

Mixing Finance and Medicine

THE EVOLUTION OF FINANCIAL PRACTICES IN HEALTHCARE

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The healthcare industry has been considered a laggard when it comes to emerging best practices, at least relative to most other industries. Historically, healthcare organizations have largely been controlled by nonprofits and local governments that were less concerned about efficiency and performance because of a lack of industry transparency and reimbursement practices that preserved margins despite excessive cost structures.

Not anymore.

New waves of chief financial officers (CFOs) are being tapped from other industries. Plus, greater environmental pressures for financial performance are helping to radically transform the state of practice for hospitals and healthcare organizations. The Patient Protection and Affordable Care Act, passed in early 2010, may further change health organizations as payment mechanisms and organizational configurations are refined. The need for sophisticated accounting systems that link to clinical systems, and the establishment of best practices for financial management professionals, will be keys to achieving positive margins for healthcare organizations. As a result, there's an evolution under way toward much greater sophistication in financial management in the U.S. healthcare industry. This evolution is creating opportunities for finance and accounting professionals.

In this article, we'll share our research involving surveys of more than 100 hospital CFOs about their views on the current state of financial practice and evolving strategies for continuous improvement in American hospitals. Specifically, we were interested in understanding how the industry differs from other industries in financial and accounting management, how CFOs are positioned within their organization, what financial techniques they utilize, and what best practices the industry employs. We focused primarily on a few key areas, namely performance management and internal controls/risk management.

A Primer on the Healthcare Industry

The healthcare industry is a large, rapidly growing segment of the U.S. economy, amounting to just over \$2.1 trillion annually. This industry focuses on prevention, diagnosis, treatment, and rehabilitation of injury and illness and makes up one sixth of the U.S. Gross Domestic Product (GDP). Healthcare spending is the largest source of the nation's public expenditures.

The healthcare industry is composed of a number of business segments that develop, manufacture, and deliver products and services. These segments include:

- ◆ Biotechnology, which uses biological principles and agents to develop pharmaceutical substances;
- ◆ Drug manufacturing, which involves commercial

production of pharmaceuticals, typically by publicly traded, for-profit companies;

- ◆ Healthcare plans and insurers, which are intermediary companies that manage risk and administrative processes in the provider-patient relationship;

- ◆ Diagnostic and medical equipment companies, which provide technology solutions to help diagnose and treat patients with advanced

devices, such as magnetic resonance imaging (MRI) or computed tomography (CT), or more basic equipment, such as beds or wheelchairs;

- ◆ Hospitals and other health facilities that provide care to patients. (We will focus primarily on this category of the industry.)

Demand for most healthcare services is based on a "need" (illness or injury) rather than a "want," although marketing of discretionary services such as cosmetic surgery is growing. While the demand for healthcare services is episodic, the need is often immediate. This requires most hospitals to maintain continuous access to emergency care around the clock every day. That constant availability of services can make it difficult to maintain productivity during times of slack demand.

Physicians can practice medicine in a variety of organizational forms ranging from a solo practitioner operating as a stand-alone small business to employment in a large clinic such as the Mayo Clinic, Cleveland Clinic, or the Permanente Medical Group. But regardless of the practice type, the actual decision to use medical services isn't entirely the patient's since the physician must provide or prescribe the treatment. He or she is therefore in the position to decide what the patient needs and to be paid for providing that service, which is similar to what your average consumer faces when dealing with auto repairs.

Yet, like a mechanic who works at a dealership and uses the company's lifts and expensive diagnostic tools, physicians usually don't have the facilities to provide sophisticated testing or surgical procedures in their offices, so they rely on hospitals and clinics to deliver more technically advanced services. Most hospitals offer state-of-the-art emergency rooms, surgical suites, lab testing, and imaging services. The hospital essentially represents the physician's workshop.

Table 1: Distribution of U.S. Hospitals

HOSPITAL TYPE	NUMBER OF FACILITIES	PERCENTAGE OF ALL FACILITIES
Government-owned	1,472	23.3%
Nonprofit	3,160	50.1%
Investor-owned	1,500	23.8%
Military and veterans	180	2.8%
Total	6,312	100.0%

Source: American Hospital Association Annual Survey, 2008.

Who's Picking Up the Tab?

