measures and indicators are not necessary because management can view overall operations. But in a large organization, top management must use the management control system to understand what is going on. In other words, to view operations, management must use measures and indicators because he or she cannot get a first-hand overall picture of the total organization.

Exhibit 1-1 Types of Organizations

Profit Oriented—Proprietary
Individual
Partnership
Corporation
Other
Nonprofit—Voluntary
Church Associated
Private School Associated
Foundation Associated
Other
Nonprofit—Government
Federal
State
County
City
City–County
Hospital District
State University
Other

As a rule of thumb, an informal management control system is acceptable only if the manager can stay in close contact with all aspects of the operation. Otherwise, a formal system is required. In the context of health care, therefore, a one-physician practice (**Figure 1-2**) could use an informal method, but a hospital system (**Figure 1-3**) must use a formal method of management control.

The structure of the organization will affect its financial management. Organization charts are often used to illustrate the structure of the organization. Each box on an organization chart represents a particular area of management responsibility. The lines between the boxes are lines of authority.

In the health system organization chart illustrated in **Figure 1-3**, the president/chief executive officer oversees seven senior vice presidents. Each senior vice president has vice presidents reporting to him or her in each

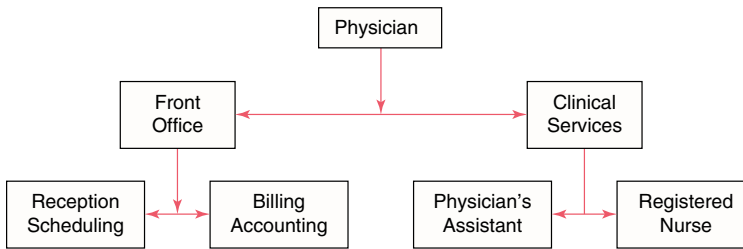


Figure 1–2 Physician’s Office Organization Chart.
 Courtesy of Resource Group, Ltd., Dallas, Texas.

particular area of responsibility designated on the chart. These vice presidents, in turn, have an array of other managers reporting to them at varying levels of managerial responsibility.

The organization chart also shows the degree of decentralization within the organization. Decentralization indicates the delegating of authority for decision making. The chart thus illustrates the pattern of how managers are allowed—or required—to make key decisions within the particular organization.

The purpose of an organization chart, then, is to indicate how responsibility is assigned to managers and to indicate the formal lines of communication and reporting.

TWO TYPES OF ACCOUNTING

Financial

Financial accounting is generally for outside, or third party, use. Thus, financial accounting emphasizes external reporting. External reporting to third parties in health care includes, for example, government entities (Medicare, Medicaid, and other government programs) and health plan payers. In addition, proprietary organizations may have to report to stockholders, taxing district hospitals have to report to taxpayers, and so on.

Financial reporting for external purposes must be in accordance with generally accepted accounting principles. Financial reporting is usually concerned with transactions that have already occurred: that is, it is retrospective.

Managerial

Managerial accounting is generally for inside, or internal, use. Managerial accounting, as its title implies, is used by managers. The planning and control of operations and related performance measures are common day-by-day uses of managerial accounting. Likewise, the reporting of profitability of services and the pricing of services are other common ongoing uses of managerial accounting. Strategic planning and other intermediate and long-term decision making represent an additional use of managerial accounting.³

Managerial accounting intended for internal use is not bound by generally accepted accounting principles. Managerial accounting deals with transactions that have already occurred, but it is also concerned with the future, in the form of projecting outcomes and preparing budgets. Thus, managerial accounting is prospective as well as retrospective.

