

# ESSENTIALS OF HEALTH CARE FINANCE

EIGHTH EDITION

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# Preface

This book represents the eighth edition of a book published originally in 1978, entitled *Essentials of Hospital Finance*. The text has evolved from a book containing seven chapters that dealt largely with understanding and interpreting hospital financial statements into a comprehensive financial text. The *Eighth Edition* has 23 chapters that cover most of the major areas of financial decision making that healthcare executives deal with on a daily basis.

This book has been widely used over the years for many reasons. No other textbook so fully melds the best of current financial theory with the tools needed in day-to-day practice by healthcare managers. The textbook also encompasses virtually the whole spectrum of the healthcare industry, including hospitals, pharmaceutical companies, health maintenance organizations, home health agencies, skilled nursing facilities, surgical centers, physician practices, hospital departments, and integrated healthcare systems.

Building on the strong foundation of the previous editions, the *Eighth Edition* introduces a number of enhancements. We have continued the inclusion of learning objectives at the beginning of each chapter. The learning objectives orient students to the material in the chapter and highlight some particular concepts and skills they should acquire by studying the chapter. Following the learning objectives, each chapter has a real-world scenario, which places the material in the chapter into the context of how the concepts and tools are used in practice. As with previous editions, each chapter concludes with a summary, followed by a large number of problems with related solutions. We believe the application of finance theory to real-world financial

problems is the best way to accomplish learning. One of the primary enhancements of the *Eighth Edition* is the addition and updating of supporting data tables that provide tangible benchmarking information for students and practitioners in a larger number of areas. In summary, the chapters are designed to provide a framework for understanding healthcare financial issues as well as resources for implementing appropriate operational strategies.

Before discussing the coverage of this book, it is important to understand the objective, which has not changed in more than 30 years. This text is intended to provide a relevant and readable resource for healthcare management students and executives. This is important to understand because *Essentials of Health Care Finance* is neither a traditional financial textbook nor a traditional management or financial accounting textbook. It attempts to blend the topics of both accounting and finance that have become part of the everyday life of most healthcare executives. This textbook does not provide as much coverage of cost of capital, capital structure, and capital budgeting topics that is present in most financial management textbooks. *Essentials of Health Care Finance* likewise does not provide major coverage of management control and budgeting systems that are present in most cost accounting and management accounting textbooks. Instead, this text tries to cover those types of financial decisions with which healthcare executives are most likely to be involved and provides the necessary materials to help them understand the conceptual basis and mechanics of financial analysis and decision making as they pertain to the healthcare industry sector.



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# Content of the Book

The general basis of financial decision making in any business is almost always built on understanding three critical elements. First, most financial decisions are based on the use of accounting information. It is difficult to make intelligent decisions without having at least a basic understanding of accounting information. The user does not need to be a CPA, but it is essential to have a little understanding of what accounting is and is not. Second, all business units operate within an industry. The healthcare industry is a huge, complex industry that in many areas is unlike any other industry. Unless the student has an appreciation for these critical differences, major mistakes can be made. Finally, both accounting and finance are, in many ways, subsets of economics. The principles of economics form the conceptual basis upon which many types of business decisions are made.

Chapter 1 provides an introduction to the role of information in decision making. Chapter 2, “Billing and Coding for Health Services,” recognizes the increasing importance that billing and coding play in financial decision making. Chapter 3 provides detailed information about the economic environment of healthcare firms. Specific coverage of payment methods for all types of providers, from hospitals to physicians, is included. Much of Chapter 3 was rewritten for this edition because payment rules are constantly changing. This edition covers current Medicare prospective payment systems for outpatient, home health, and skilled nursing facilities. Chapter 4 provides coverage of the numerous legal and regulatory provisions that affect today’s healthcare manager.

Chapter 5, “Measuring Community Benefit,” provides expanded coverage of a topic that has gained more attention with the recent passage of healthcare reform. Nonprofit healthcare providers increasingly are being asked to document the community benefits they provide to their communities. Chapter 6, “Revenue Determination,” devotes specific attention to pricing and managed-care contract negotiations. Extensive coverage of managed care, its definition, concepts, organizational structures, and its financial implications is included in Chapter 7 and woven throughout the remainder of the text. Managed-care

contracting is covered extensively in this edition along with coverage of “bundled payments.”

Chapters 8, 9, and 10 cover financial reporting for healthcare firms. Specific discussions of accounting jargon are included. Perhaps of more importance, the accounting terms are related to healthcare issues, such as self-insurance of professional liability.

Chapters 11, 12, and 13 cover financial analysis and financial planning. Chapter 11 has been thoroughly revised to reflect the best analytical tools and techniques available for financial statement analysis. Chapter 12 provides specific coverage of healthcare firms other than hospitals. Comparative financial and operating benchmark values are included for hospitals, and benchmark values are included for hospitals, health maintenance organizations, nursing homes, and medical groups. These benchmark values are used later to evaluate the financial position of a number of different kinds of healthcare firms.

Chapters 14 through 16 cover cost finding, pricing, break-even analysis, and budgeting, and other managerial-care examples and concepts have been added in this edition. This edition also features more extensive coverage of relative value units. Chapter 17 includes material on the application of variance analysis techniques to both healthcare providers and payers.

Chapters 18 through 21 include coverage of capital budgeting, consolidations, valuation, and capital formation topics as they pertain to healthcare firms. Special attention is given to capital formation in both taxable and voluntary nonprofit situations. Chapter 19 covers the increasingly important topics of consolidations, mergers, and acquisitions. In that chapter we offer detailed coverage of several valuation techniques. Chapter 21 includes extensive coverage of sources of capital used by healthcare providers, especially tax-exempt revenue bonds. Chapters 22 and 23 cover the topics of working capital management and cash budgeting.

Building from the practical educational approach of prior editions, we believe that the enhancements made to the text will provide students and practitioners with a greater understanding of financial application in the complex and changing healthcare industry.



# About the Authors

William O. Cleverley, PhD, is the chairman and founder of Cleverley & Associates, which was started in January 2000. Before forming Cleverley & Associates, Dr. Cleverley was the president and founder of CHIPS (Center for Healthcare Industry Performance Studies). United Healthcare acquired the firm in March 1998, and Dr. Cleverley remained on staff as a part-time employee until December 1999. Dr. Cleverley is also professor emeritus at The Ohio State University where he taught courses in healthcare finance starting in 1973.

Dr. Cleverley was the original author of *Essentials of Healthcare Finance* in 1978. In addition, he has authored over 250 articles on healthcare financial issues in a wide variety of both academic and professional journals.

James O. Cleverley, MHA, is the president of Cleverley & Associates, where he has worked since

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Mr. Cleverley has authored over 50 books and articles dealing with healthcare financial analysis and application, including the annual Community Value Index<sup>®</sup> hospital survey, the State of the Hospital Industry, and *The Essentials of Health Care Finance*. He is a two-time recipient of the Healthcare Financial Management Association's Yerger/Seawell Best Article award.

Mr. Cleverley received his masters in health administration from The Ohio State University in 2004. He received his bachelors of science in business administration from The Ohio State University in 1999.

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