Regardless of the cost of the care they receive, patients rarely pay the provider directly except for small copayments, instead relying on a third-party insurer (referred to in the industry as the "payer") to settle up for them. Health insurance can come from different sources. Private or "commercial" insurance is purchased by an individual or by an employer (for an employee benefit).

Examples of some of the larger private insurers are Blue Cross/Blue Shield, Aetna, Humana, MetLife, and Travelers. Insurance can also come from a public source, with the largest two being Medicare and Medicaid. Medicare is a federal government program that provides health insurance for people age 65 or older and for the disabled. Medicaid, on

the other hand, pays for care for the poor. It's a collection of state-based insurance programs jointly funded by individual states with a contribution from the federal government.

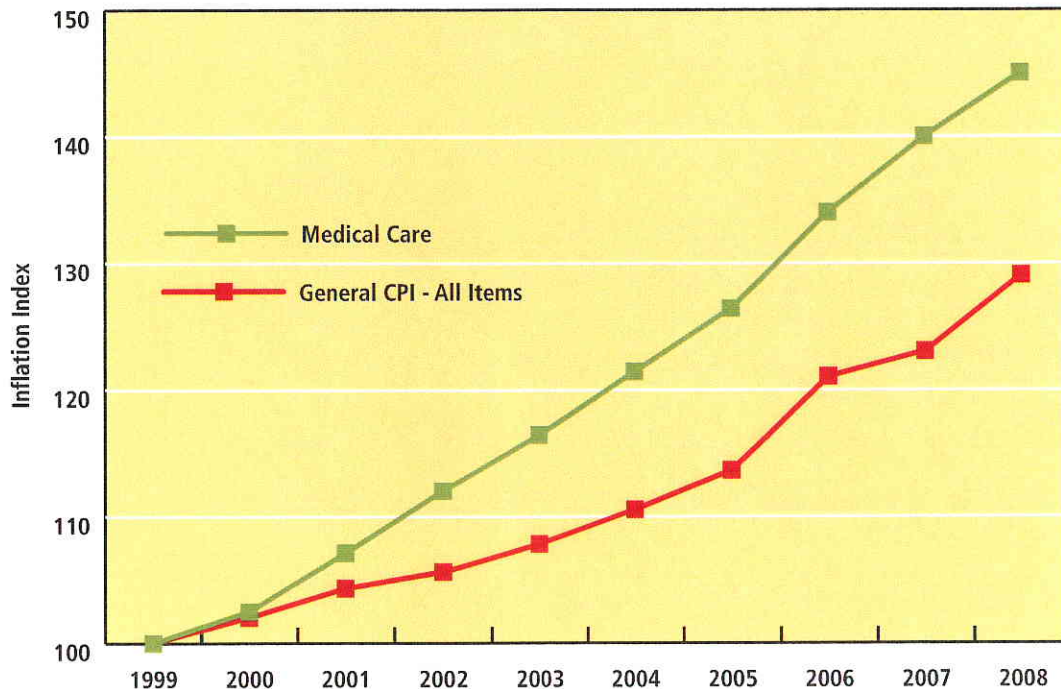
But insurers don't cover everyone. There are currently about 47 million Americans who either don't have the resources to pay for health insurance or who choose not to purchase it. Under a federal law called the Emergency Medical Treatment and Labor Act (EMTALA), hospitals are

required to provide services sufficient to resolve a life-threatening condition or care for a woman in childbirth, regardless of the patient's ability to pay. An unintended consequence of this law has increased pressures on hospitals to fund the costs of care to the uninsured from other sources, including increasing collections from insured patients to offset losses. Therefore, it's a big challenge for hospitals to document the extent of these losses and justify their price-setting methods.

Healthcare services are paid based on rates that are set by individual providers. Those prices aren't regulated, and the fee that one provider charges for a given service (such as an X-ray) will likely differ from that of a competitor. Nevertheless, most large insurance programs, including Medicare and Medicaid, dictate the price they'll pay

Table 2: Five Major Evolving Themes

PRACTICE OR THEME	IMPLICATIONS FOR MANAGEMENT ACCOUNTANTS
1 Need for heightened operational efficiency	Greater recruiting of accountants, plus a larger role and scope in jobs.
2 Finance professionals are becoming more "strategic"	CFOs are becoming increasingly more involved in the strategy process; 71% of finance executives report their roles have expanded in the past year.
3 Greater focus on internal controls	Greater use of SOX, GAAP, and information and management systems will help create significant opportunities for management accountants.
4 Increased reliance on business analysis	Roles of finance and accounting professionals will help to develop and measure business performance.
5 Industry growth will continue	The healthcare industry will continue to grow, as will the demand for accountants.

