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INTRODUCTION TO HEALTHCARE FINANCIAL MANAGEMENT

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INTRODUCTION

The study of healthcare financial management is fascinating and rewarding. It is fascinating because so many of the concepts involved have implications for both professional and personal behavior. It is rewarding because the healthcare environment today, and in the foreseeable future, is forcing managers to place increasing emphasis on financial implications when making operating decisions. First and foremost, financial management is a decision science. Whereas accounting provides decision makers with a rational means by which to budget for and measure a business's financial performance, financial management provides the theory, concepts, and tools necessary to make better decisions.

The Role of Financial Management in the Health Services Industry

Until the 1960s, financial management in all industries was generally viewed as descriptive in nature, its primary role being to secure the financing needed to meet a business's operating objectives. A business's marketing, or planning, department would project demand for the firm's goods or services; facilities managers would estimate the assets needed to meet the projected demand; and the finance department would raise the money needed to purchase the required land, buildings, equipment, and supplies. The study of financial management concentrated on business securities and the markets in which they are sold and on how businesses could access the financial markets to raise capital. Consequently, financial management textbooks of that era were almost totally descriptive in nature.

Today, financial management plays a much larger role in the overall management of a business. Now, the primary role of financial management is to plan for, acquire, and utilize funds (capital) to maximize the efficiency and value of the enterprise. Because of this role, financial management is known also as capital finance. The specific goals of financial management depend on the nature of the business, so we will postpone that discussion until later in the chapter. In larger organizations, financial management and accounting are separate functions, although the accounting function typically is carried out under the direction of the organization's chief financial officer (CFO) and hence falls under the overall category of "finance."

In general, the financial management function includes the following activities:

• **Evaluation and planning:** First and foremost, financial management involves evaluating the financial effectiveness of current operations and planning for the future.

• **Long-term investment decisions:** Although these decisions are more important to senior management, managers at all levels must be concerned with the capital investment decision process. Such decisions focus on the acquisition of new facilities and equipment (fixed assets) and are the primary means by which businesses implement strategic plans; hence, they play a key role in a business's financial future.

• **Financing decisions:** All organizations must raise funds to buy the assets necessary to support operations. Such decisions involve the choice between the use of internal versus external funds, the use of debt versus equity capital, and the use of long-term versus short-term debt. Although senior managers typically make financing decisions, these choices have ramifications for managers at all levels.

• **Working capital management:** An organization's current, or short term, assets, such as cash, marketable securities, receivables, and inventories, must be properly managed to ensure operational effectiveness and reduce costs. Generally, managers at all levels are involved, to some extent, in short-term asset management, which is often called working capital management.

• **Contract management:** Health services organizations must negotiate, sign, and monitor contracts with managed care organizations and thirdparty payers. The financial staff typically has primary responsibility for these tasks, but managers at all levels are involved in these activities and must be aware of their effect on operating decisions.

• **Financial risk management:** Many financial transactions that take place to support the operations of a business can increase a business's risk. Thus, an important financial management activity is to control financial risk.

In times of high profitability and abundant financial resources, the finance function tends to decline in importance. Thus, when most healthcare providers were reimbursed on the basis of costs 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. Today, however, healthcare providers are facing an increasingly hostile financial environment, and any business that ignores the finance function runs the risk of financial deterioration, which ultimately can lead to bankruptcy and closure.

In recent years, providers have been redesigning their finance functions to recognize the changes that have been occurring in the health services industry. Historically, the practice of finance had been driven by the Medicare program, which demanded that providers (primarily hospitals) churn out a multitude of reports to comply with regulations and maximize Medicare revenues. Third-party reimbursement complexities 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. Today, 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. Finance must help lead organizations into the future rather than merely record what has happened in the past.

In this text, the emphasis is on financial management, but there are no unimportant functions in health services organizations. Managers must understand a multitude of functions, such as marketing, accounting, and human resource management, in addition to financial management. Still, all business decisions have financial implications, so all managers—whether in operations, marketing, personnel, or facilities—must know enough about financial management to incorporate financial implications in decisions about their own specialized areas. An understanding of the theory and principles of financial management will make them even more effective at their own specialized work.

