

CHAPTER 2

The Financial Environment

- **Forms of business organization and ownership**
- **Taxes and financial decisions**
- **Third-party payer system**
- **Alternative reimbursement methods**
 - **Incentives created**
 - **Impact on provider risk**

Forms of Business Organization

- There are four major categories of **business organization** (legal forms of businesses).
 - Proprietorship (sole proprietorship)
 - Partnership
 - Corporation
 - Hybrid forms
- ? How much does the organizational form influence the practice of healthcare finance?

Proprietorships and Partnerships

■ *Advantages*

- Ease of formation
- Subject to few regulations
- No corporate income taxes

■ *Disadvantages*

- Limited life
- Difficult to transfer ownership
- Unlimited liability
- Difficult to raise capital

Corporation

■ *Advantages*

- Unlimited life
- Easy transfer of ownership
- Limited liability
- Ease of raising capital

■ *Disadvantages*

- Cost of formation and reporting
- Double (or triple) taxation for investor-owned corporations

Hybrid Forms of Organization

■ Limited partnership (LP)

- *General partners* have control
- *Limited partners* are liable only for their initial contribution
- Not commonly used by healthcare providers

■ Limited liability partnership (LLP)

- Partners share general business liability
- But partners are liable only for *their own* malpractice actions

Hybrid Forms of Organization (Cont.)

- **Limited liability company (LLC)**
 - Members are taxed like partners
 - Liability like stockholders

- **Professional corporation (PC) or professional association (PA)**
 - Owners have benefits of incorporation
 - However, still liable for malpractice
 - Often used by individual clinicians

Forms of Ownership

- In most industries, the only form of ownership is the **investor-owned (for-profit)** business.
- However, in the health services industry, a significant proportion of businesses, particularly hospitals, are organized as **not-for-profit corporations**.
- ? How much does ownership influence the practice of healthcare finance?

Investor-Owned Corporations

- **Investors become owners by purchasing shares of **common stock**.**
 - **Primary market transactions**
 - Initial public offerings (IPOs)
 - New common stock sales
 - **Secondary market transactions**
 - On exchanges
 - In the over-the-counter market

- **Stockholders have:**
 - **Right of control**
 - **Claim on residual earnings and residual liquidation proceeds**

Not-for-Profit Corporations

- If a business meets a stringent set of requirements, it can qualify as a **not-for-profit** (nonprofit) corporation. Such firms also are called **tax-exempt** or **501(c)(3)** or **(c)(4)** corporations.
- These corporations:
 - Generally have no shareholders and hence do not have a single clientele to which managers are responsible.
 - Receive various tax exemptions.

Organizational Goals

- The primary goal of *investor-owned corporations* is **shareholder wealth (stock price) maximization**.
 - ? Do investor-owned businesses have any responsibilities to society at large?
 - ? Is stock price maximization good or bad for society?
 - ? Should such firms behave ethically?
- ? What is the primary goal of proprietorships and partnerships?

Organizational Goals (Cont.)

- The primary goal of *not-for-profit corporations* is generally given by a **mission statement**, often in terms of service to the community.
- All businesses have **stakeholders**.
 - Stakeholders have an interest (usually financial) in the business.
 - Not-for-profit managers must satisfy all stakeholders.
 - For-profit managers are primarily concerned with satisfying stockholders.

Discussion Item

- ? **Not-for-profit businesses generally are exempt from local property taxes and state and federal income taxes. Should these tax exemptions *mandate* that not-for-profit healthcare organizations provide indigent (charity) services equal to the tax benefits received?**

Financial Goals

- The primary **financial goal** of *investor-owned corporations* stems from their organizational goal: shareholder wealth (stock price) maximization.
- The primary financial goal of *not-for-profit corporations* is to ensure the financial viability of the organization.
- ? Does the difference in financial goals lead to appreciably different behavior?

Tax Laws

- **Some understanding of **tax laws** is necessary because taxes influence:**
 - **Financing decisions**
 - **The operating cash flows available to an investor-owned business**
 - **The ability to raise contribution capital**
- **There are several types of taxes:**
 - **Federal versus state versus local**
 - **Personal versus corporate**
 - **Ordinary income versus capital gains**

Personal Taxes

- ***Individuals*** pay federal (and perhaps state) taxes on salaries, interest, and other income at rates that can approach **50%**. (Dividends and capital gains are taxed at lower rates.)
- Consider a person paying **40%** in taxes who receives **\$100** in interest:

$$\begin{aligned} AT &= BT \times (1 - T) \\ &= \$100 \times (1 - 0.40) \\ &= \$100 \times 0.60 = \mathbf{\$60.} \end{aligned}$$

Corporate Taxes

- ***Investor-owned corporations*** pay federal and state taxes on corporate income at rates that can exceed **40%**.
- ***Not-for-profit corporations***, for the most part, are not subject to taxation.
- ***Not-for-profit corporations*** have two additional tax benefits:
 - Can issue tax-exempt (municipal) bonds
 - Can receive tax-exempt contributions

Taxable Versus Muni Bonds

Assume FP Healthcare must offer a **10%** interest rate on its new bonds.