Figure 1: Costs Rising Faster in Healthcare than in Other Industries

Source: Data tables from U.S. Department of Labor, Bureau of Labor Statistics, 2009.

and offer a “take it or leave it” proposition to hospitals and individual physicians alike. Other insurers don’t wield quite as much market power but are still able to negotiate discounts from providers. This results in providers billing their “usual and customary rates” but having to account for a “discount” given to those insurers by virtue of regulation or prior contractual arrangements. You can imagine the challenges that a management accountant working for a healthcare provider faces in monitoring the numerous steps in the billing and collection process to minimize these revenue losses.

As you can see from Table 1, these accounting challenges extend to more than 6,300 hospitals in the United States, most of which are general community hospitals but many of which are more specialized. The largest groups of U.S. hospitals have operating budgets in excess of \$3 billion, while the smallest is just over \$20 million.

The Patient Protection and Affordable Care Act may result in substantial changes to the way hospital care is delivered in the future. As millions of people are added to insurance plans through federal coverage mandates, services to patients who currently can’t pay for care should result in additional revenue for hospitals. Access to health insurance may also foster more demand for nonemergency care, which could be a boon to individual physicians—especially primary care doctors, whom

patients usually see first. The extent and magnitude of the changes are yet to be determined because the law will be implemented gradually through 2014.

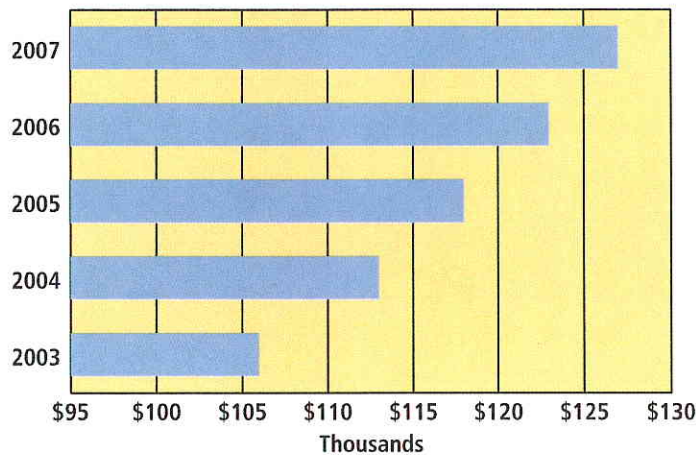
The Evolution of Financial Practices

Our primary method of research involved developing and sending a survey to 508 senior-level finance and accounting professionals with titles of chief financial officer or vice president of finance, as listed in the directories of hospital-finance trade associations. Surveys were distributed in January 2009 via an e-mail with a link to the survey, and three follow-up e-mails were sent at two-week intervals. Overall, 103 financial executives responded (20.3% response rate). On reviewing their responses, we discovered five major findings, or evolving themes, for the future of finance and accounting in the healthcare industry. These are summarized in Table 2 and will be discussed in separate sections of this article.

Finding 1: Need for Heightened Operational Efficiency

Finance and accounting professionals are relatively scarce in healthcare organizations, making up barely 1.5 of every 100 employees per facility. Yet our research shows that more finance and accounting professionals are being

Figure 2: Operating Efficiency, \$ per FTE



Source: American Hospital Association Annual Survey Database, 2002-2007.

recruited to help improve the control and management of these organizations. The current lack of finance and accounting professionals could be one reason why the industry's annual cost increases are nearly double those of traditional goods and services. Figure 1 presents the medical Producer Price Index, normalized at 1999 as the baseline year, relative to the general Consumer Price Index.

With this rapid rise in costs, it's important for healthcare finance and accounting professionals to take the lead in using systems and processes to gain tighter control over costs. From 2002 to 2007, we saw a 33% increase in costs per hospital bed and a 20% decrease in operating efficiency, as measured by operational costs per full-time equivalent (FTE). Figure 2 presents the industry's average operational cost structure per employee during that time period.