Current Challenges

In April 2009, the Healthcare Financial Management Association released its Healthcare Finance Outlook. A survey and interviews of 100 healthcare thought leaders were used to forecast issues likely to affect healthcare finance over the next ten years and preparations organizations should be making to deal with these issues.

In order of importance, survey respondents identified the following near-term actions:

1. Develop a long-term business plan for physician integration.
2. Implement substantial and sustainable cost-containment strategies.
3. Amend strategic and capital plans to account for potential shifts in revenue.
4. Develop a strategic plan for recruitment, retention, and training.
5. Develop strategies to align information technology with transformations in payment and care delivery structures.
6. Redesign care processes and delivery systems to better integrate professional and facility components of care.
7. Forge innovative alliances with other service providers and explore such pursuits as regional health initiatives, micro financing approaches, and employer relationships.
8. Ensure that online customer service capabilities keep pace with consumer expectations.
9. Significantly increase resources/planning for services delivered outside the traditional hospital setting.
10. Seek merger partner(s) to gain efficiencies of increased size and access to capital.

Taken together, these actions confirm that financial issues are of primary importance to today's healthcare managers. The remainder of this book is dedicated to helping you confront and solve these issues. (In addition to this survey, several other surveys have been conducted in recent years regarding the concerns of health services managers.3)

Tax Laws

The value of any financial asset, such as a share of stock issued by Tenet Healthcare or a municipal bond issued by the Alachua County Healthcare Financing Authority on behalf of Shands HealthCare, and the value of many real assets, such as a magnetic resonance imaging (MRI) machine, medical office building, or hospital, depend on the stream of usable cash flows that the asset is expected to produce. Because taxes reduce the cash flows that are usable to the business, financial analyses must include the impact of local, state, and federal taxes. Local and state tax laws vary widely, so we will not attempt to cover them in this text. Rather, we will focus on the federal income tax system because these taxes dominate the taxation of business income. In our examples, we will typically increase the effective tax rate to approximate the effects of state and local taxes.

Congress can change tax laws, and major changes have occurred every three to four years, on average, since 1913, when the federal tax system was initiated. Furthermore, certain aspects of the Tax Code are tied to inflation, so changes based on the previous year's inflation rate automatically occur each year. Therefore, although this section will give you an understanding of the basic nature of our federal tax system, it is not intended to be a guide for application. Tax laws are so complicated that many law and business schools offer a master's degree in taxation, and many who hold this degree are also certified public accountants. Managers and investors should rely on tax experts rather than trust their own limited knowledge. Still, it is important to know the basic elements of the tax system as a starting point for discussions with tax specialists. In a field complicated enough to warrant such detailed study, we can cover only the highlights.

Current (2010) federal income tax rates on personal income go up to 35 percent, and when state and local income taxes are added, the marginal rate can approach 50 percent. In his 2009 State of the Union Address, President Obama proposed raising the federal income tax rate from 35 percent to 39.6 percent for the uppermost tax bracket, and there is some chance that this increase will happen.

Business income is also taxed heavily. The income from partnerships and proprietorships is reported by the individual owners as personal income and, consequently, is taxed at rates of up to 50 percent. Corporate income, in addition to state and local income taxes, is taxed by the federal government at marginal rates as high as 39 percent. Because of the magnitude of the tax bite, taxes play an important role in most financial management decisions made by individuals and by for-profit organizations.

Depreciation

A fundamental accounting concept is the matching principle, which requires expenses to be recognized in the same period as the related revenue is earned. Suppose Northside Family Practice buys an x-ray machine for $100,000 and uses it for ten years, after which time the machine becomes obsolete. The cost of the services provided by the machine must include a charge for the cost of the machine; this charge is called depreciation. Depreciation reduces profit (net income) as calculated by accountants, so the higher a business's depreciation charge, the lower its reported profit. However, depreciation is a noncash charge—it is an allocation of previous cash expenditures—so higher depreciation expense does not reduce cash flow. In fact, higher depreciation increases cash flow for taxable businesses because the greater a business's depreciation expense in any year, the lower its tax bill.