Jane Green, an individual investor with a **28%** tax rate, buys one **\$1,000** bond. What is the effective (after-tax) annual interest?

$$\begin{aligned} \text{AT\$} &= (0.10 \times \$1,000) \times (1 - 0.28) \\ &= \$100 \times 0.72 = \mathbf{\$72.} \end{aligned}$$

$$\begin{aligned} \text{AT\%} &= 10\% \times (1 - 0.28) = 10\% \times 0.72 \\ &= \mathbf{7.2\%} \end{aligned}$$

Taxable Versus Muni Bonds (Cont.)

Assume NFP Healthcare can issue similar-risk **municipal bonds** with an **8%** interest rate. Should Jane buy the NFP bond rather than the FP bond?

At what rate on the FP bond would Jane be indifferent between the two bonds?

$$AT\% = BT\% \times (1 - T)$$

$$8\% = BT\% \times (1 - 0.28) = BT\% \times 0.72$$

$$BT\% = 8\% / 0.72 = \mathbf{11.1\%}.$$

Third-Party Payers

- For the most part, provider revenues come from **third-party payers** rather than from patients.
- Private insurers
 - Blue Cross/Blue Shield
 - Commercial insurers
 - Self-insurers
- Public insurers
 - Medicare
 - Medicaid

Managed Care Plans

- **Managed care plans** strive to combine both the provision of healthcare services and the insurance function in a single organization.
- There are many types of plans
 - Health maintenance organizations (HMOs)
 - Preferred provider organizations (PPOs)
 - Point of service (POS) plans
- ? In general, the purpose of managed care plans is to control costs. How?

Reimbursement Methods

- Regardless of the payer, there are only a limited number of payment methods.
- Methods fall into two broad categories:
 - **Fee-for-service (FFS)**, where payment is tied to the *amount of services provided*.
 - Charge based
 - Cost based
 - Prospective payment
 - **Capitation**, where payment is tied to the *size of the covered population* (number of enrollees).

FFS: Charge-Based Reimbursement

- Payer pays **billed (gross) charges** for services rendered.
- Historically, all third-party payers reimbursed providers on the basis of billed charges.
- Some payers still use billed charges as the payment method, but often negotiate a **discount** from gross charges ranging from 20 to 50 percent (or more).
- ? What should the uninsured pay for healthcare services?

FFS: Cost-Based Reimbursement

- Payer pays all *allowable costs* incurred in providing services.
- Typically, **periodic interim payments** are made, with a final reconciliation at the end of each year.
- Medicare used this method for hospitals in its early years (1966–1983).

FFS: Prospective Payment

- **Prospective payment** methods have a fixed payment determined beforehand that is, at least in theory, unrelated to either costs or charges.
- Prospective payment may be on a:
 - Per procedure basis
 - Per diagnosis (DRG) basis
 - Per diem (per day) basis
 - Global pricing basis

Capitation

- **Capitation** is entirely different from FFS reimbursement.
 - Payment is not tied to utilization, but rather to the number of **covered lives**.
 - Payment to providers usually is made on a **per member per month (PMPM)** basis.
 - Used primarily by managed care plans.
- The impact of capitation will be examined in later chapters.

Provider Incentives

Assume that you are the CEO of a hospital. What are the incentives to the organization under:

- **Charge-based reimbursement?**
- **Cost-based reimbursement?**
- **Per diagnosis (DRG) reimbursement?**
- **Per diem reimbursement?**
- **Global reimbursement?**
- **Capitation?**

Provider Risk

Assume that you are the CEO of a hospital. What are the risks to the organization under:

- **Charge-based reimbursement?**
- **Cost-based reimbursement?**
- **Per diagnosis (DRG) reimbursement?**
- **Per diem reimbursement?**
- **Global reimbursement?**
- **Capitation?**

Conclusion

- This concludes our discussion of *Chapter 2* (The Financial Environment).
- Although not all concepts were discussed in class, you are responsible for all of the material in the text.
- ? Do you have any questions?