CHAPTER

1

Introduction to Healthcare Finance

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 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.

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.

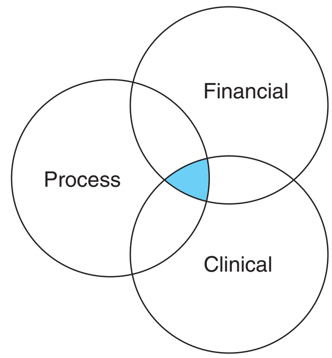

Figure 1–1 Three Views of Management Within an Organization.

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.

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.

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

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 firsthand overall picture of the total organization.

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 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.

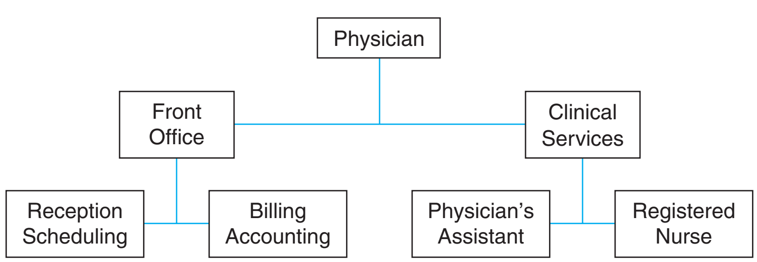

Figure 1–2 Physician's Office Organization Chart.
Courtesy of Resource Group, Ltd., Dallas, Texas.

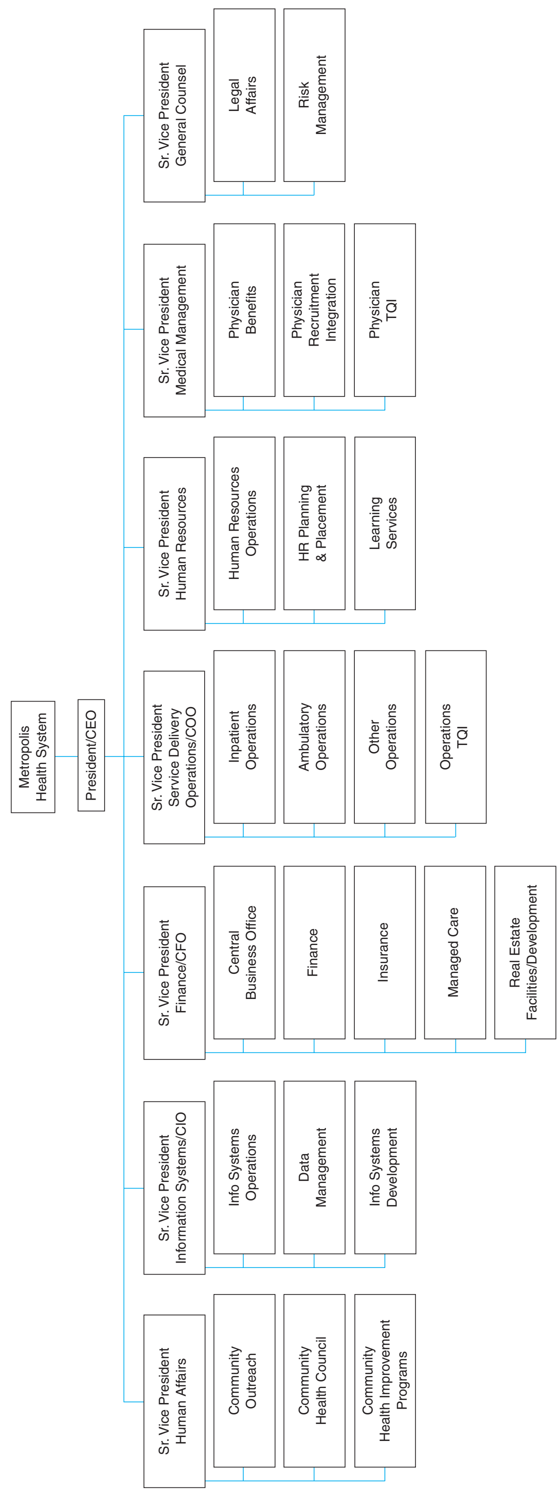

Figure 1–3 Health System Organization Chart.
Courtesy of Resource Group, Ltd., Dallas, Texas.

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.

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).