**Finding 2:
Finance Executives Are Becoming More Strategic**

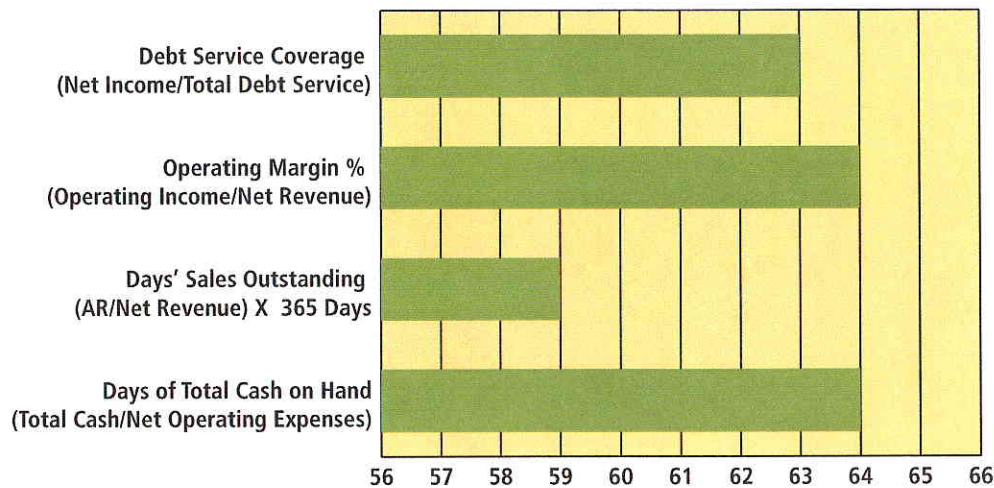
Finance executives face a considerable challenge in the healthcare industry because of growing pressures to improve quality and efficiency simultaneously. Government regulations will encourage the greater visibility of these professionals to translate into better performance, prices, and outcomes. Finance and accounting executives will be tapped to implement information and management systems to ensure that these positive changes occur.

Similarly, we found that the role of the CFO is changing. Nearly 71% of all executives we surveyed have experienced significant job expansion in the past 12 months. Historically, finance professionals in this industry have remained fairly focused on traditional functions, such as managing accounts receivable, negotiating reimbursement rates, budgeting, and overseeing debt policies. Now, senior-level accounting and finance officers are starting to get involved in a variety of functions that typically are outside the scope of finance, including strategic planning and project management tasks. As capacity and productivity grow in importance with new health reform legislation, this expansion of involvement in nontraditional finance roles likely will continue.

Table 3: Stronger Ties Between CFOs and CEOs

NUMBER OF MEETINGS PER WEEK	NUMBER OF RESPONSES	PERCENTAGE OF RESPONSES
0	2	2%
1	28	27%
2	26	25%
More than 2	47	46%
Total	103	100%

Figure 3: Most Commonly Benchmarked Financial Indicators



Finance professionals also are reporting more involvement in governance functions. Nearly 80% of CFOs report more frequent interaction with other executives and the board of directors (or trustees) during recent years. In our analysis, we found that the average number of meetings between the CFO and the CEO is just over three times per week, although 27% of our sample reported only one meeting per week (see Table 3).

Discussions with specific board members or the chair of the board's finance committee were somewhat less common. Although nearly half the respondents (44%) reported at least one meeting per month, another 46% reported two or more. Even though meetings with the board were less frequent than meetings with the CEO, the CFO and the finance department appear to be getting routine access to internal governance.

While the healthcare management accountant's job description appears to be expanding, so, too, is the importance of traditional financial management practices such as internal controls and business analysis. As the healthcare economy continues to constrain payments, financial and accounting professionals need to identify potential internal control risks that could further reduce and threaten financial viability.