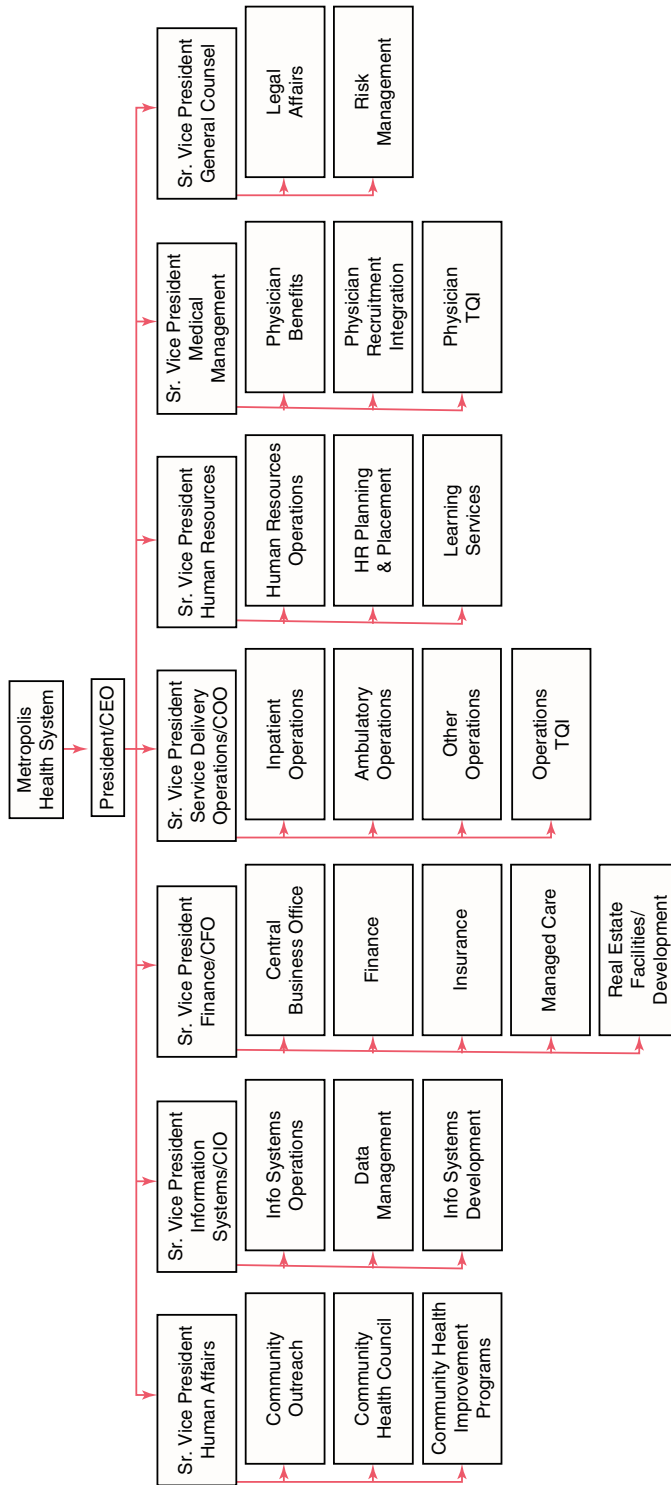


Figure 1-3 Health System Organization Chart.
 Courtesy of Resource Group, Ltd., Dallas, Texas.



INFORMATION CHECKPOINT

What is needed?	Reports for management purposes.
Where is it found?	With your supervisor.
How is it used?	To manage better.
What is needed?	Organization chart.
Where is it found?	With your supervisor or in the administrative offices.
How is it used?	To better understand the structure and lines of authority in your organization.



KEY TERMS

Controlling
 Decision Making
 Financial Accounting
 Managerial Accounting
 Nonprofit Organization (also see Voluntary Organization)
 Organization Chart
 Organizing
 Planning
 Proprietary Organization (also see Profit-Oriented Organization)



DISCUSSION QUESTIONS

1. What element of financial management do you perform most often in your job?
2. Do you perform all four elements? If not, why not?
3. Of the organization types described in this chapter, what type is the one you work for?
4. Have you ever seen your company's organization chart? If so, how decentralized is it?
5. If you receive reports in the course of your work, do you believe that they are prepared for outside (third party) use or for internal (management) use? What leads you to believe this?

NOTES

1. C. S. George, Jr., *The History of Management Thought*, 2nd ed. (Englewood Cliffs, NJ: Prentice Hall, 1972), 1–27.
2. *Ibid.*, 87.
3. S. Williamson et al., *Fundamentals of Strategic Planning for Healthcare Organizations* (New York: The Haworth Press, 1997).