To see more clearly how depreciation expense affects cash flow, consider Exhibit 1.2. Here, we examine the impact of depreciation on two investor owned hospitals that are alike in all regards except for the amount of depreciation expense each hospital has. Hospital A has $100,000 of depreciation expense, has $200,000 of taxable income, pays $80,000 in taxes, and has an after-tax income of $120,000. Hospital B has $200,000 of depreciation expense, has $100,000 of taxable income, pays $40,000 in taxes, and has an after-tax income of $60,000.

Depreciation is a noncash expense, whereas we assume that all other entries in Exhibit 1.2 represent actual cash flows. To determine each hospital's cash flow, depreciation must be added back to after-tax income. When this is done, Hospital B, with the larger depreciation expense, has the larger cash flow. In fact, Hospital B's cash flow is larger by $260,000 − $220,000 = $40,000, which represents the tax savings, or tax shield, on its additional $100,000 in depreciation expense:

Tax shield = Tax rate × Depreciation expense
= 0.40 × $100,000 = $40,000.

	Hospital A	Hospital B
Revenue	$1,000,000	$1,000,000
Costs except depreciation	700,000	700,000
Depreciation	100,000	200,000
Taxable income	**$ 200,000**	**$ 100,000**
Federal plus state taxes (assumed to be 40%)	80,000	40,000
After-tax income	**$ 120,000**	**$ 60,000**
Add back depreciation	100,000	200,000
Net cash flow	**$ 220,000**	**$ 260,000**

Because a business's financial condition depends on the actual amount of cash it earns, as opposed to some arbitrarily determined accounting profit, owners and managers should be more concerned with cash flow than reported profit. Note that if the hospitals in Exhibit 1.2 were not-for-profit hospitals, taxes would be zero for both, and they would have $300,000 in net cash flow. However, Hospital A would report $200,000 in earnings, while Hospital B would report $100,000 in earnings.

For-profit businesses generally calculate depreciation one way for tax returns and another way when reporting income on their financial statements. For tax depreciation, businesses must follow the depreciation guidelines laid down by tax laws, but for other purposes, businesses usually use accounting, or book, depreciation guidelines.

The most common method of determining book depreciation is the straight-line method. To apply the straight-line method, (1) start with the capitalized cost of the asset (generally, price plus shipping plus installation); (2) subtract the asset's salvage value, which, for book purposes, is the estimated value of the asset at the end of its useful life; and (3) divide the net amount by the asset's useful life. For example, consider Northside's x-ray machine, which cost $100,000 and has a ten-year useful life. Furthermore, assume that it cost $10,000 to deliver and install the machine and that its estimated salvage value after ten years of use is $5,000. In this case, the capitalized cost, or basis, of the machine is $100,000 + $10,000 = $110,000, and the annual depreciation expense is ($110,000 − $5,000)/10 = $10,500. Thus, the depreciation expense reported on Northside's income statement would include a $10,500 charge for "wear and tear" on the x-ray machine. The name "straight line" comes from the fact that the annual depreciation under this method is constant. The book value of the asset, which is the cost minus the accumulated depreciation to date, declines evenly (follows a straight line) over time.

For tax purposes, depreciation is calculated according to the Modified Accelerated Cost Recovery System (MACRS). MACRS spells out two procedures for calculating tax depreciation: (1) the standard (accelerated) method, which is faster than the straight-line method because it allows businesses to depreciate assets on an accelerated basis, and (2) an alternative straight-line method, which is optional for some assets but mandatory for others. Because taxable businesses want to gain the tax shields from depreciation as quickly as possible, they normally use the standard (accelerated) MACRS method when it is allowed.

The calculation of MACRS depreciation uses three components: (1) the depreciable basis of the asset, which is the total amount to be depreciated; (2) a recovery period that defines the length of time over which the asset is depreciated; and (3) a set of allowance percentages for each recovery period, which, when multiplied by the basis, gives each year's depreciation expense.

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