Finding 3: Greater Focus on Internal Controls

The sheer size of the U.S. healthcare system creates potential opportunities for financial fraud and abuse. Opinions vary on the extent of such risk. In 2008, the

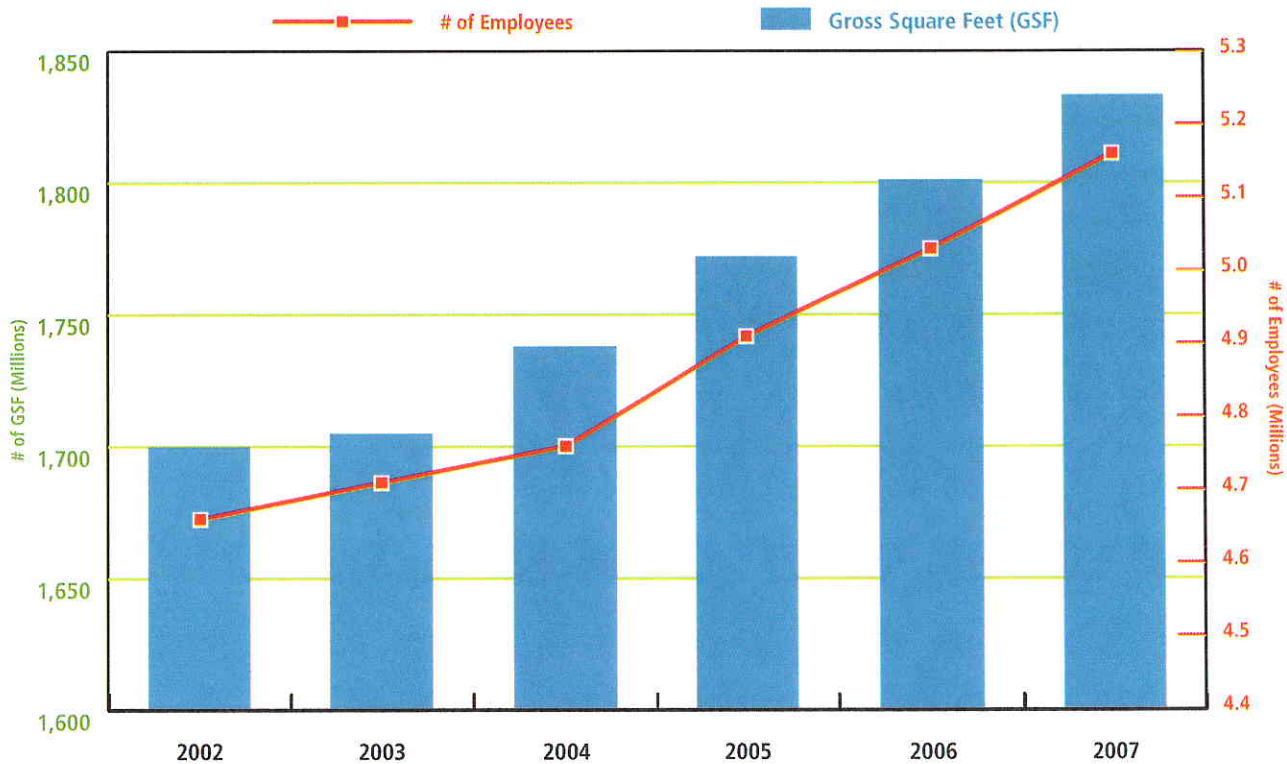
National Health Care Anti-Fraud Association (NHCAA) published a "conservative estimate" that 3% of all health-care spending (\$68 billion) was diverted to fraudulent ends. Details of another estimate compiled by the Association of Certified Fraud Examiners (ACFE) included these breakdowns:

- ◆ The Centers for Medicare & Medicaid Services (CMS) estimated that \$133 billion, or 7% of all payments governed by that agency, was disbursed improperly because of the filing of illegitimate claims;
- ◆ The Blue Cross/Blue Shield Association estimates that \$50 billion (10%) of payments made from their healthcare plans were for fraudulent services; and
- ◆ \$100 billion in other private insurer or patient payments (representing 20% of those payments) was for some form of improper billing.

Because of this, the industry has seen a trend toward increasing its internal controls and risk management frameworks. Specifically, our survey of healthcare CFOs indicated a move toward greater standardization of accounting procedures, greater use of the Sarbanes-Oxley Act (SOX), more elaborate documentation of business and administrative processes, and more diligent financial reporting.

Given the large proportion of nonprofit organizations and the fact that many others aren't subject to direct oversight by the Public Company Accounting Oversight Board (PCAOB), the implementation of internal controls under a framework such as SOX Section 404 has been limited. In our survey, 51% of the respondents' organiza-

Figure 4: Growth in the U.S. Healthcare Industry



Source: American Hospital Association Annual Survey Database, 2002-2007.

tions reported having a SOX compliance program, with an average investment of \$647,630 per facility. Another 12% of survey respondents indicated their organizations were considering such an implementation. Only 9% of the facilities reported having staff with the Certified Internal Auditor (CIA) credential, so it would appear that much of the progress on SOX compliance has been accomplished through outsourced contract work or non-internal-audit-trained staff. The management accountant's training about internal controls may be of great use in the hospital industry as the SOX compliance effort continues.

Finding 4: Increased Reliance on Business Analysis

As financial performance remains a challenge for healthcare organizations and the establishment of internal control frameworks is still a work in progress, ongoing monitoring of organizational operations has a higher degree of importance. Our survey results indicate that 91% of respondents used some form of perfor-

mance scorecard. The role of the management accountant can be significant in this effort because much of the performance tracking is financial or operations oriented. In addition, the measures previously used on performance scorecards may likely evolve as the industry evolves, creating additional opportunity for the profession to have an impact on healthcare financial management.

Data mining can also improve financial practices. This technique involves the use of computerized data analysis to canvass paid claims for potential fraudulent activity, including unusual billing or referral patterns exhibited by certain providers or unusual treatment patterns seen in a particular plan beneficiary.

Many of the hospitals responding to our survey stated that they routinely benchmark themselves against competitors (44%), while approximately 6% said that they never benchmark performance externally. Although benchmarks are useful, each organization is unique, and performance among facilities we surveyed suggests that there's no pattern of metrics or comparison of metrics that will accurately predict financial success. The most

common metrics benchmarked by survey respondents are shown in Figure 3. As a result, the challenge to the management accountant will more likely come from analyzing and understanding operations than from churning out benchmarking analyses and legacy score-card reports.

The organization and operation of health insurance markets, including costs of services and how efficiently care is delivered, are under a considerable amount of scrutiny as the U.S. tries to address the sustainability of its current spending on healthcare. A key component of most reform proposals presently under consideration is a further reduction in payments to healthcare providers.

The challenge of improving operational efficiency in the face of increasing costs and stable revenues will require finance and accounting professionals in these organizations to deliver more innovation, creativity, and ideas to help control and balance efficiency and quality.

Finding 5: Industry Growth Will Continue

While inpatient-based measures of capacity are slightly shrinking or leveling off (the total number of beds, for instance), the number of U.S. hospitals grew by 5% between 2002 and 2007. In addition, other capacity measures, such as the total gross square footage for all community hospitals nationwide, have seen fairly significant growth, as has the number of full-time employees in the industry. Figure 4 shows the growth during the six-year period from 2002 to 2007.

As income generators, many of the largest hospitals rival *Fortune* 500 firms, with annual revenues between \$5 billion and \$15 billion. As America's population ages, the need for healthcare services will remain, so the industry will certainly be a significant factor in the U.S. economy for the foreseeable future.

The landscape, however, shows few management accountants in hospital organizations, as only 12% of those we surveyed noted there were persons with a CMA® (Certified Management Accountant) on staff. Instead, a heavy reliance appears to be on the Certified Public Accountant (CPA) credential as 50% of the respondents noted staff with that qualification. Therefore, the hospital sector represents an opportunity for growth in the practice of management accounting.

Looking Ahead

The healthcare industry is a primary economic engine in the U.S., offering accounting and finance professionals

unparalleled opportunities for growth. The complexity of operations, financial transactions, and reporting, along with the challenges of improving operational efficiency to offset operating losses, requires better-trained accountants. Finance executives are becoming more visible and proactive in leading both operations and strategy in this industry.

As internal control frameworks evolve, the ability to implement and monitor those controls can fall squarely into the management accountant's skill set. An accurate and honest assessment of business processes is fast becoming a necessity as reform efforts over the next several years and market pricing practices put slim operating margins at risk of further decline. Tracking operational results and identifying opportunities to improve—long a bastion of the management accountant's practice—represent an unmet need in this evolving and substantial industry. **SF**

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